Department of the Treasury

PRESS RELEASES

The following numbers were not used:

JS-2200, 2202, 2204

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 3, 2005
js-2177

Statement by Treasury Secretary John Snow on Congressman Robert Matsui

"This weekend, America lost a great leader and a great intellect, and the people of California lost a great friend. I knew and worked with Congressman Matsui for three decades. I deeply admired and appreciated his knowledge, his compassion, and his ability to reach across the aisle to achieve progress for his country. He will be remembered fondly, and with tremendous respect, for all that he gave as both a public servant and as an individual. I especially appreciated the opportunity to work closely with him over the last two years and am grateful for all of the courtesies he extended to me."

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 3, 2005
JS-2178

Statement by Treasury Secretary John Snow on World Bank President James Wolfensohn

"Over the past ten years, Jim Wolfensohn has been an outstanding leader of the World Bank. I have worked closely with him over the past two years on a number of initiatives including President Bush's grants and measurable results programs, the reconstruction of Iraq and Afghanistan, among countless other issues. I particularly want to commend him for his leadership on anti-corruption efforts.

"I am rewarded to have known him as a colleague and a friend. Because of Jim's leadership, the World Bank today is a more dynamic and effective development organization. I view his accomplishments as historic. Jim's tireless efforts to assist the world's poor have been marked by unmatched passion and accomplishment. The world's poorest people have clearly benefited from Jim's tenure at the World Bank. He deserves great thanks and praise for his service. I look forward to working with him over the next six months as he continues to lead the Bank. His counsel will be invaluable as we go through the transition process."

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 4, 2005
2005-1-4-12-9-7-8125

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $87,104 million as of the end of that week, compared to $87,534 million as of the end of the prior week.

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

	December 24, 2004			December 31, 2004		
TOTAL		**87,534**			**87,104**	
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	12,359	15,176	27,535	12,354	15,319	27,673
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	12,130	3,050	15,180	12,137	3,079	15,216
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]			20,210			19,544
3. Special Drawing Rights (SDRs) [2]			13,566			13,628
4. Gold Stock [3]			11,043			11,043
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	December 24, 2004			December 31, 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

	December 24, 2004			December 31, 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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January 5, 2005
js-2179

Treasury Provides Guidance on Cross-Border Mergers

The Treasury Department and the Internal Revenue Service have issued proposed regulations providing guidance on the tax consequences of certain cross-border corporate mergers.

Existing regulations under section 368 of the Internal Revenue Code provide rules regarding the necessary conditions for corporate transactions to qualify as tax-free reorganizations. One type of transaction that may qualify as a tax-free reorganization is a "statutory merger." The existing regulations limit the scope of the term "statutory merger" to mergers of domestic corporations. In 2003, temporary and proposed regulations were issued to provide a functional definition of the term "statutory merger," in order to reflect developments in state corporation laws since the term was first defined in 1935.

The preamble to the 2003 regulations indicated that Treasury and the Internal Revenue Service were considering further revisions to the regulations under section 368 to address mergers that involve one or more foreign corporations. Many foreign jurisdictions now have merger laws that operate in material respects like those of the states, such that transactions effected under these laws could satisfy the functional criteria of the 2003 regulations. The Treasury Department and the Internal Revenue Service believe that consistent treatment of functionally equivalent transactions is warranted in light of the purpose of section 368. The new proposed regulations would permit mergers involving foreign corporations to qualify as statutory mergers.

The new guidance also contains detailed rules regarding the collateral consequences of cross-border corporate reorganizations, including cross-border mergers. This guidance includes proposed rules regarding the determination of stock basis in certain triangular reorganizations and proposed rules under section 367 of the Internal Revenue Code relating to cross-border corporate reorganizations.

The proposed regulations and the related notice are attached.

REPORTS

- Notice 2005-6

Part III - Administrative, Procedural, and Miscellaneous

Announcement of rule to be included in final regulations under section 367(a) regarding certain exchanges of securities for stock or securities

Notice 2005-6

This notice announces that Treasury and the Internal Revenue Service ("the Service") will amend Treas. Reg. §1.367(a)-3 regarding certain exchanges under section 354 by U.S. persons of securities of a foreign corporation in a reorganization described in section 368(a)(1)(E) or securities of a domestic or foreign corporation pursuant to an asset reorganization described in section 368(a)(1).

BACKGROUND

Section 354(a)(1) provides that no gain or loss shall be recognized by a shareholder if stock or securities in a corporation that is a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization. Section 354 further provides that a security holder may surrender securities and receive securities in the same principal amount or in a lesser principal amount without the recognition of gain or loss.

Under section 367(a), gain is recognized if a U.S. person transfers property to a foreign corporation in connection with an exchange described in section 354 unless an exception applies. Treasury Reg. §1.367(a)-3(a) provides, in part, that if in an exchange described in section 354, a U.S. person exchanges stock of a foreign corporation in a reorganization described in section 368(a)(1)(E), or a U.S. person exchanges stock of a domestic or foreign corporation for stock of a foreign corporation pursuant to an asset reorganization described in section 368(a)(1)(C), (D) or (F) that is not treated as an indirect stock transfer under Treas. Reg. §1.367(a)-3(d), such section 354 exchange is not a transfer to a foreign corporation subject to section 367(a). This language excludes from the scope of section 367(a) certain stock-for-stock exchanges under section 354 by U.S. persons, but does not address whether exchanges of securities for stock or exchanges of securities for securities, that would qualify for nonrecognition under section 354, are subject to section 367(a).

DISCUSSION

The Treasury Department and the Service will issue regulations under Treas. Reg. §1.367(a)-3 to provide that an exchange described in section 354 by a U.S. person of securities of a foreign corporation for stock or securities of the foreign corporation in a reorganization described in section 368(a)(1)(E) will not be subject to section 367(a). The regulations will further provide that an exchange described in section 354 by a U.S. person of securities of a domestic or a foreign corporation for stock or securities of a foreign corporation pursuant to an asset reorganization described in section 368(a)(1), that is not treated as an indirect transfer described in Treas. Reg. §1.367(a)-3(d), will not be subject to section 367(a). Conforming amendments to other portions of the regulations under sections 367 and 6038B will be made as well.

EFFECTIVE DATE

Regulations to be issued incorporating the guidance set forth in this notice will apply to transfers of securities after January 5, 2005. Until such regulations are issued, taxpayers may rely on this notice. Taxpayers also may apply the provisions of this notice to transfers of securities occurring on or after July 20, 1998 (the effective date of Treas. Reg. §1.367(a)-3(a)) and on or before January 5, 2005. Taxpayers applying this notice, however, must do so consistently to all transactions within its scope.

COMMENTS

Written comments on the issues addressed in this notice may be submitted to the Office of Associate Chief Counsel International, Attention: Mark R. Pollard (Notice 2004-6), room 4555, CC:INTL:BR3, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, 20224. Alternatively, taxpayers may submit comments electronically to Notice.Comments@m1.irscounsel.treas.gov. Comments will be available for public inspection and copying. Treasury and the IRS request comments by April 28, 2005.

DRAFTING INFORMATION

The principal author of this notice is Mark R. Pollard of the Office of Associate Chief Counsel (International). For further information regarding this notice contact Mr. Pollard at (202) 622-3860 (not a toll-free call).

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-125628-01]

RIN- 1545-BA65

Revision of Income Tax Regulations under Sections 358, 367, and 884 dealing with statutory mergers or consolidations under section 368(a)(1)(A) involving one or more foreign corporations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations amending the income tax regulations under various provisions of the Internal Revenue Code (Code) to account for statutory mergers and consolidations under section 368(a)(1)(A) (including reorganizations described in section 368(a)(2)(D) and (E)) involving one or more foreign corporations. These proposed regulations are issued concurrently with proposed regulations (REG-117969-00) that would amend the definition of a reorganization under section 368(a)(1)(A) to include certain statutory mergers or consolidations effected pursuant to foreign law.

DATES: Written and electronic comments and requests to speak and outlines of topics to be discussed at the public hearing scheduled for May 19, 2005, at 10:00 a.m. must be received by April 28, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-125628-01), room 5203, Internal Revenue Service, P.O. 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-125628-01), 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-125628-01). 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, Robert W. Lorence, Jr., (202) 622-3860; concerning submissions, the hearing, or placement on the building access list to attend the hearing, Guy Traynor, (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 (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 no later than March 7, 2005. 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 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 §1.367(a)-3(d)(2)(vi)(B)(1)(ii). This information is required to inform the IRS of a domestic corporation that is claiming an exception from the application of section 367(a) and (d) to certain transfers of property to a foreign corporation that is re-transferred by the foreign corporation to a domestic corporation controlled by the foreign corporation. The information is in the form of a statement attached to the domestic corporation's U.S. income tax return for the year of the transfer certifying that if the foreign corporation disposes of the stock of the domestic controlled corporation with a tax avoidance purpose, the domestic corporation will file an income tax return (or amended return, as the case may be) reporting gain. The collection of information is mandatory. The likely respondents are domestic corporations.

Estimated total annual reporting burden: 50 hours.

Estimated average annual burden hours per respondent: 1 hour.

Estimated number of respondents: 50.

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 368(a)(1)(A) defines a reorganization to include a statutory merger or consolidation (A reorganization). For transactions completed before January 24, 2003, regulations under section 368(a)(1)(A) provided that a reorganization was a merger or consolidation effected pursuant to the corporation law of the United States or a State or Territory or the District of Columbia. See §1.368-2(b)(1), as in effect before January 24, 2003.

On January 24, 2003, the IRS and the Treasury Department issued proposed regulations (REG-126485-01, 2003-9 I.R.B. 542, 66 FR 57400) and temporary regulations (TD 9038, 2003-9 I.R.B. 524, 68 FR 3384), revising the definition of a statutory merger or consolidation. The proposed and temporary regulations define a statutory merger or consolidation in a manner intended to ensure that those transactions are not divisive in nature. Accordingly, the regulations generally require that all the assets and liabilities of the merged corporation (other than assets distributed or liabilities discharged in the transaction) are transferred to the acquiring corporation and that the separate legal identity of the merged corporation ceases to exist in the transaction.

Pursuant to a notice of proposed rulemaking (proposed section 368 regulations) published contemporaneously with this document, the IRS and Treasury are proposing further revisions to the definition of a statutory merger or consolidation to take into account those transactions effected pursuant to foreign law. The proposed section 368 regulations amend the 2003 proposed regulations and provide that an A reorganization may occur, if certain conditions are satisfied, pursuant to the laws of a foreign jurisdiction, including a U.S. possession.

In light of this change, this document contains proposed amendments to the regulations under certain international Code provisions (sections 367, 884, and 6038B) to account for statutory mergers and consolidations involving one or more foreign corporations. Current international tax regulations are premised on an A reorganization being limited to a statutory merger or consolidation involving domestic corporations effected pursuant to domestic law. See, e.g., Rev. Rul. 57-465 (1957-2 C.B. 250). As a result, conforming changes must be made to these international tax regulations to ensure that they apply appropriately to statutory mergers and consolidations effected pursuant to foreign law. The proposed regulations also modify the section 367(a) and (b) regulations to address several other related issues.

Explanation of Provisions

A. Basis and Holding Period Rules

The proposed regulations provide basis and holding period rules for certain transactions involving foreign corporations with section 1248 shareholders in order to preserve relevant section 1248 amounts. A section 1248 shareholder is a U.S. person that satisfies the ownership requirements of section 1248(a) with respect to a foreign corporation. Section 1248(a) applies to a U.S. person that owns stock (directly, indirectly, or constructively) with 10 percent or more of the voting power in the foreign corporation at any time during the 5-year period ending on the sale or exchange of the stock when the foreign corporation was a controlled foreign corporation (CFC). Gain recognized by a section 1248 shareholder on the sale or exchange of stock of the foreign corporation is included in gross income as a dividend to the extent of the earnings and profits of the foreign corporation that are attributable to the stock sold or exchanged and that were accumulated while the stock was held by the U.S. person when the foreign corporation was a CFC (the section 1248 amount).

The IRS and Treasury believe that it is important to preserve section 1248 amounts in certain nonrecognition exchanges of foreign corporation stock. Preservation of section 1248 amounts is a function of the holding period and basis in the stock of the foreign corporation being exchanged. One of the underlying policies of section 367(b) is the preservation of the potential application of section 1248 in connection with certain nonrecognition exchanges. H. Rep. No. 94-658, 94th Cong., 1st Sess., at 242 (Nov. 12, 1975). These proposed regulations provide basis and holding period rules to preserve section 1248 amounts in the context of certain section 354 exchanges and certain triangular reorganizations.

The basis and holding period rules of the proposed regulations also apply to a foreign corporate shareholder of a foreign corporation that is a party to the reorganization, provided that the foreign corporate shareholder has at least one U.S. person that is a section 1248 shareholder with respect to the foreign corporate shareholder and to the foreign corporation. This rule is necessary to preserve application of section 964(e) to the foreign corporate shareholder with respect to lower-tier foreign corporations. Under section 964(e), if a CFC sells or exchanges stock in another foreign corporation, gain recognized on the sale or exchange is included in the income of the CFC as a dividend to the same extent that it would have been included under section 1248(a) if the CFC were a U.S. person. Such dividend income may be treated as subpart F income that is included in the income of U.S. shareholders of the CFC.

1. Section 354 exchanges

The proposed regulations apply to certain section 354 exchanges involving foreign corporations, including exchanges of multiple blocks of stock. The proposed regulations preserve the bases and holding periods in different blocks of stock in certain foreign target corporations by requiring the exchanging shareholder to establish the particular shares of stock that were received in exchange for shares of a particular block of target stock. If the exchanging shareholder cannot establish the particular shares of target stock that were received for shares of a particular block of stock, then the shareholder must designate which shares of stock were received in exchange for shares of a particular block of stock, provided that the designation is consistent with the terms of the exchange. These tracing methods are used to determine the resulting tax consequences when stock received in a nonrecognition exchange is subsequently sold or otherwise exchanged. If the exchanging shareholder cannot establish, and does not designate, the particular shares received, the shareholder is treated as selling or otherwise exchanging a share received in a nonrecognition exchange for a share that was purchased or acquired at the earliest time.

The IRS and Treasury recently published proposed section 358 regulations (REG-116564-03) that determine the basis of stock or securities received in section 354 exchanges (proposed section 358 regulations). The proposed section 358 regulations generally provide that the basis of each share of stock or security received in an exchange to which section 354, 355, or 356 applies will be the same as the basis of the share of stock or security exchanged therefor. For these purposes, the determination of which share of stock or security is received in exchange for a particular share of stock or security is made in accordance with the terms of the exchange or distribution.

These proposed regulations apply the principles of the proposed section 358 regulations to certain exchanges of stock of a foreign corporation by either a section 1248 shareholder, or a foreign corporate shareholder where at least one U.S. person is a section 1248 shareholder with respect to such foreign corporate shareholder and to the foreign corporation whose shares are exchanged (collectively and individually, section 367(b) shareholder), to ensure the preservation of section 1248 amounts. The proposed regulations also include specific guidance on the shareholder's holding period in the stock received in the section 354 exchange. The proposed regulations do not, however, apply to distributions described in section 355.

Consistent with the proposed section 358 regulations, the proposed regulations hereunder would not apply to section 351 exchanges or to exchanges to which both section 351 and section 354 (or section 356) apply, if, in addition to stock being received, other property is received or liabilities are assumed. This limitation is intended to prevent a conflict between the rules for determining basis in a section 351 exchange (including the application of section 357(c)) and the rules proposed in this document. The IRS and Treasury are considering approaches for the preservation of section 1248 amounts in section 351 transactions in which liabilities are assumed or other property is received, and comments are requested in this regard.

In addition, the IRS and Treasury are considering developing specific rules for situations in which stock of the foreign acquiring corporation is not issued in the exchange (for example, when the exchanging shareholder owns all the stock of the foreign acquiring corporation). One possible approach may be for each existing share of stock in that corporation to be divided into portions to account for the different basis and holding periods of the stock of the foreign acquiring corporation and the stock of the acquired corporation in order to preserve section 1248 amounts. Comments are requested regarding this approach or possible alternative approaches.

2. Triangular reorganizations

The proposed regulations provide special basis and holding period rules for triangular reorganizations where the merging or surviving corporation is a foreign corporation with a section 367(b) shareholder. These rules apply to reorganizations described in section 368(a)(1)(A) and (a)(2)(D) (forward triangular merger) and to parenthetical section 368(a)(1)(C) reorganizations. In these transactions, the surviving corporation (S) acquires substantially all the assets of the acquired corporation (T), and the T shareholders exchange their T stock for stock of the corporation (P) that is in control (within the meaning of section 368(c)) of S. These rules also apply to reorganizations described in section 368(a)(1)(A) and (a)(2)(E) (reverse triangular merger). In a reverse triangular merger, S, a controlled subsidiary of P, merges into T, the surviving corporation, and the T shareholders exchange their T stock for stock of P.

Under current regulations, in a forward triangular merger or a parenthetical C reorganization, P's basis in its S stock is adjusted as if P had acquired the T assets directly from T in a section 362(b) exchange and then had transferred the T assets to S in a transaction in which P's basis in S stock is determined under section 358. See §1.358-6(c)(1) (commonly referred to as the "over-the-top" basis rules). Under current regulations, in a reverse triangular merger, P's basis in the T stock it receives immediately after the transaction is equal to its basis in its S stock immediately before the transaction adjusted as if T had merged into S in a forward triangular merger and the over-the-top basis rules had applied. See §1.358-6(c)(2). If a reverse triangular merger also qualifies as a section 351 transfer or a section 368(a)(1)(B) reorganization, P can determine its basis in its S stock either by using the over-the-top basis rules as described in the prior sentence or by treating P as if it had acquired the T stock from the former shareholders of T in a transaction in which basis is determined under section 362(b) (carryover stock basis).

The IRS and Treasury are concerned that, in certain exchanges involving foreign corporations, application of the over-the-top basis rules would not properly preserve the section 1248 or 964(e) amounts with respect to the stock of S or T. The proposed regulations provide that, in determining the stock basis of the surviving corporation in certain triangular reorganizations, outside stock basis will be used instead of inside asset basis pursuant to §1.358-6(c). For example, in the case of a forward triangular merger (or a parenthetical C reorganization), where P is a domestic corporation, S is a foreign corporation, T is a foreign corporation, and T has a section 1248 shareholder, the basis and holding period in the T stock, not the T assets, are used to determine P's basis in the S stock. The same rules apply to certain reverse triangular mergers, where S merges into T with T surviving. In that case, P's basis in the T stock immediately after the transaction would reflect the basis and holding period of the T stock instead of the T assets.

Under this stock basis approach for triangular reorganizations, the proposed regulations provide for a divided basis and holding period in each share of stock in the surviving corporation to reflect the relevant section 1248 amounts in the S stock and T stock. In particular, each share of S stock in a forward triangular merger, and each share of T stock in a reverse triangular merger, where P is a section 367(b) shareholder immediately after the transaction, is divided into portions reflecting the basis and holding period of the S stock and the T stock before the transaction. However, the proposed regulations contain a de minimis exception to this rule. Under this exception, if the value of the S stock immediately before the transaction is de minimis (for example, where S is a corporation formed to facilitate the transaction), then each share of the surviving corporation is not divided; instead, the basis of the S stock is added to the basis of the stock of the surviving corporation held by P. The value of the S stock would be de minimis for this purpose if it is less than 1 percent of the value of the surviving corporation (S or T) immediately after the transaction.

If there are two or more blocks of stock in T or S held by a section 367(b) shareholder immediately before the transaction, then each share of the surviving corporation (S or T) is further divided to account for each block of stock. If two or more blocks of stock are held by one or more shareholders that are not section 367(b) shareholders, then shares in these blocks are aggregated into one divided portion for basis purposes. If none of the S or T shareholders is a section 367(b) shareholder, then the over-the-top basis rules of §1.358-6 apply instead of the rules in these proposed regulations.

The proposed regulations provide special rules when stock of the surviving corporation has a divided basis and holding period. Earnings and profits accumulated prior to the reorganization are attributed to a divided portion of a share of stock based on the block of stock whose basis and holding period the divided portion reflects. Post-reorganization earnings and profits are attributed to each divided share of stock pursuant to section 1248 and the regulations thereunder. The amount of earnings and profits attributed to a divided share of stock pursuant to section 1248 are further attributed to a divided portion of such share of stock based on its fair market value in relation to the other divided portions. Finally, shares of stock are no longer divided into separate portions if section 1248 or 964(e) becomes inapplicable to a subsequent sale or exchange of the stock.

The special basis rules in these proposed regulations apply to all triangular reorganizations where T has at least one section 367(b) shareholder, even if such shareholders own less than a controlling interest in T. The IRS and Treasury are considering whether the current basis rules of §1.358-6 should apply in cases where section 367(b) shareholders do not own a substantial percentage of the stock of T, or whether taxpayers should be permitted to elect to apply the current basis rules under §1.358-6 to determine P's basis in the stock of the surviving corporation (S or T), provided that all section 367(b) shareholders of T include in income the section 1248 amounts with respect to the stock exchanged. Comments are requested in this regard.

The use of stock basis to determine P's basis in the surviving corporation also presents administrative concerns when a portion of the stock of T is widely held. In the case of a reorganization described in section 368(a)(1)(B), which presents similar issues, Rev. Proc. 81-70 (1980-2 C.B. 729) provides that statistical sampling techniques, if appropriate, are permitted to determine the basis of stock received by the acquiring corporation. In this regard, the IRS and Treasury recently have requested comments whether Rev. Proc. 81-70 should be revised to reflect changes in the marketplace since its publication. See Notice 2004-44 (2004-28 I.R.B. 32). Comments are requested on expanding this guidance to apply under the proposed regulations, for example in cases where blocks of T stock are held by persons that are not section 367(b) shareholders and such shares are aggregated into a single divided portion for basis and holding period purposes.

B. Exceptions to the Application of Section 367(a)

Under section 367(a), a U.S. person recognizes gain, but not loss, on the transfer of property to a foreign corporation in an exchange described in section 351, 354, 356, or 361, unless an exception applies. Section 367(a), however, does not apply to a section 354 exchange by a U.S. person of: (1) stock of a foreign corporation in a section 368(a)(1)(E) reorganization; or (2) stock of a domestic or foreign corporation for stock of a foreign corporation in an asset reorganization described in section 368(a)(1)(C), (D), or (F) that is not treated as an indirect stock transfer under §1.367(a)-3(a).

The proposed regulations amend §1.367(a)-3(a) so that this exception to the application of section 367(a) also applies to A reorganizations (including forward and reverse triangular mergers). In addition, the proposed regulations clarify that §1.367(a)-3(a) applies to exchanges described in section 356, as well as in section 354. Section 356 applies to an exchange that would qualify as a section 354 exchange except for the fact that money or other property is received in the exchange.

Taxpayers have questioned why the exception to the application of section 367(a) in §1.367(a)-3(a) includes exchanges of stock but not exchanges of securities in section 368(a)(1)(E) reorganizations and certain asset reorganizations. The IRS and Treasury believe that it is appropriate to provide comparable treatment for exchanges of securities in this context. Accordingly, Notice 2005-6 (2005-5 IRB), published contemporaneously with these proposed regulations, announces that the IRS and Treasury intend to amend §1.367(a)-3(a) to apply the exception from section 367(a) to exchanges of stock or securities. Notice 2005-6 provides that the applicable date of the amendment will be **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

The proposed regulations also provide rules concerning the application of section 367(a) to reverse triangular mergers, where stock of P, a corporation that controls the merging corporation S, is treated as transferred (along with any other property of S) to the surviving corporation T in a section 361 transfer. If S is a domestic corporation and T is a foreign corporation, section 367(a) applies to the transfer by S of the P stock to T, unless an exception applies.

The IRS and Treasury believe that, if the stock of P is provided to S pursuant to the plan of reorganization, the section 361 transfer of the P stock from S to T should not be subject to section 367(a), and the proposed regulations so provide. If P does not provide its stock to S pursuant to the plan of reorganization, then the P stock will be treated as property of S and the transfer of such stock will be subject to section 367(a).

The IRS and Treasury intend to amend the regulations under section 6038B to conform with the changes made in these regulations.

C. Concurrent Application of Section 367(a) and (b)

The proposed regulations modify the current application of section 367(a) and (b) to transactions that require the inclusion in income of the all earnings and profits amount under section 367(b). Section 1.367(a)-3(b)(2) provides rules for the concurrent application of section 367(a) and (b) to transfers of stock of a foreign corporation. This may occur, for example, when a U.S. shareholder exchanges stock of a foreign corporation (foreign acquired corporation) for stock of another foreign corporation (foreign acquiring corporation). See §1.367(a)-3(b)(1). It may also occur when an acquiring corporation (foreign or domestic) acquires the assets of a foreign acquired corporation, and the U.S. shareholder exchanges stock of the foreign acquired corporation for stock of the foreign parent of the acquiring corporation in a triangular reorganization.

The U.S. person's exchange of stock of the foreign acquired corporation for stock of either the foreign acquiring corporation or the foreign parent is subject to section

367(a). See §1.367(a)-3(b) and (d). If the exchanging U.S. shareholder owns 5 percent or more (by vote or value) of the stock of the foreign acquiring corporation or the foreign parent immediately after the exchange, the shareholder recognizes gain, if any, under section 367(a), unless the shareholder enters into a gain recognition agreement as provided in §1.367(a)-8. If the exchanging shareholder is not a 5-percent shareholder, then the exchanging shareholder does not recognize gain, if any, on the exchange.

The U.S. shareholder's exchange described above also may be subject to section 367(b). If the exchanging U.S. shareholder is a section 1248 shareholder of the foreign acquired corporation, and the stock of the foreign acquiring corporation (or its foreign parent corporation) is not stock in a corporation that is a CFC as to which the U.S. shareholder is a section 1248 shareholder immediately after the exchange, then the exchanging shareholder must include in income the section 1248 amount with respect to the stock exchanged. See §1.367(b)-4. If, instead, a domestic acquiring corporation acquires the assets of a foreign acquired corporation, and the U.S. shareholder exchanges stock of the foreign acquired corporation for stock of the foreign parent of the acquiring corporation in a triangular reorganization, then the exchanging shareholder must include in income the all earnings and profits amount with respect to the stock of the acquired corporation. See §1.367(b)-3. Unlike the section 1248 amount, the all earnings and profits amount is not limited by the shareholder's gain inherent in the stock of the foreign acquired corporation.

In cases where section 367(a) and (b) apply concurrently to a transaction, existing §1.367(a)-3(b)(2) provides that section 367(b) will not apply if the transfer is taxable under section 367(a). If the transfer is taxable under section 367(a), the exchanging U.S.

shareholder will recognize gain inherent in the exchanged stock (subject to recharacterization as dividend income under section 1248). If the transfer is not taxable under section 367(a), because the exchanging U.S. shareholder either is not a 5-percent shareholder or enters into a gain recognition agreement, then section 367(b) applies and the exchange is subject to either §1.367(b)-3 or 1.367(b)-4 at the shareholder level.

Questions with respect to the concurrent application of section 367(a) and (b) have arisen in situations that otherwise would require inclusion of the all earnings and profits amount under §1.367(b)-3. If the all earnings and profits amount is greater than the section 367(a) gain with respect to the stock of the foreign acquired corporation, under current law the exchanging shareholder effectively may elect to be taxed on the lesser amount of gain under section 367(a) simply by failing to file a gain recognition agreement. In that case, section 367(b) would not apply and the shareholder would avoid inclusion in income of the greater all earnings and profits amount.

The ability to elect to recognize the lesser gain inherent in the stock exchanged in such cases is inconsistent with the policies of section 367(b) that apply to inbound transactions, including preventing conversion of tax deferral into tax forgiveness and ensuring that the domestic acquiring corporation's section 381 carryover basis reflects an after-tax amount. Accordingly, the IRS and Treasury believe that the all earnings and profits amount provisions under §1.367(b)-3 should not operate electively in these cases. The proposed regulations require that, for exchanges subject to §1.367(b)-3 and section 367(a), section 367(b) would apply before section 367(a). In that case, inclusion of the all earnings and profits amount would increase the exchanging shareholder's stock basis for purposes of computing the shareholder's gain under section 367(a). Thus, if the all earnings and profits amount exceeds the inherent gain in the exchanged stock, gain is not recognized under section 367(a). If the transaction does not involve inclusion of the all earnings and profits amount (for example, if §1.367(b)-4 applies), the existing ordering rules continue to apply.

D. Parenthetical Section 368(a)(1)(B) Reorganizations

In a parenthetical reorganization under section 368(a)(1)(B), if a U.S. shareholder exchanges stock of an acquired corporation for voting stock of a foreign corporation that controls (within the meaning of section 368(c)) the acquiring corporation, the U.S. shareholder is treated as making an indirect transfer of stock of the acquired corporation to the foreign controlling corporation in a transfer subject to section 367(a). See §1.367(a)-3(d)(1)(iii). This result occurs even if the acquiring corporation is domestic. If the U.S. shareholder owns five percent or more (by vote or value) of the stock of the foreign controlling corporation, the shareholder must recognize gain inherent in the exchanged stock, unless a gain recognition agreement is filed. A gain recognition agreement filed with respect to the transfer may be triggered (and gain on the initial transfer of stock will be recognized) if the foreign controlling corporation disposes of the stock of the acquiring corporation, or the acquiring corporation disposes of the stock of the acquired corporation, within 5 years of the initial transfer. See §1.367(a)-3(d)(2)(ii).

The proposed regulations revise the indirect stock transfer rules to include triangular section 368(a)(1)(B) reorganizations in which a U.S. shareholder exchanges stock of the acquired corporation for voting stock of a domestic corporation that controls a foreign acquiring corporation. In such a case, the gain recognition agreement may be triggered if the domestic controlling corporation disposes of the stock of the foreign acquiring corporation, or the foreign acquiring corporation disposes of the stock of the acquired corporation, within 5 years of the initial transfer.

E. Transfers of Assets Following Certain Asset Reorganizations

If a U.S. shareholder exchanges stock or securities of an acquired corporation for stock or securities of a foreign acquiring corporation in a reorganization described in section 368(a)(1)(C), and the foreign acquiring corporation transfers all or part of the assets of the acquired corporation to a subsidiary controlled (within the meaning of section 368(c)) by the foreign acquiring corporation in a transaction described in section 368(a)(2)(C), the U.S. shareholder is treated, for purposes of section 367(a), as transferring the stock of the acquired corporation to the foreign acquiring corporation to the extent of the assets transferred to the controlled subsidiary. §1.367(a)-3(d)(1)(v). Section 368(a)(2)(C) provides that a transaction otherwise qualifying as a reorganization under section 368(a)(1)(A), (B), (C), and (G) will not be disqualified because all or part of the assets or stock acquired in the transaction are transferred to a corporation controlled by the acquiring corporation.

On August 16, 2004, the IRS and Treasury issued proposed regulations under §1.368-2(k) that permit assets or stock acquired in any reorganization under section 368(a)(1) to be transferred to a corporation controlled by the acquiring corporation without disqualifying the reorganization. Prior to these proposed regulations, the IRS and Treasury issued Rev. Rul. 2002-85 (2002-2 C.B. 986) which extended this treatment to section 368(a)(1)(D) reorganizations. Notice 2002-77 (2002-2 C.B. 997) issued contemporaneously with Rev. Rul. 2002-85, provided that §1.367(a)-3(d)(1)(v) would be amended to treat transactions described in Rev. Rul. 2002-85 as indirect stock transfers, if the transfer of assets by the acquiring corporation to its controlled subsidiary occurred pursuant to the plan of reorganization.

The effect of the proposed regulations under §1.368-2(k) is to permit transfers of assets or stock to a controlled subsidiary in reorganizations not specifically identified or mentioned in section 368(a)(2)(C) (section 368(a)(1)(D) and (F) reorganizations). The proposed regulations amend the indirect stock transfer rules to conform to the changes in the section 368 regulations. As a result, the proposed regulations provide that the transfer of assets to a controlled subsidiary subsequent to an asset reorganization under section 368(a)(1) would constitute an indirect transfer of stock, provided the transfer of assets by the foreign acquiring corporation to its controlled subsidiary occurs as part of the same transaction.

F. Indirect Transfers Involving a Change in Domestic or Foreign Status of Acquired Corporation

As indicated above, under existing §1.367(a)-3(d)(1)(v), a U.S. shareholder of an acquired corporation is treated as transferring the stock of the acquired corporation to the foreign acquiring corporation to the extent of the assets transferred to the controlled subsidiary. Thus, if the acquired corporation is foreign, the U.S. shareholder is treated as transferring stock of a foreign corporation to the foreign acquiring corporation in a transaction that is subject to the §1.367(a)-3(b) stock transfer rules. If the acquired corporation is domestic, the U.S. shareholder is treated as transferring stock of a domestic corporation to the foreign acquiring corporation in a transaction that is subject to §1.367(a)-3(c). This deemed transfer of domestic stock prevails even if the controlled subsidiary is foreign. Similar rules apply to parenthetical C reorganizations.

Some commentators have suggested that the determination of whether domestic or foreign stock is deemed transferred should be based on the status of the controlled subsidiary, rather than the status of the acquired corporation. Under this approach, if the acquired corporation were domestic and the controlled subsidiary were foreign, the U.S. shareholders would be deemed to transfer foreign corporation stock subject to §1.367(a)-3(b), rather than domestic corporation stock subject to §1.367(a)-3(c). The IRS and Treasury believe that, consistent with the framework of the current regulations, it is appropriate for the rules to continue to apply based on the stock that is owned and exchanged by the U.S. person in the transaction (rather than on the stock of the controlled subsidiary). The IRS and Treasury are considering the application of §§1.367(a)-3(b), 1.367(a)-3(c), and 1.367(a)-8 to situations where the foreign acquiring corporation transfers assets of the acquired corporation to multiple controlled subsidiaries (including both domestic and foreign subsidiaries), comments are requested in this regard.

G. Coordination of the Indirect Stock Transfer Rules and the Asset Transfer Rules

In the case of an indirect stock transfer that also involves a transfer of assets by a domestic corporation to a foreign corporation, §1.367(a)-3(d)(2)(vi) generally provides that section 367(a) and (d) apply to the transfer of assets prior to application of the indirect stock transfer rules. However, section 367(a) does not apply to such transfers to the extent that the foreign acquiring corporation transfers the assets received in the asset transfer to a domestic corporation controlled (within the meaning of section 368(c)) by the foreign acquiring corporation in a transfer described in section 368(a)(2)(C) or in a transfer described in section 351, provided the domestic transferee's basis in the assets is no greater than the basis that the domestic acquired corporation had in such assets. The initial asset transfer to the foreign corporation is not subject to section 367(a) in such cases because the assets re-transferred to the domestic corporation remain subject to U.S. corporate tax.

The IRS and Treasury are concerned that asset reorganizations subject to this coordination rule may be used to facilitate corporate inversion transactions. An inversion generally involves a U.S. multinational corporation reincorporating outside the United States for tax purposes (either as a foreign corporation or as a subsidiary of a new foreign corporation). The IRS and Treasury also are concerned that the coordination rule might be used to facilitate divisive transactions. The proposed regulations address both of these concerns by modifying the scope of the coordination rule.

The revised coordination rule operates as follows. Section 367(a) and (d) generally apply to the transfer of assets to a foreign corporation even if the foreign corporation transfers all or part of the assets received to a controlled domestic corporation. This general rule, however, is subject to two exceptions which do not require income recognition under section 367(a) and (d) on the transfer of assets to the foreign corporation to the extent that assets are re-transferred to the domestic controlled corporation.

The first exception applies if the domestic acquired corporation is controlled (within the meaning of section 368(c)) by 5 or fewer domestic corporations, appropriate basis adjustments as provided in section 367(a)(5) are made to the stock of the foreign acquiring corporation, and any other conditions provided in regulations under section 367(a)(5) are satisfied. Although there currently are no regulations under section

367(a)(5), this exception will incorporate any conditions or limitations in future regulations once published.

In cases where the first exception does not apply, the second exception applies if the following two conditions are satisfied: (1) the indirect transfer of stock of the domestic acquired corporation satisfies the requirements of §1.367(a)-3(c)(1)(i), (ii), and (iv), and (c)(6); and (2) the domestic acquired corporation attaches a statement (described below) to its tax return for the taxable year of the transfer.

The statement that the domestic acquired corporation files must certify that, if the foreign acquiring corporation disposes of any stock of the domestic controlled corporation with a principal purpose of avoiding U.S. tax that would have been imposed on the domestic acquired corporation had it disposed of the re-transferred assets, the domestic acquired corporation will amend its return for the year of the initial transaction and recognize gain (described below). The disposition of stock is presumed to have a principal purpose of tax avoidance if the disposition occurs within 2 years of the transfer. The presumption may be rebutted, however, if the domestic acquired corporation (or the foreign acquiring corporation on its behalf) demonstrates to the satisfaction of the Commissioner that the transaction did not have a principal purpose of tax avoidance.

If the domestic acquired corporation recognizes gain pursuant to the statement, it is treated as if, immediately prior to the exchange, it had transferred the re-transferred assets, including any intangible assets, directly to a domestic corporation in exchange for stock of the corporation in a transaction that is treated as a section 351 exchange, and immediately sold the stock to an unrelated party at fair market value in a sale in which it recognizes gain, if any, but not loss. For purposes of this rule, the deemed transfer to a domestic corporation is treated as a section 351 exchange regardless of whether all the requirements for nonrecognition under section 351 are otherwise satisfied. Treating the domestic acquired corporation as recognizing gain on the disposition of stock, rather than assets, is intended to approximate the consequences that would have resulted had the domestic acquired corporation transferred the assets to a corporation and sold the stock received in such transfer prior to the outbound reorganization. In addition, this treatment is consistent with other provisions that address divisive transactions. See, e.g., section 355(e) and §1.367(e)-(2)(b)(2)(iii).

The basis that the foreign acquiring corporation has in the stock of the domestic controlled corporation is increased by the amount of gain recognized by the domestic acquired corporation under these rules immediately prior to its disposition; however, the basis of the re-transferred assets held by the domestic controlled corporation will not be increased by such gain. Finally, the anti-abuse provision under §1.367(d)-1T(g)(6) will not apply to intangible property included in the re-transferred assets.

H. <u>Application of Section 367(b) Regulations to Certain Triangular Reorganizations</u>

Section 367(b) applies to exchanges under sections 332, 351, 354, 355, 356, and 361 (except to the extent described in section 367(a)(1)) in which the status of a foreign corporation as a corporation for tax purposes is necessary for application of the relevant nonrecognition provisions. Except as provided in regulations, under section 367(b) a foreign corporation that is a party to such an exchange is considered to be a corporation for tax purposes, and therefore the parties involved in the transaction are eligible for nonrecognition treatment.

Section 1.367(b)-4 applies to acquisitions by a foreign corporation (the foreign acquiring corporation) of the stock or assets of another foreign corporation (the foreign acquired corporation) in certain nonrecognition exchanges (a section 367(b) exchange). Consistent with section 1248, §1.367(b)-4(b)(1)(i) addresses exchanges by a section 1248 shareholder (or, in certain cases, a CFC shareholder that has a section 1248 shareholder), and generally requires such a shareholder to include in income its section 1248 amount as a result of a section 367(b) exchange, if immediately after the exchange (i) the stock received in the exchange is not stock in a corporation that is a controlled foreign corporation as to which the section 1248 shareholder described above is a section 1248 shareholder, or (ii) the foreign acquiring corporation or the foreign acquired corporation (if any, such as in a transaction described in section 368(a)(1)(B) or 351), is not a controlled foreign corporation as to which the section 1248 shareholder described above is a section 1248 shareholder.

Therefore, in a triangular reorganization (such as a triangular reorganization described in section 368(a)(1)(C)) that is within the scope of §1.367(b)-4, a section 367(b) shareholder must include in income the section 1248 amount if, for example, it receives stock of a domestic corporation in exchange for its stock in a controlled foreign corporation. This is the case because, immediately after the exchange, the section 367(b) shareholder does not hold stock in a corporation that is a controlled foreign corporation as to which such shareholder is a section 367(b) shareholder.

Pursuant to the basis rules contained in this proposed regulation under §1.367(b)-13, the section 1248 amount with respect to the stock of the foreign acquired corporation that is exchanged can be properly preserved in the stock of a foreign corporation owned by a domestic corporation when the section 367(b) shareholder receives stock of the domestic corporation in a triangular reorganization. Consequently, the proposed regulations provide that a section 367(b) shareholder receiving stock of a domestic corporation in a triangular reorganization is not required to include in income the section 1248 amount under §1.367(b)-4(b)(1)(i), provided that the domestic corporation, immediately after the exchange, is a section 1248 shareholder of the surviving corporation (or in the case of a parenthetical section 368(a)(1)(B) reorganization, of the acquired corporation) that is itself a controlled foreign corporation.

I. Application of Section 367(b) Regulations to Certain Outbound Reorganizations

If a domestic corporation is a section 1248 shareholder with respect to a foreign corporation and transfers the stock in such foreign corporation to another foreign corporation in a section 361 transfer, the domestic corporation must include in income the section 1248 amount, if any, with respect to the stock of the transferred foreign corporation. See section 1248(f)(1) and §1.367(b)-4(b)(2)(ii), Example 4.

Taxpayers have commented that this rule may result in income inclusions in some cases where the section 1248 amount could be preserved, such that a current inclusion may not be necessary or appropriate. The IRS and Treasury are considering the application of section 367(a)(5) and section 1248(f)(1) to such transactions, in conjunction with §1.367(b)-13 of these regulations, to preserve section 1248 amounts, and comments are requested in this regard. The IRS and Treasury also are considering, and request comments, on situations in which there are multiple shareholders (including minority shareholders) of the domestic corporation; multiple assets (including appreciated and depreciated assets being transferred as part of the section 361 transfer); and liabilities being assumed in connection with the transaction.

J. Nonrecognition Transactions under the FIRPTA and PFIC Provisions

Section 897(a) generally treats gain or loss from the disposition of a U.S. real property interest by a nonresident alien individual or a foreign corporation as gain or loss that is effectively connected with the conduct of a trade or business within the United States. Sections 897(d) and (e) provide rules that apply section 897 in the context of distributions and nonrecognition exchanges of U.S. real property interests. Temporary regulations were issued under sections 897(d) and (e) providing guidance on the application of section 897 to certain corporate transactions involving U.S. real property interests. See §1.897-5T, 1.897-6T, and Notice 89-85 (1989-2 C.B. 403). These rules do not specifically address A reorganizations because such regulations were based on A reorganizations being limited to statutory mergers between domestic corporations. The IRS and Treasury intend to revise these regulations to reflect A reorganizations and welcome comments on revisions that are necessary to apply these regulations to A reorganizations, as well as comments on other issues under the regulations.

Section 1291(f) provides authority to issue regulations concerning the exchange of stock in a passive foreign investment company (PFIC) in a nonrecognition transaction. Proposed regulations were published in the **Federal Register** (57 FR 11047) on April 1, 1992, providing rules for the disposition of PFIC stock by U.S. shareholders in nonrecognition exchanges. See §1.1291-6 of the proposed regulations. The application of these proposed regulations is based on A reorganizations being limited to statutory mergers between domestic corporations. The IRS and Treasury intend to revise these proposed regulations to reflect A reorganizations and welcome comments on revisions that are necessary in this regard, as well as comments on other issues under these regulations.

Proposed Effective Date

Except as otherwise specified, these regulations are proposed to apply to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

Special Analyses

The IRS and the Treasury Department have determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment pursuant to that Order is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and that because this 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 regulation 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 regulations and on 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 May 19, 2005, beginning at 10:00 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 portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by April 28, 2005. 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 Robert W. Lorence, Jr., 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 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. In section 1.358-1, paragraph (a) is amended by adding a sentence at the end of the paragraph to read as follows:

§1.358-1 Basis to distributes.

(a) * * * In the case of certain section 354 or 356 exchanges of stock in a foreign corporation, §1.367(b)-13 applies instead of the rules of §1.358-2.

* * * * *

Par. 3. In §1.358-6, paragraph (e) is amended by adding a sentence at the end of the paragraph to read as follows:

§1.358-6 Stock basis in certain triangular reorganizations.

* * * * *

(e) * * * For certain triangular reorganizations where the surviving corporation (S or T) is foreign, see §1.367(b)-13.

* * * * *

Par.4. Section 1.367(a)-3 is amended as follows:

1. In paragraph (a), remove the third and fourth sentences, and add five sentences in their place.

2. Revise paragraph (b)(2)(i).

3. Revise paragraph (c)(5)(vi).

4. In paragraph (d)(1), introductory text, first sentence, add the parenthetical "(or in a domestic corporation in control of a foreign acquiring corporation in a triangular section 368(a)(1)(B) reorganization)" after the words "for stock or securities in a foreign corporation".

5. In paragraph (d)(1), introductory text, remove the last sentence and add three sentences in its place.

6. In paragraph (d)(1)(i), remove the last sentence and add a sentence in its place.

7. In paragraph (d)(1)(ii), add a sentence at the end of the paragraph.

8. Paragraph (d)(1)(iii) is revised.

9. In paragraph (d)(1)(iv), remove the language "Example 7" and add "Example 8" in its place, and remove "Example 11" and add "Example 14" in its place.

10. Revise paragraph (d)(1)(v).

11. Revise paragraphs (d)(2)(i) and (ii).

12. In paragraph (d)(2)(iv), last sentence, remove the language "Example 4" and add "Examples 5 and 5A" in its place.

13. Revise paragraph (d)(2)(v)(C).

14. Redesignate paragraph (d)(2)(v)(D) as paragraph (d)(2)(v)(F).

15. Add new paragraphs (d)(2)(v)(D) and (E).

16. Revise paragraph (d)(2)(vi).

17. In paragraph (d)(3), redesignate the examples as follows and add the following new examples:

Redesignate	As	Add
Example 12	Example 16	

		Example 15
Examples 11 and 11A	Examples 14 and 14A	
Examples 10 and 10A	Examples 13 and 13A	
Example 9	Example 12	
		Examples 10 and 11
Example 8	Example 9	
Examples 7, 7A, 7B, and 7C	Examples 8, 8A, 8B, and 8C	
Examples 6 and 6A	Examples 7 and 7A	
Examples 5, 5A, and 5B	Examples 6, 6A, and 6B	
		Examples 6C and 6D
Example 4	Example 5	
		Example 5A
Example 3	Example 4	
Example 2	Example 3	
		Example 2

18. In paragraph (d)(3), newly designated Example 6A, paragraph (i), the first and last sentences are revised.

19. In paragraph (d)(3), newly designated Example 6B and Example 9 are revised.

20. In paragraph (d)(3), for each of the newly designated examples listed in the first column, replace the language in the second column with the language in the third column:

Redesignated Examples	Remove	Add
Example 6A, paragraph (i), first sentence	Example 5	Example 6
Example 7, paragraph (i)	Example 5	Example 6
Example 7A, paragraph (i) and paragraph (ii), penultimate sentence	Example 6	Example 7
Example 8, paragraph (i)	Example 5	Example 6
Example 8A, paragraph (i)	Example 7	Example 8
Example 8B, paragraph (i)	Example 7	Example 8
Example 8C, paragraph (i)	Example 7	Example 8
Example 12, paragraph (i), third sentence	Example 9	Example 12
Example 13A, paragraph (i) and paragraph (ii), first sentence	Example 10	Example 13
Example 14A, paragraph (i)	Example 11	Example 14

22. In paragraph (e)(1), remove the first sentence and add two sentences in its place.

The revisions and additions are as follows:

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

* * * * *

(a) * * * However, if, in an exchange described in section 354 or 356, a U.S. person exchanges stock of a foreign corporation in a reorganization described in section 368(a)(1)(E), or a U.S. person exchanges stock of a domestic or foreign corporation for stock of a foreign corporation pursuant to an asset reorganization that is not treated as an indirect stock transfer under paragraph (d) of this section, such section 354 or 356 exchange is not a transfer to a foreign corporation subject to section 367(a). See paragraph (d)(3), Example 16, of this section. For purposes of this section, an asset reorganization is defined as a reorganization described in section 368(a)(1) involving a transfer of assets under section 361. If, in a transfer described in section 361, a domestic merging corporation transfers stock of a controlling corporation to a foreign surviving corporation in a reorganization described in sections 368(a)(1)(A) and (a)(2)(E), such section 361 transfer is not subject to section 367(a) if the stock of the controlling corporation is provided to the merging corporation by the controlling corporation pursuant to the plan of reorganization; a section 361 transfer of other property, including stock of the controlling corporation not provided by the controlling corporation pursuant to the plan of reorganization, by the domestic merging corporation to the foreign surviving corporation pursuant to such a reorganization is subject to section 367(a). For special basis and holding period rules involving foreign corporations that are parties to certain reorganizations under section 368(a)(1), see §1.367(b)-13.* * *

(b) * * *

(2) * * *

(i) In general. A transfer of foreign stock or securities described in section 367(a)

and

the regulations thereunder as well as in section 367(b) and the regulations thereunder shall be subject concurrently to sections 367(a) and (b) and the regulations thereunder, except as provided in paragraph (b)(2)(i)(A) or (B) of this section. See paragraph (d)(3), Example 11, of this section.

(A) If a foreign corporation transfers assets to a domestic corporation in a transaction to which §1.367(b)-3(a) and (b) and the indirect stock transfer rules of paragraph (d) of this section apply, then the section 367(b) rules shall apply prior to the section 367(a) rules. See paragraph (d)(3), Example 15, of this section. This paragraph (b)(2)(i)(A) applies only to transactions occurring after the date these regulations are published as final regulations in the **Federal Register.**

(B) Except as provided in paragraph (b)(2)(i)(A) of this section, section 367(b) and the regulations thereunder shall not apply if the foreign corporation is not treated as a corporation under section 367(a)(1). See paragraph (d)(3), Example 14, of this section.

* * * * *

(c) * * *

(5) * * *

(vi) Transferee foreign corporation. Except as provided in paragraph (d)(1)(iii)(B) of this section, the transferee foreign corporation shall be the foreign corporation that issues stock or securities to the U.S. person in the exchange.

* * * * *

(d) * * *

(1) * * * For examples of the concurrent application of the indirect stock transfer rules under section 367(a) and the rules of section 367(b), see paragraph (d)(3), Examples 14 and 15 of this section. For purposes of this paragraph (d), if a corporation acquiring assets in a reorganization described in section 368(a)(1) transfers all or a portion of such assets to a corporation controlled (within the meaning of section 368(c)) by the acquiring corporation as part of the same transaction, the subsequent transfer of assets to the controlled corporation will be referred to as a controlled asset transfer. See section 368(a)(2)(C).

(i) * * * See paragraph (d)(3), Example 1 of this section for an example of a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) involving domestic acquired and acquiring corporations, and see paragraph (d)(3), Example 10 of this section for an example involving a domestic acquired corporation and a foreign acquiring corporation.

(ii) * * * See paragraph (d)(3), Example 2 of this section for an example of a reorganization described in sections 368(a)(1)(A) and (a)(2)(E) involving domestic acquired and acquiring corporations, and see paragraph (d)(3), Example 11 of this section for an example involving a domestic acquired corporation and a foreign acquiring corporation.

(iii) Triangular reorganizations described in section 368(a)(1)(B)--(A) A U.S. person exchanges stock of the acquired corporation for voting stock of a foreign corporation that is in control (as defined in section 368(c)) of the acquiring corporation in a reorganization described in section 368(a)(1)(B). See paragraph (d)(3), Example 5 of this section.

(B) A U.S. person exchanges stock of the acquired corporation for voting stock of a domestic corporation that is in control (as defined in section 368(c)) of a foreign acquiring corporation in a reorganization described in section 368(a)(1)(B).

(1) For purposes of paragraphs (b) and (c) of this section, the foreign acquiring corporation is considered to be the transferee foreign corporation even though the U.S. transferor receives stock of the domestic controlling corporation in the exchange.

(2) If stock of a foreign acquired corporation is exchanged for the voting stock of a domestic corporation in control of a foreign acquiring corporation, then the exchange will be subject to the rules of paragraph (b) of this section. If the exchanging shareholder is a section 1248 shareholder with respect to the foreign acquired corporation, the indirect transfer will be subject to sections 367(a) and (b) concurrently. For the application of section 367(b) to the exchange, see §§1.367(b)-4 and 1.367(b)-13(c).

(3) If stock of a domestic acquired corporation is exchanged for the voting stock of a domestic corporation in control of a foreign acquiring corporation, then the exchange will be subject to the rules of paragraph (c) of this section.

(4) For purposes of applying the gain recognition agreement provisions of paragraph (d)(2) of this section and §1.367(a)-8, the domestic controlling corporation will be treated as the transferee foreign corporation. Thus, a disposition of foreign acquiring corporation stock by the domestic controlling corporation, or a disposition of acquired corporation stock by the foreign acquiring corporation, will trigger the gain recognition agreement. See paragraph (d)(3), Example 5A of this section.

(5) This paragraph (d)(1)(iii)(B) applies only to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

(v) Transfers of assets to subsidiaries in certain section 368(a)(1) reorganizations. A U.S. person exchanges stock or securities of a corporation (the acquired corporation) for stock or securities of a foreign acquiring corporation in an asset reorganization (other than a triangular section 368(a)(1)(C) reorganization described in paragraph (d)(1)(iv) of this section or a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) or (a)(2)(E) described in paragraphs (d)(1)(i) or (ii) of this section) that is followed by a controlled asset transfer. In the case of a transaction described in this paragraph (d)(1)(v) in which some but not all of the assets of the acquired corporation are transferred in a controlled asset transfer, the transaction shall be considered to be an indirect transfer of stock or securities subject to this paragraph (d) only to the extent of the assets so transferred. The remaining assets shall be treated as having been transferred in an asset transfer rather than an indirect stock transfer, and such asset transfer shall be subject to the other provisions of section 367, including sections 367(a)(1), (3), and (5), and (d) if the acquired corporation is a domestic corporation. See paragraph (d)(3), Examples 6A and 6B of this section.

* * * * *

(2) * * *

(i) Transferee foreign corporation. Except as provided in paragraph (d)(1)(iii)(B) of this section, the transferee foreign corporation shall be the foreign corporation that issues stock or securities to the U.S. person in the exchange.

(ii) Transferred corporation. The transferred corporation shall be the acquiring corporation, except as provided in this paragraph (d)(2)(ii). In the case of a triangular section 368(a)(1)(B) reorganization described in paragraph (d)(1)(iii) of this section, the transferred corporation shall be the acquired corporation. In the case of an indirect stock transfer described in paragraph (d)(1)(i), (ii), or (iv) of this section followed by a controlled asset transfer, or an indirect stock transfer described in paragraph (d)(1)(v) of this section, the transferred corporation shall be the controlled corporation to which the assets are transferred. In the case of successive section 351 transfers described in paragraph (d)(1)(vi) of this section, the transferred corporation shall be the corporation to which the assets are transferred in the final section 351 transfer. The transferred property shall be the stock or securities of the transferred corporation, as appropriate under the circumstances.

* * * * *

(v) * * *

(C) In the case of an asset reorganization followed by a controlled asset transfer, as described in paragraph (d)(1)(v) of this section, the assets of the acquired corporation that are transferred to the corporation controlled by the acquiring corporation;

(D) In the case of a triangular reorganization described in section 368(a)(1)(C) followed by a controlled asset transfer, or a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) followed by a controlled asset transfer, the assets of the acquired corporation including those transferred to the corporation controlled by the acquiring corporation;

(E) In the case of a reorganization described in sections 368(a)(1)(A) and (a)(2)(E) followed by a controlled asset transfer, the assets of the acquiring corporation including those transferred to the corporation controlled by the acquiring corporation; and

* * * * *

(vi) Coordination between asset transfer rules and indirect stock transfer rules--

(A) General rule. If, pursuant to any of the transactions described in paragraph (d)(1) of this section, a U.S. person transfers (or is deemed to transfer) assets to a foreign corporation in an exchange described in section 351 or 361, the rules of section 367, including sections 367(a)(1), (a)(3), and (a)(5), as well as section 367(d), and the regulations thereunder shall apply prior to the application of the rules of this section.

(B) Exceptions. (1) If a transaction is described in paragraph (d)(2)(vi)(A) of this section, sections 367(a) and (d) shall not apply to the extent a domestic corporation (domestic acquired corporation) transfers its assets to a foreign corporation (foreign acquiring corporation) in an asset reorganization, and such assets (re-transferred assets) are transferred to a domestic corporation (domestic controlled corporation) controlled (within the meaning of section 368(c)) by the foreign acquiring corporation as part of the same transaction, provided that the domestic controlled corporation's basis in such assets is no greater than the basis that the domestic acquired corporation had in such assets and the conditions contained in either of the following paragraphs are satisfied:

(i) The domestic acquired corporation is controlled (within the meaning of section 368(c)) by 5 or fewer domestic corporations, appropriate basis adjustments as provided in section 367(a)(5) are made to the stock of the foreign acquiring corporation, and any other conditions as provided in regulations under section 367(a)(5) are satisfied. For purposes of determining whether the domestic acquired corporation is controlled by 5 or fewer domestic corporations, all members of the same affiliated group within the meaning of section 1504 shall be treated as 1 corporation.

(ii) The requirements of paragraphs (c)(1)(i), (ii), and (iv), and (c)(6) of this section are satisfied with respect to the indirect transfer of stock in the domestic acquired corporation, and the domestic acquired corporation attaches a statement described in paragraph (d)(2)(vi)(C) of this section to its U.S. income tax return for the taxable year of the transfer.

(2) Sections 367(a) and (d) shall not apply to transfers described in paragraph (d)(1)(vi) of this section where a U.S. person transfers assets to a foreign corporation in a section 351 exchange, to the extent that such assets are transferred by such foreign corporation to a domestic corporation in another section 351 exchange, but only if the domestic transferee's basis in the assets is no greater than the basis that the U.S. transferor had in such assets.

(C) Required statement. The statement required by paragraph (d)(2)(vi)(B)(1)(ii) of this section shall be entitled "Required Statement under §1.367(a)-3(d) for Assets Transferred to a Domestic Corporation" and shall be signed under penalties of perjury by an authorized officer of the domestic acquired corporation and by an authorized officer of the foreign acquiring corporation. The required statement shall contain a certification that, if the foreign acquiring corporation disposes of any stock of the domestic controlled corporation in a transaction described in paragraph (d)(2)(vi)(D) of this section, the domestic acquired corporation shall recognize gain as described in paragraph (d)(2)(vi)(E)(1) of this section. The domestic acquired corporation (or the foreign acquiring corporation on behalf of the domestic acquired corporation) shall file a U.S. income tax return (or an amended U.S. tax return, as the case may be) for the year of the transfer reporting such gain.

(D) Gain recognition transaction. (1) A transaction described in this paragraph (d)(2)(vi)(D) is one where a principal purpose of the transfer by the domestic acquired corporation is the avoidance of U.S. tax that would have been imposed on the domestic acquired corporation on the disposition of the re-transferred assets. A transfer may have a principal purpose of tax avoidance even though the tax avoidance purpose is outweighed by other purposes when taken together.

(2) For purposes of paragraph (d)(2)(vi)(D)(1) of this section, a transaction is deemed to have a principal purpose of tax avoidance if the foreign acquiring corporation disposes of any stock of the domestic controlled corporation (whether in a recognition or non-recognition transaction) within 2 years of the transfer. The rule in this paragraph (d)(2)(vi)(D)(2) shall not apply if the domestic acquired corporation (or the foreign acquiring corporation on behalf of the domestic acquired corporation) demonstrates to the satisfaction of the Commissioner that the avoidance of U.S. tax was not a principal purpose of the transaction.

(E) Amount of gain recognized and other matters. (1) In the case of a transaction described in paragraph (d)(2)(vi)(D) of this section, solely for purposes of this paragraph (d)(2)(vi)(E), the domestic acquired corporation shall be treated as if, immediately prior to the transfer, it transferred the re-transferred assets, including any intangible assets, directly to a domestic corporation in exchange for stock of such domestic corporation in a transaction that is treated as a section 351 exchange, and immediately sold such stock to an unrelated party for its fair market value in a sale in which it shall recognize gain, if any (but not loss). Any gain recognized by the domestic acquired corporation pursuant to this paragraph (d)(2)(vi)(E) will increase the basis that the foreign acquiring corporation has in the stock of the domestic controlled corporation immediately before the transaction described in paragraph (d)(2)(vi)(D) of this section, but will not increase the basis of the re-transferred assets held by the domestic controlled corporation. Section 1.367(d)-1T(g)(6) shall not apply with respect to any intangible property included in the re-transferred assets described in the preceding sentence.

(2) If additional tax is required to be paid as a result of a transaction described in paragraph (d)(2)(vi)(D) of this section, then interest must be paid on that amount at rates determined under section 6621 with respect to the period between the date prescribed for filing the domestic acquired corporation's income tax return for the year of the transfer and the date on which the additional tax for that year is paid.

(F) Examples. For illustrations of the rules in paragraph (d)(2)(vi) of this section, see paragraph (d)(3), Examples 6B, 6C, 6D, 9, and 13A of this section.

(G) Effective dates. Paragraph (d)(2)(vi) of this section applies only to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**. See §1.367(a)-3(d)(2)(vi), as contained in 26 CFR Part 1 revised as of April 1, 2004, for transactions occurring on or after July 20, 1998, until the date these regulations are published as final regulations in the **Federal Register**.

(3) * * *

Example 2. Section 368(a)(1)(A)/(a)(2)(E) reorganization--(i) Facts. The facts are the same as in Example 1, except that Newco merges into W and Newco receives stock of W which it distributes to F in a reorganization described in sections 368(a)(1)(A) and (a)(2)(E). Pursuant to the reorganization, A receives 40 percent of the stock of F in an exchange described in section 354.

(ii) Result. The consequences of the transfer are similar to those described in Example 1. Pursuant to paragraph (d)(1)(ii) of this section, the reorganization is subject to the indirect stock transfer rules. F is treated as the transferee foreign corporation, and W is treated as the transferred corporation. Provided that the requirements of paragraph (c)(1) of this section are satisfied, including the requirement that A enter into a five-year gain recognition agreement as described in §1.367(a)-8, A's exchange of W stock for F stock under section 354 will not be subject to section 367(a)(1).

* * * * *

Example 5A. Triangular section 368(a)(1)(B) reorganization--(i) Facts. The facts are the same as in Example 5, except that F is a domestic corporation and S is a foreign corporation.

(ii) Result. U's exchange of Y stock for stock of F, a domestic corporation in control of S, the foreign acquiring corporation, is treated as an indirect transfer of Y stock to a foreign corporation under paragraph (d)(1)(iii) of this section. U's exchange of Y stock for F stock will not be subject to section 367(a)(1) provided that all of the requirements of paragraph (c)(1) are satisfied, including the requirement that U enter in a five-year gain recognition agreement. In satisfying the 50 percent or less ownership requirements of paragraph (c)(1)(i) and (ii) of this section, U's indirect ownership of S stock (through its direct ownership of F stock) will determine whether the requirement of paragraph (c)(1)(i) is satisfied and will be taken into account in determining whether the requirement of paragraph (c)(1)(ii) is satisfied. See paragraph (c)(4)(iv)). For purposes of applying the gain recognition agreement provisions of paragraph (d)(2) of this section and §1.367(a)-8, F is treated as the transferee foreign corporation. The gain recognition agreement would be triggered if F sold all or a portion of the stock of S, or if S sold all or a portion of the stock of Y.

* * * * *

Example 6A. Section 368(a)(1)(C) reorganization followed by a controlled asset transfer--(i) Facts. The facts are the same as in Example 6, except that the transaction is structured as a section 368(a)(1)(C) reorganization, followed by a controlled asset transfer, and R is a foreign corporation. * * * F then contributes Businesses B and C to R in a controlled asset transfer. * * *

* * * * *

Example 6B. Section 368(a)(1)(C) reorganization followed by a controlled asset transfer to a domestic controlled corporation--(i) Facts. The facts are the same as in Example 6A, except that R is a domestic corporation.

(ii) Result. As in Example 6A, the outbound transfer of the Business A assets to F is not affected by the rules of this paragraph (d) and is subject to the general rules under section 367. However, the Business A assets qualify for the section 367(a)(3) active trade or business exception. The Business B and C assets are part of an indirect stock transfer under this paragraph (d) but must first be tested under sections 367(a) and (d). The Business B assets qualify for the active trade or business exception under section 367(a)(3); the Business C assets do not. However, pursuant to paragraph (d)(2)(vi)(B) of this section, the Business C assets are not subject to section 367(a) or (d), provided that the basis of the Business C assets in the hands of R is no greater than the basis of the assets in the hands of Z, and appropriate basis adjustments are made pursuant to section 367(a)(5) to the stock of F held by V. (In this case, no adjustments are required because, pursuant to section 358, V takes a basis of $30 in the stock of F, which is equal to V's proportionate share of the basis in the assets of Z ($30) transferred to F.) V also is deemed to make an indirect transfer of stock under the rules of paragraph (d). To preserve non-recognition treatment under section 367(a), V must enter into a 5-year gain recognition agreement in the amount of $50, the amount of the appreciation in the Business B and C assets, as the transfer of such assets by Z was not taxable under section 367(a)(1) and constituted an indirect stock transfer.

Example 6C. Section 368(a)(1)(C) reorganization followed by a controlled asset transfer to a domestic controlled corporation--(i) Facts. The facts are the same as in Example 6B, except that Z is owned by individuals, none of whom qualify as five-percent target shareholders with respect to Z within the meaning of paragraph (c)(5)(iii) of this section. The following additional facts are present. No U.S. persons that are either officers or directors of Z own any stock of F immediately after the transfer. F is engaged in an active trade or business outside the United States that satisfies the test set forth in paragraph (c)(3) of this section.

(ii) Result. The transfer of the Business A assets is not affected by the rules of this paragraph (d). However, the transfer of such assets is subject to gain recognition under section 367(a)(1), because the section 367(a)(3) active trade or business exception is inapplicable pursuant to section 367(a)(5). The Business B and C assets are part of an indirect stock transfer under this paragraph (d) but must first be tested under sections 367(a) and (d). The transfer of the Business B assets (which otherwise would satisfy the section 367(a)(3) active trade or business exception) generally is subject to section 367(a)(1) pursuant to section 367(a)(5). The transfer of the Business C assets generally is subject to sections 367(a)(1) and (d). However, pursuant to paragraph (d)(2)(vi)(B) of this section, the transfer of the Business B and C assets is not subject to sections 367(a)(1) and (d), provided the basis of the Business B and C assets in the hands of R is no greater than the basis in the hands of Z and certain other requirements are satisfied. Since Z is not controlled within the meaning of section 368(c) by 5 or fewer domestic corporations, the indirect transfer of Z stock must satisfy the requirements of paragraphs (c)(1)(i), (ii), and (iv), and (c)(6) of this section, and Z must attach a statement described in paragraph (d)(2)(vi)(C) of this section to its U.S. income tax return for the taxable year of the transfer. In general, the statement must contain a certification that, if F disposes of the stock of R (in a recognition or nonrecognition transaction) and a principal purpose of the transfer is the avoidance of U.S. tax that would have been imposed on Z on the disposition of the Business B and C assets transferred to R, then Z (or F on behalf of Z) will file a return (or amended return as the case may be) recognizing gain ($50), as if, immediately prior to the reorganization, Z transferred the Business B and C assets to a domestic corporation in exchange for stock in a transaction treated as a section 351 exchange and immediately sold such stock to an unrelated party for its fair market value. A transaction is deemed to have a principal purpose of U.S. tax avoidance if F disposes of

R stock within two years of the transfer, unless Z (or F on behalf of Z) can rebut the presumption to the satisfaction of the Commissioner. See paragraph (d)(2)(vi)(D)(2) of this section. With respect to the indirect transfer of Z stock, the requirements of paragraphs (c)(1)(i), (ii), and (iv) of this section are satisfied. Thus, assuming Z attaches the statement described in paragraph (d)(2)(vi)(C) of this section to its U.S. income tax return and satisfies the reporting requirements of (c)(6) of this section, the transfer of Business B and C assets is not subject to section 367(a) or (d).

Example 6D. Section 368(a)(1)(C) reorganization followed by a controlled asset transfer to a domestic controlled corporation--(i) Facts. The facts are the same as in Example 6C, except that the Z shareholders receive 60 percent of the F stock in exchange for their Z stock in the reorganization.

(ii) Result. The requirement of paragraph (c)(1)(i) of this section is not satisfied because the Z shareholders that are U.S. persons do not receive 50 percent or less of the total voting power and the total value of the stock of F in the transaction. Accordingly, Z shareholders that are U.S. persons are subject to section 367(a)(1) on their exchange of Z stock for F stock pursuant to the reorganization. For the same reason, the conditions of paragraph (d)(2)(vi)(B)(1)(ii) of this section are not met. Accordingly, the transfer of Business B and C assets is subject to sections 367(a)(1) and (d), even though such assets are re-transferred to R, a domestic corporation. As in Example 6C, the transfer of Business A assets, which is not affected by the rules of paragraph (d) of this section, is subject to gain recognition under sections 367(a)(1) and (5).

* * * * *

Example 9. Concurrent application with a controlled asset transfer--(i) Facts. The facts are the same as in Example 8, except that R transfers the Business A assets to M, a wholly owned domestic subsidiary of R, in a controlled asset transfer. In addition, V's basis in its Z stock is $90.

(ii) Result. Pursuant to paragraph (d)(2)(vi)(B) of this section, sections 367(a) and (d) do not apply to Z's transfer of the Business A assets to R, because such assets are re-transferred to M, a domestic corporation, provided that the basis of the Business A assets in the hands of M is no greater than the basis of the assets in the hands of Z, and certain other requirements are satisfied. Because Z is controlled (within the meaning of section 368(c)) by V, a domestic corporation, appropriate basis adjustments must be made pursuant to section 367(a)(5) to the stock of F held by V. (In this case, no adjustments are required because, pursuant to section 358, V takes a basis of $90 in the stock of F, which is less than V's proportionate share of the basis in the assets of Z ($100) transferred to R.) Section 367(a)(1) does not apply to Z's transfer of its Business B assets to R (which are not re-transferred to M) because such assets qualify for an exception to gain recognition under section 367(a)(3). With respect to the indirect transfer of Z stock, such transfer is not subject to gain recognition under section 367(a)(1) if the requirements of paragraph (c) of this section are satisfied, including the requirement that V enter into a 5-year gain recognition agreement and comply with the requirements of §1.367(a)-8 with respect to the gain ($100) realized on the Z stock. Under paragraphs (d)(2)(i) and (ii) of this section, the transferee foreign corporation is F and the transferred corporation is M. Pursuant to paragraph (d)(2)(iv) of this section, a disposition by F of the stock of R, or a disposition by R of the stock of M, will trigger the gain recognition agreement. To determine whether an asset disposition constitutes a deemed disposition of the transferred corporation's stock under the rules of §1.367(a)-8(e)(3)(i), both the Business A assets in M and the Business B assets in R must be considered.

Example 10. Concurrent application in section 368(a)(1)(A)/(a)(2)(D) reorganization--(i) Facts. The facts are the same as in Example 8, except that R acquires all of the assets of Z in a reorganization described in sections 368(a)(1)(A) and (a)(2)(D). Pursuant to the reorganization, V receives 30 percent of the stock of F in a section 354 exchange.

(ii) Result. The consequences of the transaction are similar to those in Example 8. The assets of Businesses A and B that are transferred to R must be tested under section 367(a) prior to the consideration of the indirect stock transfer rules of this paragraph (d). The Business B assets qualify for the active trade or business exception under section 367(a)(3). Because the Business A assets do not qualify for the exception, Z must recognize $40 of gain under section 367(a) on the transfer of Business A assets to R. Because V and Z file a consolidated return, V's basis in the stock of Z is increased from $100 to $140 as a result of Z's $40 gain. V's indirect transfer of Z stock will be taxable under section 367(a) unless V enters into a gain recognition agreement in the amount of $60 ($200 value of Z stock less $140 adjusted basis) and the other requirements of paragraph (c)(1) of this section are satisfied.

Example 11. Section 368(a)(1)(A)/(a)(2)(E) reorganization--(i) Facts. F, a foreign corporation, owns all the stock of D, a domestic corporation. V, a domestic corporation, owns all the stock of Z, a foreign corporation. V has a basis of $100 in the stock of Z which has a fair market value of $200. D is an operating corporation with assets valued at $100 with a basis of $60. In a reorganization described in sections 368(a)(1)(A) and (a)(2)(E), D merges into Z, and V exchanges its Z stock for 55 percent of the outstanding F stock.

(ii) Result. Under paragraph (d)(1)(ii) of this section, V is treated as making an indirect transfer of Z stock to F. V's exchange of Z stock for F stock will be taxable under section 367(a) (and section 1248 will be applicable) if V fails to enter into a 5-year gain recognition agreement in accordance with the requirements of §1.367(a)-8. Under paragraph (b)(2) of this section, if V enters into a gain recognition agreement, the exchange will be subject to the provisions of section 367(b) and the regulations thereunder as well as section 367(a). Under §1.367(b)-4(b) of this chapter, however, no income inclusion is required because both F and Z are controlled foreign corporations with respect to which V is a section 1248 shareholder immediately after the exchange. Under paragraphs (d)(2)(i) and (ii) of this section, the transferee foreign corporation is F, and the transferred corporation is Z (the acquiring corporation). If F disposes (within the meaning of §1.367(a)-8(e)) of all (or a portion) of Z stock within the 5-year term of the agreement (and V has not made a valid election under §1.367(a)-8(b)(1)(vii)), V is required to file an amended return for the year of the transfer and include in income, with interest, the gain realized but not recognized on the initial section 354 exchange. To determine whether Z (the transferred corporation) disposes of substantially all of its assets, the assets of Z immediately prior to the transaction are taken into account, pursuant to paragraph (d)(2)(v)(B) of this section. Because D is owned by F, a foreign corporation, section 367(a)(5) precludes any assets of D from qualifying for nonrecognition under section 367(a)(3). Thus, D recognizes $40 of gain on the transfer of its assets to Z under section 367(a)(1).

* * * * *

Example 15. Concurrent application of indirect stock transfer rules and section 367(b)--(i) Facts. F, a foreign corporation, owns all of the stock of Newco, a domestic corporation. P, a domestic corporation, owns all of the stock of FC, a foreign corporation. P's basis in the stock of FC is $50 and the value of FC stock is $100. The all earnings and profits amount with respect to the FC stock held by P is $60. See §1.367(b)-2(d). In a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) (and paragraph (d)(1)(i) of this section), Newco acquires all of the properties of FC, and P exchanges its stock in FC for 20 percent of the stock in F.

(ii) Result. Because a domestic corporation, Newco, acquires the assets of a foreign corporation, FC, in an asset reorganization to which §1.367(b)-3(a) and (b) and the indirect stock rules of paragraph (d) of this section apply, the section 367(b) rules apply before the section 367(a) rules apply. See §1.367(a)-3(b)(2)(i)(A). Under the rules of section 367(b), P must include in income the all earnings and profits amount of $60 with respect to its FC stock. See §1.367(b)-3. Although P's exchange of FC stock for F stock under section 354 is an indirect stock transfer, no gain is recognized under section 367(a), because P's basis in the FC stock is increased by the amount ($60) included in income under the rules of section 367(b). See §1.367(b)-2(e)(3)(ii). Alternatively, if P's all earnings and profits amount were $30, then the amount of the income inclusion and basis adjustment under the rules of section 367(b) would be $30, and the amount of gain subject to section 367(a)(1) would be $20 unless P entered into a 5-year gain recognition agreement in accordance with §1.367(a)-8.

*   *   *   *   *

(e) * * *

(1) In general. Except as provided in paragraphs (b)(2)(i)(A), (d)(1)(iii)(B), and (d)(2)(vi)(G), or in this paragraph (e), the rules in paragraphs (a), (b), and (d) of this section apply to transfers occurring on or after July 20, 1998. The rules in paragraphs (a) and (d) of this section, as they apply to section 368(a)(1)(A) reorganizations (including

reorganizations described in section 368(a)(2)(D) or (E)) involving a foreign acquiring or acquired corporation, apply only to transfers occurring after the date these regulations are published as final regulations in the **Federal Register**. * * *

* * * * *

Par.5. Section 1.367(a)-8 is amended as follows:

1. In paragraphs (c)(2) and (d), remove the words "district director" and add "Director of Field Operations" in their place.

2. In paragraph (e)(1)(i), a sentence is added after the first sentence.

The addition reads as follows:

§1.367(a)-8 Gain recognition agreement requirements.

* * * * *

(e) * * *

(1) * * *

(i) * * * It also includes an indirect disposition of the stock of the transferred corporation as described in §1.367(a)-3(d)(2)(iv). * * *

* * * * *

Par. 6. In §1.367(b)-1(a), remove the third and fourth sentences and add a sentence in their place to read as follows:

§1.367(b)-1 Other transfers.

(a) * * * For rules coordinating the concurrent application of sections 367(a) and (b), including the extent to which section 367(b) does not apply if the foreign corporation is not treated as a corporation under section 367(a), see §1.367(a)-3(b)(2)(i). * * *

* * * * *

Par.7. In §1.367(b)-3(b)(3)(ii), revise paragraph (i) of Example 5 to read as follows:

§1.367(b)-3 Repatriation of foreign corporate assets in certain nonrecognition transactions.

* * * * *

(b) * * *

(3) * * *

(ii) * * *

Example 5--(i) Facts. DC1, a domestic corporation, owns all of the outstanding stock of FC1, a foreign corporation. FC1 owns all of the outstanding stock of FC2, a foreign corporation. The all earnings and profits amount with respect to the FC2 stock owned by FC1 is $20. In a reorganization described in section 368(a)(1)(A), DC2, a domestic corporation unrelated to FC1 or FC2, acquires all of the assets and liabilities of FC2 pursuant to a State W merger. FC2 receives DC2 stock and distributes such stock to FC1. The FC2 stock held by FC1 is canceled, and FC2 ceases its separate legal existence.

* * * * *

Par.8. Section 1.367(b)-4 is amended as follows.

1. Paragraph (a) is revised.

2. Redesignate paragraph (b)(1)(ii) as paragraph (b)(1)(iii), and add new paragraph (b)(1)(ii).

3. In newly designated paragraph (b)(1)(iii), after Example 3, add Examples 3A and 3B.

The revisions and additions read as follows:

§1.367(b)-4 Acquisition of foreign corporate stock or assets by a foreign corporation in certain nonrecognition transactions.

(a) Scope. This section applies to an acquisition by a foreign corporation (the foreign acquiring corporation) of the stock or assets of a foreign corporation (the foreign acquired corporation) in an exchange described in section 351 or a reorganization described in section 368(a)(1). In the case of a reorganization described in sections 368(a)(1)(A) and (a)(2)(E), this section applies if stock of the foreign surviving corporation is exchanged for stock of a foreign corporation in control of the merging corporation; in such a case, the foreign surviving corporation is treated as a foreign acquired corporation for purposes of this section. A foreign corporation that undergoes a reorganization described in section 368(a)(1)(E) is treated as both the foreign acquired corporation and foreign acquiring corporation for purposes of this section. See §1.367(a)-3(b)(2) for transactions subject to the concurrent application of this section and section 367(a).

(b) * * *

(1) * * *

(ii) Exception. In the case of a triangular reorganization described in section 368(a)(1)(B) or (C), or a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) or (E), an exchange is not described in paragraph (b)(1)(i) of this section if the stock received in the exchange is stock of a domestic corporation and, immediately after the exchange, such domestic corporation is a section 1248 shareholder of the acquired corporation (in the case of a triangular section 368(a)(1)(B) reorganization) or the surviving corporation (in the case of a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) or (E)) and such acquired or surviving corporation is a controlled foreign corporation. See paragraph (b)(1)(iii) of this section, Example 3B for an illustration of this rule.

(iii) * * *

Example 3A. (i) Facts. The facts are the same as in Example 3, except that FC1 merges into FC2 in a reorganization described in sections 368(a)(1)(A) and (a)(2)(E). Pursuant to the reorganization, DC exchanges its FC2 stock for stock of FP.

(ii) Result. The result is similar to the result in Example 3. The transfer is an indirect stock transfer subject to section 367(a). See §1.367(a)-3(d)(1)(ii). Accordingly, DC's exchange of FC2 stock for FP stock will be taxable under section 367(a) (and section 1248 will be applicable) if DC fails to enter into a gain recognition agreement,. If DC enters into a gain recognition agreement, the exchange will be subject to the provisions of section 367(b) and the regulations thereunder, as well as section 367(a). If FP and FC2 are controlled foreign corporations as to which DC is a (direct or indirect) section 1248 shareholder immediately after the reorganization, then paragraph (b)(1)(i) of this section does not apply to require inclusion in income of the section 1248 amount and the amount of the gain recognition agreement is the amount of gain realized on the indirect stock transfer. If FP or FC2 is not a controlled foreign corporation as to which DC is a (direct or indirect) section 1248 shareholder immediately after the exchange, then DC must include in income the section 1248 amount ($20) attributable to the FC2 stock that DC exchanged. Under these circumstances, the gain recognition agreement would be the amount of gain realized on the indirect transfer, less the $20 section 1248 income inclusion.

Example 3B. (i) Facts. The facts are the same as Example 3, except that USP, a domestic corporation, owns the controlling interest (within the meaning of section 368(c)) in FC1 stock. FC2 merges into FC1 in a reorganization described in sections 368(a)(1)(A) and (a)(2)(D). Pursuant to the reorganization, DC exchanges its FC2 stock for USP stock.

(ii) Result. Because DC receives stock of a domestic corporation, USP, in the section 354 exchange, the transfer is not an indirect stock transfer subject to section 367(a). Accordingly, the exchange will be subject only to the provisions of section 367(b) and the regulations thereunder. Under paragraph (b)(1)(ii)(A) of this section, because the stock received is stock of a domestic corporation (USP) and, immediately after the exchange, USP is a section 1248 shareholder of FC1 (the acquiring corporation) and FC1 is a controlled foreign corporation, the exchange is not described in paragraph (b)(1)(i) of this section and DC includes no amount in its gross income. See §1.367(b)-13(b) and (c) for the basis and holding period rules applicable to this transaction, which cause USP's adjusted basis and holding period in the stock of FC1 after the transaction to reflect the basis and holding period that DC had in its FC2 stock.

* * * * *

Par. 9. In §1.367(b)-6, paragraph (a)(1), add a sentence to the end to read as follows:

§1.367(b)-6 Effective dates and coordination rules.

(a) * * *

(1) * * * The rules of §§1.367(b)-3 and 1.367(b)-4, as they apply to reorganizations described in section 368(a)(1)(A) (including reorganizations described in section 368(a)(2)(D) or (E)) involving a foreign acquiring or foreign acquired corporation, apply only to transfers occurring after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

Par. 10. Section 1.367(b)-13 is added to read as follows:

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

(a) Scope and definitions--(1) Scope. This section provides special basis and holding period rules for certain transactions involving the acquisition of property by a foreign acquiring corporation in nonrecognition exchanges. Special rules apply to determine the basis and holding period of stock in a foreign corporation received by certain shareholders in a section 354 or 356 exchange. In addition, special rules apply to determine the basis and holding period of stock of certain foreign surviving corporations held by a controlling corporation whose stock is issued in an exchange under section 354 or 356 in a triangular reorganization. This section applies to transactions that are subject to section 367(b) as well as section 367(a), including transactions concurrently subject to sections 367(a) and (b).

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

(i) A foreign acquired corporation is a foreign corporation whose stock or assets are acquired by a foreign corporation in a reorganization described in section 368(a)(1). In a reverse triangular merger, where T is a foreign corporation, T is treated as a foreign acquired corporation. A foreign corporation that undergoes a reorganization described in section 368(a)(1)(E) is treated as a foreign acquired corporation.

(ii) A block of stock has the meaning provided in §1.1248-2(b).

(iii) A triangular reorganization is a reorganization described in §1.358-6(b)(2)(i), (ii), or (iii) (but not a reorganization described in §1.358-6(b)(2)(iv)). A triangular C reorganization, a forward triangular merger, and a reverse triangular merger each is a reorganization described in §1.358-6(b)(2)(i), (ii), or (iii), respectively. For purposes of triangular reorganizations--

(A) P is a corporation that is a party to a reorganization that is in control (within the meaning of section 368(c)) of another party to the reorganization and whose stock is transferred pursuant to the reorganization;

(B) S is a corporation that is a party to the reorganization and that is controlled by P; and

(C) T is a corporation that is another party to the reorganization.

(b) Determination of basis and holding period for exchanges of foreign stock--(1) Application. Except as provided in paragraph (b)(4) of this section, this paragraph (b) applies to a shareholder that exchanges stock of a foreign acquired corporation in an exchange under section 354 or 356 for stock of a controlled foreign corporation, if--

(i) Immediately before the exchange either such shareholder is a section 1248 shareholder with respect to the foreign acquired corporation, or such shareholder is a foreign corporation and a United States person is a section 1248 shareholder with respect to both such foreign corporation and the foreign acquired corporation; and

(ii) The exchange is not described in §1.367(b)-4(b)(1)(i), (2)(i), or (3).

(2) Basis and holding period rules--(i) If a shareholder surrenders a share of stock in an exchange under the terms of section 354 or 356, the basis and holding period of each share of stock received in the exchange shall be the same as the basis and holding period of the allocable portion of the share or shares of stock exchanged therefor, as adjusted under §1.358-1 (such that the section 1248 amount of each share of stock exchanged is preserved in the share or shares of stock received). If more than one share of stock is received in exchange for one share of stock, the basis of the share of stock surrendered shall be allocated to the shares of stock received in the exchange in proportion to the fair market value of the shares of stock received. If one share of stock is received in respect of more than one share of stock or a fraction of a share of stock is received, the basis of the shares of stock surrendered must be allocated to the share of stock received, or a fraction thereof received, in a manner that reflects, to the greatest extent possible, that a share of stock is received in respect of shares of stock acquired on the same date and at the same price. The provisions of this paragraph may be applied, to the extent possible, on the basis of blocks of stock.

(ii) If a shareholder that purchased or acquired shares of stock in a corporation on different dates or at different prices exchanges such shares of stock under the terms of section 354 or 356, and the shareholder is not able to identify which particular share or shares of stock (or portion of a share of stock) is received in exchange for a particular share or shares of stock, the shareholder may designate which share or shares of stock is received in exchange for a particular share or shares of stock, provided that such designation is consistent with the terms of the exchange or distribution. The designation must be made on or before the first date on which the basis of a share of stock received is relevant. The basis of a share received, for example, is relevant when such share is sold or otherwise transferred. The designation will be binding for purposes of determining the Federal tax consequences of any sale or transfer of a share received. If the shareholder fails to make a designation, then the shareholder will not be able to identify which share is sold or transferred for purposes of determining the basis of property sold or transferred under section 1012 and §1.1012-1(c) and, instead, will be treated as selling or transferring the share received in respect of the earliest share purchased or acquired. See paragraph (e), Example 1 of this section for an illustration of this paragraph (b).

(3) In the case of a triangular reorganization, this paragraph (b) applies only to the exchange of T stock for P stock by T shareholders. See paragraph (c) of this section to determine the basis and holding period of stock of the surviving corporation (S or T) held by P immediately after a triangular reorganization.

(4) Paragraphs (b)(1) through (3) of this section shall not apply to determine the basis of a share of stock received by a shareholder in an exchange described in both section 351 and section 354 or 356, if, in connection with the exchange, the shareholder exchanges property for stock in an exchange to which neither section 354 nor 356 applies or liabilities of the shareholder are assumed.

(c) Determination of basis and holding period for triangular reorganizations--(1) Application. In the case of a triangular reorganization, this paragraph (c) applies, if--

(i) In the case of a reverse triangular merger—

(A) Immediately before the transaction, either P is a section 1248 shareholder with respect to S, or P is a foreign corporation and a United States person is a section 1248 shareholder with respect to both P and S; and

(B) P's exchange of S stock is not described in §1.367(b)-3(a) and (b) or in §1.367(b)-4(b)(1)(i), (2)(i), or (3); or

(ii)(A) Immediately before the transaction, a shareholder of T is either a section 1248 shareholder with respect to T or a foreign corporation and a United States person is a section 1248 shareholder with respect to both such foreign corporation and T; and

(B) With respect to at least one of the exchanging shareholders described in paragraph (c)(1)(ii)(A) of this section, the exchange of T stock is not described in §1.367(b)-3(a) and (b) or in §1.367(b)-4(b)(1)(i), (2)(i), or (3).

(2) Basis and holding period rules. In the case of a triangular reorganization described in this paragraph (c), each share of stock of the surviving corporation (S or T) held by P must be divided into portions attributable to the S stock and the T stock immediately before the exchange. See paragraph (e) of this section, Examples 2 through 5 for illustrations of this rule.

(i) Portions attributable to S stock--(A) In the case of a forward triangular merger or a triangular C reorganization, the basis and holding period of the portion of each share of surviving corporation stock attributable to the S stock is the basis and holding period of such share of stock immediately before the exchange.

(B) In the case of a reverse triangular merger, the basis and holding period of the portion of each share of surviving corporation stock attributable to the S stock is the basis and the holding period immediately before the exchange of a proportionate amount of the

S stock to which the portion relates. If P is a shareholder described in paragraph (c)(1)(i)(A) of this section with respect to S, and P exchanges two or more blocks of S stock pursuant to the transaction, then each share of the surviving corporation (T) attributable to the S stock must be further divided into separate portions to account for the separate blocks of stock in S.

(C) If the value of S stock immediately before the triangular reorganization is less than one percent of the value of the surviving corporation stock immediately after the triangular reorganization, then P may determine its basis in the surviving corporation stock by applying the rules of paragraph (c)(2)(ii) of this section to determine the basis and holding period of the surviving corporation stock attributable to the T stock, and then increasing the basis of each share of surviving corporation stock by the proportionate amount of P's aggregate basis in the S stock immediately before the exchange (without dividing the stock of the surviving corporation into separate portions attributable to the S stock).

(ii) <u>Portions attributable to T stock</u>--(A) If any exchanging shareholder of T stock is described in paragraph (c)(1)(ii) of this section, the basis and holding period of the portion of each share of stock in the surviving corporation attributable to the T stock is the basis and holding period immediately before the exchange of a proportionate amount of the T stock to which such portion relates. If any exchanging shareholder of T stock is described in paragraph (c)(1)(ii) of this section, and such shareholder exchanges two or more blocks of T stock pursuant to the transaction, then each share of surviving corporation stock attributable to the T stock must be further divided into separate portions to account for the separate blocks of T stock.

(B) If no exchanging shareholder of T stock is described in paragraph (c)(1)(ii) of this section, the rules of §1.358-6(c) apply to determine the basis of the portion of each share of the surviving corporation attributable to T immediately before the exchange.

(d) Special rules applicable to divided shares of stock --(1) In general--(i) Shares of stock in different blocks can be aggregated into one divided portion for basis purposes, if such shares immediately before the exchange are owned by one or more shareholders that are--

(A) Neither section 1248 shareholders with respect to the corporation nor foreign corporate shareholders; or

(B) Foreign corporate shareholders, provided that no United States persons are section 1248 shareholders with respect to both such foreign corporate shareholders and the corporation.

(ii) For purposes of determining the amount of gain realized on the sale or exchange of stock that has a divided portion pursuant to paragraph (c) of this section, any amount realized on such sale or exchange will be allocated to each divided portion of the stock based on the relative fair market value of the stock to which the portion is attributable at the time the portions were created.

(iii) Shares of stock will no longer be required to be divided if section 1248 or section 964(e) would not apply to a disposition or exchange of such stock.

(2) Pre-exchange earnings and profits. All earnings and profits (or deficits) accumulated by a foreign corporation before the reorganization and attributable to a share (or block) of stock for purposes of section 1248 are attributable to the divided portion of stock with the basis and holding period of that share (or block). See §1.367(b)-4(d).

(3) Post-exchange earnings and profits. Any earnings and profits (or deficits) accumulated by the surviving corporation subsequent to the reorganization are attributed to each divided share of stock pursuant to section 1248 and the regulations thereunder. The amount of earnings and profits (or deficits) attributable to a divided share of stock is further attributed to the divided portions of such share of stock based on the relative fair market value of each divided portion of stock.

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

Example 1. (i) Facts. US1 is a domestic corporation that owns all the stock of FT, a foreign corporation with 100 shares of stock outstanding. Each share of FT stock is valued at $10x. Because US1 acquired the stock of FT at two different dates, US1 owns two blocks of FT stock for purposes of section 1248. The first block consists of 60 shares. The shares in the first block have a basis of $300x ($5x per share), a holding period of 10 years, and $240x ($4x per share) of earnings and profits attributable to the shares for purposes of section 1248. The second block consists of 40 shares. The shares in the second block have a basis of $600x ($15x per share), a holding period of 2 years, and $80x ($2x per share) of earnings and profits attributable to the shares for purposes of section 1248. US2, a domestic corporation, owns all of the stock of FP, a foreign corporation, which owns all of the stock of FS, a foreign corporation. FT merges into FS with FS surviving in a reorganization described in section 368(a)(1)(A). Pursuant to the reorganization, US1 receives 50 shares of FS stock with a value of $1,000x for its FT stock in an exchange that qualifies for nonrecognition under section 354.

(ii) Basis and holding period determination--(A) US1 is a section 1248 shareholder of FT immediately before the exchange and exchanges its FT stock for stock of a controlled foreign corporation (FS) as to which US1 is a section 1248 shareholder immediately after the exchange. US1 is not required to include income under §1.367(b)-4(b) with respect to the exchange. Accordingly, the basis and holding period of the FS stock received by US1 is determined pursuant to paragraph (b) of this section.

(B) Pursuant to paragraph (b) of this section, 30 shares of the FS stock received by US1 in the reorganization (valued at $20x per share and exchanged for US1's first block of 60 shares of FT stock) have a basis of $300x ($10x per share), a holding period of 10 years, and $240x of earnings and profits ($8x per share) attributable to such shares for purposes of section 1248. In addition, 20 shares of the FS stock (valued at $20 per share and exchanged for US1's second block of 40 shares of FT stock) have a basis of $600x ($30x per share), a holding period of 2 years, and $80x of earnings and profits ($4x per share) attributable to such shares for purposes of section 1248.

(iii) Subsequent Disposition. Assume, subsequent to the exchange, US1 disposes of 20 shares of FS stock. On or before the date of the disposition when the basis of the F1 shares received by US1 becomes relevant, US1 can designate the 20 shares from the first block, the second block, or from any combination of shares in both blocks.

Example 2. (i) Facts. The facts are the same as in Example 1, except that US1 receives 50 shares of FP stock (instead of FS stock) with a value of $1,000x in exchange for its FT stock. Accordingly, the merger of FT into FS qualifies as forward triangular merger, and immediately after the exchange US1 is a section 1248 shareholder with respect to FP and FS. Additionally, prior to the transaction, FP owned two blocks of FS stock. Each block consisted of 10 shares with a value of $200x ($20x per share). The shares in the first block had a basis of $50x ($5x per share), a holding period of 10 years, and $50x ($5x per share) of earnings and profits attributable to such shares for purposes of section 1248. The shares in the second block had a basis of $100x ($10x per share), a holding period of 5 years, and $20x ($2x per share) of earnings and profits attributable to such shares for purposes of section 1248.

(ii) Basis and holding period determination. (A) The basis and holding period of the FP shares received by US1 in the exchange are determined pursuant to paragraph (b) of this section and are identical to the results in Example 1.

(B)(1) US1 is a section 1248 shareholder of FT immediately before the transaction. Moreover, US1 is not required to include income under §1.367(b)-3(b) or 1.367(b)-4(b) as described in paragraph (c)(2) of this section. Accordingly, the basis and holding period of the FS stock held by FP immediately after the triangular reorganization is determined pursuant to paragraph (c) of this section.

(2) Pursuant to paragraph (c) of this section, each share of FS stock is divided into portions attributable to the basis and holding period of the FS stock held by FP immediately before the exchange (the FS portion) and the FT stock held by US1 immediately before the exchange (the FT portion). The basis and holding period of the FS portion is the basis and holding period of the FS stock held by FP immediately before the exchange. Thus, each share of FS stock in the first block has a portion with a basis of $5x, a value of $20x, a holding period of 10 years, and $5x of earnings and profits attributable to such portion for purposes of section 1248. Each share of FS stock in the second block has a portion with a basis of $10x, a value of $20x, a holding period of 5 years, and $2x of earnings and profits attributable to such portion for purposes of section 1248.

(3) Because the exchanging shareholder of FT stock (US1) is a section 1248 shareholder, the holding period and basis of the FT portion is the holding period and the proportionate amount of the basis of the FT stock immediately before the exchange to which such portion relates. Further, because US1 exchanged two blocks of FT stock, the FT portion must be divided into two separate portions attributable to the two blocks of FT stock. Thus, each share of FS stock will have a second portion with a basis of $15x ($300x basis / 20 shares), a value of $30x ($600x value / 20 shares), a holding period of

10 years, and $12x ofearnings and profits ($240x / 20 shares) attributable to such portion for purposes of section 1248. Each share of FS stock will have a third portion with a basis of $30x ($600x basis / 20 shares), a value of $20x ($400x value / 20 shares), a holding period of 2 years, and $4x of earnings and profits ($80x / 20 shares) attributable to such portion for purposes of section 1248.

(iii) Assume, immediately after the transaction, FP disposes of a share of FS stock from the first block. When FP disposes of any share of its FS stock, it is treated as disposing of each divided portion of such share. With respect to the first portion (attributable to the FS stock), FP recognizes a gain of $15x ($20x value - $5x basis), $5x of which is treated as a dividend under section 1248. With respect to the second portion (attributable to the first block of FT stock), FP recognizes a gain of $15x ($30x value - $15x basis), $12x of which is treated as a dividend under section 1248. With respect to the third portion (attributable to the second block of FT stock), FP recognizes a capital loss of $10x ($20x value - $30x basis).

(iv) Assume further, immediately after the transaction, FP also disposes of a share of stock from the second block of FS stock. With respect to the first portion (attributable to the FS stock), FP recognizes a gain of $10x ($20x value - $10x basis), $2x of which is treated as a dividend under section 1248. With respect to the second portion (attributable to the first block of FT stock), FP recognizes a gain of $15x ($30x value - $15x basis), $12x of which is treated as a dividend under section 1248. With respect to the third portion (attributable to the second block of FT stock), FP recognizes a capital loss of $10x ($20x value - $30x basis).

Example 2A. (i) Facts. The facts are the same as in Example 2, except that FS merges into FT with FT surviving in a reverse triangular merger. Pursuant to the merger, US1 receives FP stock with a value of $1,000x in exchange for its FT stock, and FP receives 10 shares of FT stock with a value of $1,400x in exchange for its FS stock. Immediately after the exchange, US1 is a section 1248 shareholder with respect to FP and FT.

(ii) Basis and holding period determination--(A) The basis and holding period of the FP shares received by US1 and the stock of the surviving corporation held by FP are the same as in Example 2, except that each share of the surviving corporation (FT, instead of FS) will be divided into four portions instead of three portions. Because FP exchanges two blocks of FS stock, the FS portion must be divided into two separate portions attributable to the two blocks of FS stock. Because US1 exchanges two blocks of FT stock, the FT portion must be divided into two separate portions attributable to the two blocks of FT stock.

(B) Thus, each share of the surviving corporation (FT) will have a first portion (attributable to the first block of FS stock) with a basis of $5x ($50x / 10 shares), a value of $20x ($200x / 10 shares), a holding period of 10 years, and $5x of earnings and profits ($50x / 10 shares) attributable to such portion for purposes of section 1248. Each share of FT stock will have a second portion (attributable to the second block of FS stock) with a basis of $10x ($100x / 10 shares), a value of $20x ($200x / 10 shares), a holding period of 5 years, and $2x of earnings and profits ($20x / 10 shares) attributable to such portion for purposes of section 1248. Moreover, each share of FT stock will have a third portion (attributable to the first block of FT stock) with a basis of $30x ($300x basis / 10 shares), a value of $60x ($600x value / 10 shares), a holding period of 10 years, and $24x of earnings and profits ($240x / 10 shares) attributable to such portion for purposes of section 1248. Lastly, each share of FT stock will have a fourth portion (attributable to the second block of FT stock) with a basis of $60x ($600x basis / 10 shares), a value of $40x ($400x value / 10 shares), a holding period of 2 years, and $8x of earnings and profits ($80x / 10 shares) attributable to such portion for purposes of section 1248.

Example 3. (i) Facts. USP, a domestic corporation, owns all the stock of FS, a foreign corporation with 10 shares of stock outstanding. Each share of FS stock has a value of $10x, a basis of $5x, a holding period of 10 years, and $7x of earnings and profits attributable to such share for purposes of section 1248. FP, a foreign corporation, owns the stock of FT, another foreign corporation. FP and FT do not have any section 1248 shareholders. FT has assets with a value of $100x, a basis of $50x, and no liabilities. The FT stock held by FP has a value of $100x and a basis of $75x. FT merges into FS with FS surviving in a forward triangular merger. Pursuant to the reorganization, FP receives USP stock with a value of $100x in exchange for its FT stock.

(ii) Basis and holding period determination--(A) Because USP is a section 1248 shareholder of FS immediately before the transaction, the basis and holding period of the FS stock held by USP immediately after the triangular reorganization is determined pursuant to paragraph (c) of this section.

(B) Pursuant to paragraph (c) of this section, each share of FS stock is divided into portions attributable to the basis and holding period of the FS stock held by USP immediately before the exchange (the FS portion) and the basis of FT's net assets (the FT portion) immediately before the exchange. The basis of FT's net assets (and not FT stock) is used to determine the FT portion because FT does not have a section 1248 shareholder immediately before the transaction. As a result, the rules of §1.358-6(c) apply to determine the basis of the FT portion of each share of FS stock. The basis and holding period of the FS portion is the basis and holding period of the FS stock held by USP immediately before the exchange. Thus, each share of FS stock has a portion with a basis of $5x, a value of $10x, and a holding period of 10 years. The basis of the FT portion is the basis of the FT assets to which such portion relates. Thus, each share of FS stock has a second portion with a basis of $5x ($50x basis in FT's assets / 10 shares) and a value of $10x ($100x value of FT's assets / 10 shares). All of FS's earnings and profits prior to the transaction ($70x) is attributed solely to the FS portion in each share of FS stock. The FS portion of each share of FS stock has earnings and profits of $7x ($70x / 10 shares) attributable to such portion for purposes of section 1248. As a result of each share of stock being divided into portions, the basis of the FS stock is not averaged with the basis of the FT assets to increase the section 1248 amount with respect to the stock of the surviving corporation (FS).

Example 4. (i) Facts. US, a domestic corporation, owns all of the stock of FT, a foreign corporation. The FT stock held by US constitutes a single block of stock with a value of $1,000x, a basis of $600x, and holding period of 5 years. USP, a domestic corporation, forms FS, a foreign corporation, pursuant to the plan of reorganization and capitalizes it with $10x of cash. FS merges into FT with FT surviving in a reverse triangular merger and a reorganization described in section 368(a)(1)(B). Pursuant to the reorganization, US receives USP stock with a value of $1,000x in exchange for its FT stock, and USP receives 10 shares of FT stock with a value of $1,010x in exchange for its FS stock.

(ii) Basis and holding period determination. (A) US and USP are section 1248 shareholders of FT and FS, respectively, immediately before the transaction. Neither US nor USP is required to include income under §1.367(b)-3(b) or 1.367(b)-4(b) as described in paragraph (c)(2) of this section. The basis and holding period of the FT stock held by USP is determined pursuant to paragraph (c) of this section.

(B) Pursuant to paragraph (c) of this section, because the exchanging shareholder of FT stock (US) is a section 1248 shareholder of FT, each share of the surviving corporation (FT) has a proportionate amount of the basis and holding period of the FT stock immediately before the exchange to which such share relates. Thus, the portion of each share of FT stock attributable to the FT stock has a basis of $60x ($600x basis / 10 shares), a value of $100x ($1,000x value / 10 shares), and a holding period of 5 years. Because the value of FS stock immediately before the triangular reorganization ($10x) is less than one percent of the value of the surviving corporation (FT) immediately after the triangular reorganization ($1,010x), USP may determine its basis in the stock of the surviving corporation (FT) by increasing the basis of each share of FT stock by the proportionate amount of USP's aggregate basis in the FS stock immediately before the exchange (without dividing each share of FT stock into separate portions to account for FS and FT). If USP so elects, USP's basis in each share of FT stock is increased by $1x ($10x basis in FS stock / 10 shares). As a result, each share of FT stock has a basis of $61x, a value of $101x, and a holding period of 5 years.

Example 5. (i) Facts. US, a domestic corporation, owns all of the stock of FT, a foreign corporation. The FT stock held by US constitutes one block of stock with a basis of $170x, a value of $200x, a holding period of 5 years, and $10x of earnings and profits attributable to such stock for purposes of section 1248. FP, a foreign corporation, owns all the stock of FS, a foreign corporation. FS has 10 shares of stock outstanding. No United States person is a section 1248 shareholder with respect to FP or FS. The FS stock held by FP has a value of $100x and a basis of $50x ($5x per share). FT merges into FS with FS surviving in a forward triangular merger. Pursuant to the merger, US receives FP stock with a value of $200x for its FT stock in an exchange that qualifies for non-recognition under section 354. FP is a controlled foreign corporation and US is a section 1248 shareholder with respect to FP and FS immediately after the exchange.

(ii) Basis and holding period determination. (A) Because US is a section 1248 shareholder of FT immediately before the transaction, and US is not required to include income under §§1.367(b)-3(b) and 1.367(b)-4(b) as described in paragraph (c)(2) of this section, the basis and holding period of the FS stock held by FP immediately after the triangular reorganization is determined pursuant to paragraph (c) of this section.

(B) Pursuant to paragraph (c) of this section, each share of FS stock is divided into portions attributable to the basis and holding period of the FS stock held by FP immediately before the exchange (the FS portion) and the FT stock held by US immediately before the exchange (the FT portion). The basis and holding period of the FS portion is the basis and holding period of the FS stock held by FP immediately before the exchange. Thus, each share of FS stock has a portion with a basis of $5x and a value of $10x. Because the exchanging shareholder of FT stock (US) is a section 1248 shareholder of FT, the basis and holding period of the FT portion is the proportionate amount of the basis and the holding period of the FT stock immediately before the exchange to which such portion relates. Thus, each share of FS stock will have a second portion with a basis of $17x ($170x basis / 10 shares), a value of $20x ($200x value / 10 shares), a holding period of 5 years, and $1x of earnings and profits ($10x earnings and profits / 10 shares) attributable to such portion for purposes of section 1248.

(iii) Subsequent disposition. (A) Several years after the merger, FP disposes of all of its FS stock in a transaction governed by section 964(e). At the time of the disposition, FS stock has decreased in value to $210x (a post-merger reduction in value of $90x), and FS has incurred a post-merger deficit in earnings and profits of $30x.

(B) Pursuant to paragraph (d)(1)(ii) of this section, for purposes of determining the amount of gain realized on the sale or exchange of stock that has a divided portion, any amount realized on such sale or exchange is allocated to each divided portion of the stock based on the relative fair market value of the stock to which the portion is attributable at the time the portions were created. Immediately before the merger, the value of the FS stock in relation to the value of both the FS stock and the FT stock was one-third ($100x / ($100x plus $200x)). Likewise, immediately before the merger, the value of the FT stock in relation to the value of both the FT stock and the FS stock was two-thirds ($200x / $100x plus $200x). Accordingly, one-third of the $210x amount realized is allocated to the FS portion of each share and two-thirds to the FT portion of each share. Thus, the amount realized allocated to the FS portion of each share is $7x (one-third of $210x divided by 10 shares). The amount realized allocated to the FT portion of each share is $14x (two-thirds of $210x divided by 10 shares).

(C) Pursuant to paragraph (d)(3) of this section, any earnings and profits (or deficits) accumulated by the surviving corporation subsequent to the reorganization are attributed to the divided portions of shares of stock based on the relative fair market value of each divided portion of stock. Accordingly, one-third of the post-merger earnings and profits deficit of $30x is allocated to the FS portion of each share and two-thirds to the FT portion of each share. Thus, the deficit in earnings and profits allocated to the FS portion of each share is $1x (one-third of $30x divided by 10 shares). The deficit in earnings and profits allocated to the FT portion of each share is $2x (two-thirds of $30x divided by 10 shares).

(D) When FP disposes of its FS stock, FP is treated as disposing of each divided portion of a share of stock. With respect to the FS portion of each share of stock, FP recognizes a gain of $2x ($7x value - $5x basis), which is not recharacterized as a dividend because a deficit in earnings and profits of $1x is attributable to such portion for purposes of section 1248. With respect to the FT portion of each share of stock, FP recognizes a loss of $3x ($14x value - $17x basis).

(e) Effective date. This section applies to exchanges occurring after the date these regulations are published as final regulations in the **Federal Register.**

Par. 11. Section 1.884-2 is amended as follows:

1. Paragraphs (c)(3) through (c)(6)(i)(A) are revised.

2. Paragraphs (c)(6)(i)(B), (C), and (D) are added.

3. Paragraphs (c)(6)(ii) through (f) are revised.

4. Paragraph (g) is amended by adding a sentence at the end.

The revisions and additions read as follows:

§1.884-2 Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary.

*   *   *   *   *

(c)(3) through (c)(6)(i)(A) [Reserved]. For further guidance, see §1.884-2T(c)(3) through (c)(6)(i)(A).

(c)(6)(i)(B) Shareholders of the transferee (or of the transferee's parent in the case of a triangular reorganization described in section 368(a)(1)(C) or a reorganization described in sections 368(a)(1)(A) and 368(a)(2)(D) or (E)) who in the aggregate owned more than 25 percent of the value of the stock of the transferor at any time within the 12-month period preceding the close of the year in which the section 381(a) transaction occurs sell, exchange or otherwise dispose of their stock or securities in the transferee at any time during a period of three years from the close of the taxable year in which the section 381(a) transaction occurs.

(c)(6)(i)(C) In the case of a triangular reorganization described in section 368(a)(1)(C) or a reorganization described in sections 368(a)(1)(A) and 368(a)(2)(D) or (E), the transferee's parent sells, exchanges, or otherwise disposes of its stock or securities in the transferee at any time during a period of three years from the close of the taxable year in which the section 381(a) transaction occurs.

(c)(6)(i)(D) A corporation related to any such shareholder or the shareholder itself if it is a corporation (subsequent to an event described in paragraph (c)(6)(i)(A) or (B) of this section) or the transferee's parent (subsequent to an event described in paragraph (c)(6)(i)(C) of this section), uses, directly or indirectly, the proceeds or property received in such sale, exchange or disposition, or property attributable thereto, in the conduct of a trade or business in the United States at any time during a period of three years from the date of sale in the case of a disposition of stock in the transferor, or from the close of the taxable year in which the section 381(a) transaction occurs in the case of a disposition of the stock or securities in the transferee (or the transferee's parent in the case of a triangular reorganization described in section 368(a)(1)(C) or a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) or (E)). Where this paragraph (c)(6)(i) applies, the transferor's branch profits tax liability for the taxable year in which the section 381(a) transaction occurs shall be determined under §1.884-1, taking into account all the adjustments in U.S. net equity that result from the transfer of U.S. assets and liabilities to the transferee pursuant to the section 381(a) transaction, without regard to any provisions in this paragraph (c). If an event described in paragraph (c)(6)(i)(A), (B), or (C) of this section occurs after the close of the taxable year in which the section 381(a) transaction occurs, and if additional branch profits tax is required to be paid by reason of the application of this paragraph (c)(6)(i), then interest must be paid on that amount at the underpayment rates determined under section 6621(a)(2), with respect to the period between the date that was prescribed for filing the transferor's income tax return for the year in which the section 381(a) transaction occurs and the date on which the additional tax for that year is paid. Any such additional tax liability together with interest thereon shall be the liability of the transferee within the meaning of section 6901 pursuant to section 6901 and the regulations there under.

(c)(6)(ii) through (f) [Reserved]. For further guidance, see §1.884-2T(c)(6)(ii) through (f).

(g) * * * Paragraphs (c)(6)(i)(B), (C), and (D), are applicable for tax years beginning after December 31, 1986, except that such paragraphs are applicable to transactions occurring after the date these regulations are published as final regulations in the **Federal Register** in the case of reorganizations described in sections 368(a)(1)(A) and 368(a)(2)(D) or (E).

Par. 12. In §1.884-2T, paragraphs (c)(6)(i)(B), (C), and (D) are revised to read as follows:

§1.884-2T Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary (Temporary).

*   *   *   *   *

(c) * * *

(6) * * *

(i) * * *

(B), (C), and (D) [Reserved]. For further guidance, see §1.884-2(c)(6)(i)(B), (C), and (D).

Mark E. Matthews,

Deputy Commissioner for Services and

Enforcement.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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January 5, 2005
js-2180

Treasury and IRS Issue Clarifications of Transition Rules for Deferred Compensation Plans Under 409a

The Treasury Department and IRS today issued clarifications to Notice 2005-1 today which provide additional guidance regarding transition rules under section 409A for nonqualified deferred compensation plans. An advance version of Notice 2005-1 was released to the public on December 20, 2004. Two clarifications are being added to the transition rules in the notice. The revised notice, incorporating these two clarifications, will be included as scheduled in Internal Revenue Bulletin 2005-2, to be published on January 10, 2005.

A copy of the revised Notice 2005-1 and the accompanying IRS announcement are attached.

REPORTS

- Notice 2005-1

ANNOUNCEMENT

Clarification of Certain Transition Rules in Notice 2005-1

Notice 2005-1 provides guidance on the executive compensation provisions of new section 409A of the Internal Revenue Code, which was added by the American Jobs Creation Act of 2004. An advance version of the notice was released to the public on December 20, 2004. Two small but helpful clarifications are being added to the transition rules in the notice. Notice 2005-1, revised to incorporate these two clarifications, will be included as scheduled in Internal Revenue Bulletin 2005-2, to be published on January 10, 2005.

Specifically, the revisions are being made to paragraph (c) of Q&A 19 and to the first sentence of Q&A 20. Paragraph (c) of Q&A 19 in the December 20 version of the notice provides transition relief under which certain amendments and elections will not be treated as a change in the form or timing of a payment under section 409A(a)(4). The revisions to the paragraph make it clear that those amendments and elections also will not be treated as an acceleration of the payment under section 409A(a)(3). The first sentence of Q&A 20 provides transition relief with respect to certain terminations of participation in a plan and certain cancellations of deferrals by participants. The revisions to that sentence make it clear that the relief in that sentence also applies to deferrals prior to 2005 that are subject to section 409A (and that otherwise meet the conditions for the transition relief).

Q&A 19, paragraph (c) now reads as follows: Payment elections. With respect to amounts subject to § 409A, the plan may be amended to provide for new payment elections with respect to amounts deferred prior to the election and the election will not be treated as a change in the form and timing of a payment under § 409A(a)(4) or an acceleration of a payment under § 409A(a)(3), provided that the plan is so amended and the participant makes the election on or before December 31, 2005. Similarly, an outstanding stock option or stock appreciation right that provides for a deferral of compensation subject to § 409A may be amended to provide for fixed payment terms consistent with § 409A, or to permit holders of such rights to elect fixed payment terms consistent with § 409A, and such amendment or election will not be treated as a change in the form and timing of a payment under § 409A(a)(4) or an acceleration of a payment under § 409A(a)(3), provided that the option or right is so amended and any elections are made, on or before December 31, 2005.

The first sentence of Q&A 20, paragraph (a) now reads as follows: A plan adopted before December 31, 2005 may be amended to allow a participant during all or part of the calendar year 2005 to terminate participation in the plan or cancel a deferral election, without causing the plan to fail to conform to the provisions of § 409A(a)(2), (3) or (4), provided that (i) the amendment is enacted and effective on or before December 31, 2005, and (ii) the amounts subject to the termination or cancellation are includible in income of the participant in the calendar year 2005, or if later, the taxable year in which the amounts are earned and vested (as defined in Q&A 16).

Accordingly, the revised Notice 2005-1 reads as follows:

Part IV – Items of General Interest

Guidance Under § 409A of the Internal Revenue Code

Notice 2005-1

I. Purpose and Overview

Section 885 of the recently enacted American Jobs Creation Act of 2004, Pub. Law No. 108-357, 118 Stat. 1418 (the Act), added § 409A to the Internal Revenue Code (Code). Section 409A provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are met. Section 409A also includes rules applicable to certain trusts or similar arrangements associated with nonqualified deferred compensation, where such arrangements are located outside of the United States or are restricted to the provision of benefits in connection with a decline in the financial health of the sponsor.

As explained more fully below, this notice provides the first part of what is expected to be a series of guidance with respect to the application of § 409A. The Treasury Department and the Internal Revenue Service (Service) intend to incorporate the principles of this notice into additional, more comprehensive guidance in 2005.

Taxpayers should note that although the statute makes a number of fundamental changes, § 409A does not alter or affect the application of any other provision of the Code or common law tax doctrine. Accordingly, deferred compensation not required to be included in income under § 409A may nevertheless be required to be included in income under § 451, the constructive receipt doctrine, the cash equivalency doctrine, § 83, the economic benefit doctrine, the assignment of income doctrine or any other applicable provision of the Code or common law tax doctrine.

A. Definitions and Coverage

This notice generally outlines the scope of coverage of § 409A. The notice first provides definitions of a nonqualified deferred compensation plan, a plan and the deferral of compensation. Guidance is provided on the application of § 409A to welfare plans, plans covered by § 457, stock appreciation rights, and arrangements between partners and partnerships. This notice provides a definition of a substantial risk of forfeiture.

The definition of nonqualified deferred compensation contains an exception for amounts actually or constructively received by the service provider within a short period following the lapse of a substantial risk of forfeiture. The exception is intended to address multi-year compensation arrangements, where the right to the compensation is or may be earned over multiple years but is payable at the end of the earning period. For example, a three-year bonus program requiring the performance of services over three years and entitling the service provider to a payment within a short specified period following the end of the third year generally would not constitute a deferral of compensation. The Treasury Department and the Service are, however, concerned about arrangements purported to involve a substantial risk of forfeiture and fixed payment date where the parties do not intend for the substantial risk of forfeiture or fixed payment date to be enforced. Accordingly, the Treasury Department and the Service are considering a more restrictive rule under which arrangements involving payments in later taxable years structured to coincide with a lapse in a substantial risk of forfeiture would constitute deferrals of compensation subject to § 409A. However, even under a more restrictive rule, the Treasury Department and the Service anticipate that a payment within a short period following a scheduled vesting date and, in specified circumstances, within a short period following an accelerated vesting date, would be permitted under the statutory authority provided to permit accelerated payments that are not inconsistent with the purposes of the statute. Comments are requested with respect to these issues and the extent to which additional guidance is required to prevent arrangements designed to evade application of § 409A.

This notice does not provide generally applicable methods for calculating the amount of deferrals for a given year. However, a rule is provided for calculation of the amount of deferrals before January 1, 2005 for purposes of applying the effective date provisions. The Treasury Department and the Service anticipate issuing guidance in 2005 providing methods for calculating the amount of deferrals for purposes of all deferrals to which § 409A applies, including deferrals preceding the issuance of the guidance. Until such guidance is issued, certain transition relief is provided to address information reporting and withholding requirements. However, nothing in this guidance should be interpreted to exempt amounts actually distributed to the taxpayer in 2005 from inclusion in income or from applicable reporting or withholding requirements.

B. Nonstatutory Stock Options and Stock Appreciation Rights

The definition of nonqualified deferred compensation contains an exception that generally excludes certain nonstatutory stock options from coverage under § 409A. This exception is consistent with the further exception covering transfers of restricted property, as the taxation of transfers of nonstatutory stock options and transfers of restricted property generally both are governed by § 83. Commentators have pointed out that under certain conditions, stock appreciation rights yield economically equivalent results to nonstatutory stock options exercised in a cashless transaction, and have requested that stock appreciation rights be treated similarly. However, the Treasury Department and the Service are concerned that a general exception for stock appreciation rights may be exploited as a method to avoid application of § 409A, particularly in regard to valuation of the underlying stock where the value is not established by and in an established securities market. In many respects, stock appreciation rights are similar to other forms of nonqualified deferred compensation, particularly where the recipient of a stock appreciation right may receive cash. In such cases, the taxation of stock appreciation rights generally is governed by § 451 and the constructive receipt doctrine. See Rev. Rul. 80-300, 1982-2 C.B. 165.

Accordingly, this notice provides limited exceptions from coverage under § 409A for certain stock appreciation rights which do not present potential for abuse or intentional circumvention of the purposes of § 409A. Under this exception, a stock appreciation right will not constitute a deferral of compensation if (1) the value of the stock the excess over which the right provides for payment upon exercise (the SAR exercise price) may never be less than the fair market value of the underlying stock on the date the right is granted, (2) the stock of the service recipient subject to the right is traded on an established securities market, (3) only such traded stock of the service recipient may be delivered in settlement of the right upon exercise, and (4) the right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right. In addition, until further guidance is issued, a payment of stock or cash pursuant to the exercise of a stock appreciation right (or economically equivalent right), or the cancellation of such a right for consideration, where such right is granted pursuant to a program in effect on or before October 3, 2004 will not be treated as a payment of a deferral of compensation subject to the requirements of § 409A if: (1) the SAR exercise price may never be less than the fair market value of the underlying stock on the date the right is granted, and (2) the right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right. The Treasury Department and the Service request comments on the extent to which stock appreciation rights should be excepted from coverage under § 409A, in light of the statutory purpose.

The Treasury Department and the Service also are concerned about the potential for taxpayers to avoid application of § 409A by combining an exception from coverage under § 409A for nonstatutory stock options or stock appreciation rights with a requirement or right that the stock acquired by the service provider be repurchased by the service recipient. Accordingly, the Treasury Department and the Service are considering a restriction on the exception from coverage under § 409A for nonstatutory stock options or stock appreciation rights, to options or rights that are not accompanied by an arrangement or agreement under which the service recipient has an obligation or right to repurchase the acquired shares (including repurchases for an amount other than fair market value). In this context, the Treasury Department and the Service also request comments on appropriate techniques for valuation of stock subject to options or stock appreciation rights where the value of such stock is not established by and in an established securities market, in order to ensure that such valuation reflects the actual fair market value of the stock.

To the extent the additional guidance adopts a position on an issue addressed in this notice with respect to stock options or stock appreciation rights that is less favorable to taxpayers than provided in this notice, the Treasury Department and the Service anticipate that such a position will be applied only on a prospective basis with adequate transition relief to allow modification of plans to comply on a prospective basis.

C. Change in Control Events

This notice next addresses what constitutes a change in ownership or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation (Change in Control Event) for purposes of § 409A. Section 885(e) of the Act requires that within 90 days of the enactment of the legislation, the Treasury Department and the Service issue guidance on what constitutes a Change in Control Event. Section 409A provides that, to the extent provided by the Treasury Department and the Service in guidance, a nonqualified deferred compensation plan may permit amounts deferred under the plan to be distributed upon a Change in Control Event.

D. Acceleration of Payments

Except under circumstances specified by the Treasury Department and the Service in guidance, a nonqualified deferred compensation plan may not permit the acceleration of payments under the plan. This notice provides circumstances under which payments under the plan may be accelerated, such as to meet the requirements of a domestic relations order or conflict of interest divestiture requirements. Comments are requested as to other circumstances under which a plan should be allowed to accelerate payments under the plan.

E. Effective Dates and Transition Relief

The notice provides guidance on the effective date provisions and transition relief. Section 409A generally is effective with respect to amounts deferred after December 31, 2004. Section 409A also is effective with respect to amounts deferred in taxable years beginning before January 1, 2005 if the plan under which the deferral is made is materially modified after October 3, 2004. This notice addresses what amounts will be considered deferred after December 31, 2004, generally providing that an amount will be treated as deferred on or before December 31, 2004 only if the service recipient has a binding legal obligation to pay an amount in a future taxable year and the service provider's right to the amount is earned and vested as of December 31, 2004. Methods of calculating amounts treated as deferred on or before December 31, 2004 are provided. This notice also addresses when a plan under which a deferral is made will be considered materially modified after October 3, 2004.

This notice addresses the requirements of § 885(f) of the Act, which provides that within 60 days of the enactment of the legislation, the Treasury Department and the Service must issue guidance providing that for a limited period and under certain conditions, a nonqualified deferred compensation plan may be amended without violating certain provisions of § 409A to (i) allow a participant to terminate participation in the plan, or cancel an outstanding deferral election with respect to amounts deferred after December 31, 2004, or (ii) conform the plan to the provisions of § 409A with respect to amounts deferred after December 31, 2004. This notice provides certain relief addressing the application of the initial deferral election requirements to compensation attributable, in whole or in part, to the performance of services in the years 2004 or 2005. This includes, for example, provisions addressing the deferral of bonuses, including bonuses for services performed in 2004.

F. Application of Information Reporting and Wage Withholding Requirements

This notice next addresses certain information reporting and wage withholding requirements imposed by § 885(b) of the Act with respect to deferred amounts. For information reporting purposes, the Act amends §§ 6041 and 6051 to require that all deferrals for the year under a nonqualified deferred compensation plan be separately reported on a Form 1099 (Miscellaneous Income) or a Form W-2 (Wage and Tax Statement). For wage withholding purposes, the Act amends § 3401(a) to provide that the term "wages" includes any amount includible in gross income of an employee under § 409A. Finally, for purposes of reporting nonemployee compensation, the Act further amends § 6041 to require that amounts includible in gross income under § 409A that are not treated as wages under § 3401(a) must be reported as gross income. This notice does not provide methods for calculating the amount of deferrals for the year or the amounts includible in gross income under § 409A and in wages under § 3401(a).

Consequently, interim guidance is provided with respect to an employer's withholding and reporting obligations where the employer furnishes an expedited Form W-2 prior to the issuance of additional guidance providing such methods.

II. Reliance on Transition Guidance; Good Faith, Reasonable Interpretation

This notice provides rules governing the application of § 409A. The Treasury Department and the Service anticipate issuing additional guidance that incorporates this notice. To the extent the additional guidance adopts a position on an issue addressed in this notice that is less favorable to taxpayers than provided in this notice, the Treasury Department and the Service anticipate that such a position will be applied only on a prospective basis with adequate transition relief to allow modification of plans to comply on a prospective basis.

This notice does not provide comprehensive guidance with respect to the application of § 409A. Until additional guidance is issued, to comply with the requirements of § 409A with respect to issues not addressed in this notice, taxpayers should base their positions upon a good faith, reasonable interpretation of the statute and its purpose, which includes consideration of the legislative history. Whether a taxpayer position constitutes a good faith, reasonable interpretation of the statutory language generally will be determined based upon all of the relevant facts and circumstances, including whether the taxpayer has applied the position consistently and the extent to which the taxpayer has resolved unclear issues in the taxpayer's favor. In addition, certain provisions of § 409A provide definitive rules, but allow the Treasury Department and the Service to issue guidance providing exceptions to such rules. For example, § 409A(a)(3) provides that the Treasury Department and the Service may issue guidance providing an exception to the general prohibition against the acceleration of the time or schedule of any payment under a nonqualified deferred compensation plan. A taxpayer position based on an expected exception that the taxpayer speculates that the Treasury Department and the Service will adopt in future guidance is not a good faith, reasonable interpretation of the statutory language. In addition, as discussed above, the Treasury Department and the Service intend to issue guidance in 2005 providing methods for calculating the amount of deferrals for a year for purposes of all amounts of deferrals to which § 409A applies, including deferrals predating the issuance of the anticipated guidance. Accordingly, taxpayers will not be able to rely upon methods of calculation that differ from the methods provided in the 2005 guidance.

III. Request for Comments on Anticipated Guidance

A. Request for Comments

The Treasury Department and the Service request comments on all aspects of the application of § 409A, including but not limited to the topics addressed in this notice. The Treasury Department and the Service specifically request comments with respect to the following:

(1) The application of § 409A to severance plans, including whether to exclude any specific types of severance plans or arrangements (see Q&A 19).

(2) Funding arrangements for nonqualified deferred compensation that involve foreign trusts or similar arrangements, and identification of arrangements that will not result in an improper deferral of United States tax and will not result in assets being effectively beyond the reach of creditors for purposes of the potential exemption from the provisions of § 409A(b) that the Treasury Department and the Service are authorized to provide under § 409A(e)(3).

(3) The application of § 409A to arrangements involving partners and partnerships. Comments are specifically requested with respect to the applicability of § 409A to arrangements subject to § 736, and whether there should be a distinction between payments subject to § 736(a) and (b) and the coordination of the timing rules of § 1.736-1(b)(5) with the rules of § 409A for nonqualified deferred compensation plans. Comments are also specifically requested on whether there should be special rules in applying § 409A in the case of a putative allocation and distribution which is recast, under § 707(a)(2)(A), as a payment to a nonpartner under § 707(a)(1).

(4) Potential additional exclusions from coverage under § 409A with respect to contractual arrangements between businesses (see Q&A 8).

(5) Situations where the acceleration of benefits should be permitted under § 409A(a)(3) (see Q&A 15), particularly in light of the legislative history regarding accelerated payments required for reasons beyond the control of the participant.

All materials submitted will be available for public inspection and copying.

B. Submission of Comments

Comments may be submitted to Internal Revenue Service, CC:PA:LPD:RU (Notice 2005-1), Room 5203, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may also be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to the Courier's Desk at 1111 Constitution Avenue, NW, Washington DC 20224, Attn: CC:PA:LPD:RU (Notice 2005-1), Room 5203. Submissions may also be sent electronically via the internet to the following email address: *Notice.comments@irscounsel.treas.gov*. Include the notice number (Notice 2005-1) in the subject line.

IV. Guidance

A. Definitions and Coverage

Q-1 What does § 409A provide, in general?

A-1 Section 409A provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are satisfied. Section 409A also includes rules applicable to certain trusts or similar arrangements associated with nonqualified deferred compensation, where such arrangements are located outside of the United States or are restricted to the provision of benefits in connection with a decline in the financial health of the sponsor.

Q-2 What are the federal income tax consequences of a failure to satisfy the requirements of § 409A?

A-2 Generally, if at any time during a taxable year a nonqualified deferred compensation plan fails to meet the requirements of § 409A, or is not operated in accordance with those requirements, all amounts deferred under the plan for the taxable year and all preceding taxable years, by any participant with respect to whom the failure relates, are includible in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. If a deferred amount is required to be included in income under § 409A, the amount also is subject to interest and an additional income tax. The interest imposed is equal to the interest at the underpayment rate plus one percentage point, imposed on the underpayments that would have occurred had the compensation been includible in income for the taxable year when first deferred, or if later, when not subject to a substantial risk of forfeiture. The additional income tax is equal to 20 percent of the compensation required to be included in gross income.

Q-3 What is a nonqualified deferred compensation plan?

A-3 (a) In general. Except as otherwise provided in this A-3, the term nonqualified deferred compensation plan means any plan (within the meaning of Q&A 9) that provides for the deferral of compensation (within the meaning of Q&A 4). The application of § 409A is not limited to arrangements between an employer and an employee. For example, § 409A may apply to arrangements between a service recipient and an independent contractor, or arrangements between a partner and a partnership (see Q&A 7 and Q&A 8).

(b) Qualified employer plans. The term nonqualified deferred compensation plan does not include (i) any plan, contract, pension, account, or trust described in subparagraph (A) or (B) of § 219(g)(5) (without regard to subparagraph (A)(iii)), (ii) any eligible deferred compensation plan (within the meaning of § 457(b)), and (iii) any plan described in § 415(m). Accordingly, the term nonqualified deferred compensation plan does not include a qualified retirement plan, tax-deferred annuity, simplified employee pension, SIMPLE or § 501(c)(18) trust.

(c) Certain welfare benefits. The term nonqualified deferred compensation plan does not include any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. For these purposes, the term disability pay has the same meaning as provided in § 31.3121(v)(2)-1(b)(4)(iv)(C) of the Employment Tax Regulations, and the term death benefit plan refers to a plan providing death benefits as defined in § 31.3121(v)(2)-1(b)(4)(iv)(C). The term nonqualified deferred compensation plan also does not include any Archer Medical Savings Account as described in § 220, any Health Savings Account as described in § 223, or any other medical reimbursement arrangement, including a health reimbursement arrangement, that satisfies the requirements of § 105 and § 106.

Q-4 What constitutes a deferral of compensation?

A-4 (a) Deferral of compensation defined. A plan provides for the deferral of compensation only if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year. A service provider does not have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated by the service recipient or other person after the services creating the right to the compensation have been performed. However, if the facts and circumstances indicate that the discretion to reduce or eliminate the compensation is available or exercisable only upon a condition that is unlikely to occur, or the discretion to reduce or eliminate the compensation is unlikely to be exercised, a service provider will be considered to have a legally binding right to the compensation. For this purpose, compensation is not considered subject to unilateral reduction or elimination merely because it may be reduced or eliminated by operation of the objective terms of the plan, such as the application of an objective provision creating a substantial risk of forfeiture (within the meaning of Q&A 10). Similarly, a service provider does not fail to have a legally binding right to compensation merely because the amount of compensation is determined under a formula that provides for benefits to be offset by benefits provided under a plan that is qualified under § 401(a), or because benefits are reduced due to actual or notional investment losses, or in a final average pay plan, subsequent decreases in compensation.

(b) Compensation payable pursuant to the service recipient's customary payment timing arrangement. A deferral of compensation does not occur solely because compensation is paid after the last day of the service provider's taxable year pursuant to the timing arrangement under which the service recipient normally compensates service providers for services performed during a payroll period described in § 3401(b), or with respect to a non-employee service provider, a period not longer than the payroll period described in § 3401(b).

(c) Short-term deferrals. Until additional guidance is issued, a deferral of compensation does not occur if, absent an election to otherwise defer the payment to a later period, at all times the terms of the plan require payment by, and an amount is actually or constructively received by the service provider by, the later of (i) the date that is 2 ½ months from the end of the service provider's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture (as defined in Q&A 10) or (ii) the date that is 2 ½ months from the end of the service recipient's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture (as defined in Q&A 10). For these purposes, an amount that is never subject to a substantial risk of forfeiture is considered to be no longer subject to a substantial risk of forfeiture on the date the service provider has a legally binding right to the amount. For example, an employer with a calendar year taxable year who on November 1, 2006 awards a bonus so that the employee is considered to have a legally binding right to the payment as of November 1, 2006, will not be considered to have provided for a deferral of compensation if, in accordance with the terms of the bonus plan, the amount is paid or made available to the employee on or before March 15, 2007. An employer with a September 1 to August 31 taxable year who on November 1, 2006 awards a bonus so that the employee is considered to have a legally binding right to the payment as of November 1, 2006, will not be considered to have provided for a deferral of compensation if, in accordance with the terms of the bonus plan, the amount is paid or made available to the employee on or before November 15, 2007. Notwithstanding the foregoing, if an election is provided to the service provider with respect to the taxable year in which payment of the compensation will occur, and the service provider elects a taxable year later than the taxable year in which he or she obtained a legally binding right to the payment, the arrangement constitutes a deferral of compensation subject to § 409A, including the deferral election timing rules of § 409A(a)(4). In addition, the arrangement continues to be subject to applicable U.S. Federal tax principles which may require immediate income inclusion.

(d) Stock options, stock appreciation rights, and other equity-based compensation. (i) Except as provided in paragraphs (ii), (iii) and (iv), the grant of a stock option, stock appreciation right or other equity-based compensation provides for a deferral of compensation subject to § 409A. Stock appreciation rights generally will be covered by § 409A; however, stock appreciation rights may be structured to comply with the provisions of § 409A. For example, the terms of a stock appreciation right with a fixed payment date generally will comply with the provisions of § 409A.

(ii) Nonstatutory stock options. An option to purchase stock of the service recipient, other than an incentive stock option described in § 422 or an option granted under an employee stock purchase plan described in § 423, does not provide for a deferral of compensation if: (1) the amount required to purchase stock under the option (the exercise price) may never be less than the fair market value of the underlying stock on the date the option is granted, (2) the receipt, transfer or exercise of the option is subject to taxation under § 83, and (3) the option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of exercise or disposition of the option under § 1.83-7. For purposes of the preceding sentence, the right to receive substantially nonvested stock (as defined in § 1.83-3(b)) upon the exercise of a stock option does not constitute a feature for the deferral of compensation. If under the terms of the option, the amount required to purchase the stock is or could become less than the fair market value of the stock on the date of grant, the grant of the stock option may provide for the deferral of compensation within the meaning of this A-4. For purposes of determining the fair market value of the stock at the date of grant, any reasonable valuation method may be used. Such methods include, for example, the valuation method described in § 20.2031-2 of the Estate Tax Regulations. To the extent an arrangement grants the recipient a right other than to purchase stock at a defined price and such additional rights allow for the deferral of compensation (for example, tandem arrangements involving options and stock appreciation rights), the entire arrangement provides for the deferral of compensation. If the requirements of § 1.424-1 would be met if the nonstatutory option were a statutory option, the substitution of a new option pursuant to a corporate transaction for an outstanding option or the assumption of an outstanding option will not be treated as the grant of a new option or a change in the form of payment for purposes of § 409A. For purposes of the preceding sentence, the requirement of § 1.424-1(a)(5)(iii) will be deemed to be satisfied if the ratio of the option price to the fair market value of the shares subject to the option immediately after the substitution or assumption is not greater than the ratio of the option price to the fair market value of the shares subject to the option immediately before the substitution or assumption.

(iii) Statutory stock options. The grant of an incentive stock option as described in § 422, or the grant of an option under an employee stock purchase plan described in § 423 (including the grant of an option with an exercise price discounted in accordance with § 423(b)(6) and the accompanying regulations), does not constitute a deferral of compensation.

(iv) Certain stock appreciation rights. A stock appreciation right with respect to stock of the service recipient does not provide for a deferral of compensation if: (1) the value of the stock the excess over which the right provides for payment upon exercise (the SAR exercise price) may never be less than the fair market value of the underlying stock on the date the right is granted, (2) the stock of the service recipient subject to the right is traded on an established securities market, (3) only such traded stock of the service recipient may be delivered in settlement of the right upon exercise, and (4) the right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right. For purposes of the preceding sentence, the right to receive substantially nonvested stock (as defined in § 1.83-3(b)) upon the exercise of a stock appreciation right does not constitute a feature for the deferral of compensation. If, under the terms of the stock appreciation right, the SAR exercise price is or could become less than the fair market value of the underlying stock on the date of grant, the right may be settled upon exercise in a medium other than the traded stock of the service recipient, or there is an agreement or arrangement under which the service recipient will purchase the stock delivered in settlement of the right upon exercise, then the grant of the stock appreciation right may provide for the deferral of compensation within the meaning of this A-4. In addition, until further guidance is issued, a payment of stock or cash pursuant to the exercise of a stock appreciation right (or economically equivalent right), or the cancellation of such right for consideration, where such right is granted pursuant to a program in effect on or before October 3, 2004 will not be treated as a payment of a deferral of compensation subject to the requirements of § 409A if: (1) the SAR exercise price may never be less than the fair market value of the underlying stock on the date the right is granted, and (2) the right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right.

(e) Restricted property. If a service provider receives property from, or pursuant to, a plan maintained by a service recipient, there is no deferral of compensation merely because the value of the property is not includible in income (under § 83) in the year of receipt by reason of the property being nontransferable and subject to a substantial risk of forfeiture, or is includible in income (under § 83) solely due to a valid election under § 83(b). However, a plan under which a service provider obtains a legally binding right to receive property (whether or not the property is restricted property) in a future year may provide for the deferral of compensation and, accordingly, may constitute a nonqualified deferred compensation plan. For purposes of this paragraph, a transfer of property includes the transfer of a beneficial interest in a trust or annuity plan, or a transfer to or from a trust or under an annuity plan, to the extent such a transfer is subject to § 83, § 402(b) or § 403(c).

(f) Earnings. References to the deferral of compensation include references to income (whether actual or notional) attributable to such compensation or such income.

Q-5 Who is the service recipient?

A-5 For purposes of § 409A, the service recipient refers to the person for whom the services are performed, and all persons with whom such person would be considered a single employer under § 414(b) (employees of controlled group of corporations), and all persons with whom such person would be considered a single employer under § 414(c) (employees of partnerships, proprietorships, etc., which are under common control).

Q-6 How Does § 409A Apply to Arrangements Covered by § 457?

A-6 The rules of § 409A apply to nonqualified deferred compensation plans under § 457(f) in addition to any requirements already applicable to such plans under § 457(f). Eligible plans under § 457(b) are not subject to the requirements of § 409A. However, nonelective deferred compensation of nonemployees described in § 457(e)(12) and grandfathered plans under prior § 457 transition rules generally are subject to § 409A. Pending additional guidance, length of service awards to bona fide volunteers under § 457(e)(11)(A)(ii) are not subject to § 409A. Further, pending additional guidance, State and local government and tax exempt entities may rely on the definitions of bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans for purposes of § 457(f) as applicable for purposes of applying § 409A to nonqualified deferred compensation plans under § 457(f). However, State and local government and tax exempt entities may not rely upon the definition of a deferral of compensation for purposes of § 409A as applicable for purposes of the § 457(f) definition of a deferral of compensation. For example, for purposes of § 457(f), a deferral of compensation includes stock options (whether nonstatutory or under § 422 or § 423) and arrangements in which an employee or independent contractor of a State or local government or tax-exempt entity earns the right to future payments for services, even if those amounts are paid immediately upon vesting.

Q-7 How Does § 409A Apply to Arrangements Between a Partnership and a Partner of the Partnership?

A-7 The application of § 409A is not limited to arrangements between an employer and employee. Accordingly, § 409A may apply to arrangements between a partner and a partnership which provides for the deferral of compensation under a nonqualified deferred compensation plan. However, until additional guidance is issued, for purposes of § 409A taxpayers may treat the issuance of a partnership interest (including a profits interest), or an option to purchase a partnership interest, granted in connection with the performance of services under the same principles that govern the issuance of stock (see Q&A 4). Specifically, until additional guidance is issued, for purposes of § 409A, taxpayers may treat an issuance of a profits interest in connection with the performance of services that is properly treated under applicable guidance as not resulting in inclusion of income by the service provider at the time of issuance, as also not resulting in the deferral of compensation. Similarly, until additional guidance is issued, for purposes of § 409A, taxpayers may treat an issuance of a capital interest in connection with the performance of services in the same manner as an issuance of stock. The § 409A rules governing other stock-based compensation may be applied by analogy to grants of equity-based compensation where the compensation is determined by reference to partnership equity. In addition, until further guidance is issued, taxpayers may treat arrangements providing for payments subject to § 736 as not being subject to § 409A, except that an arrangement providing for payments which qualify as payments to a partner under § 1402(a)(10) are subject to § 409A. Finally, § 409A may apply to payments covered by § 707(a)(1) (partner not acting in capacity as partner), if such payments otherwise would constitute a deferral of compensation under a nonqualified deferred compensation plan.

Q-8 To Which Service Providers Does § 409A Apply?

A-8 Until additional guidance is issued, a service provider for purposes of § 409A includes (i) an individual, (ii) a personal service corporation (as defined in § 269A(b)(1)), or a noncorporate entity that would be a personal service corporation if it were a corporation, or (iii) a qualified personal service corporation (as defined in § 448(d)(2)), or a noncorporate entity that would be a qualified personal service corporation if it were a corporation. Section 409A does not apply to arrangements between taxpayers all of whom use the accrual method of accounting. Section 409A also does not apply to arrangements between a service provider and a service recipient if (a) the service provider is actively engaged in the trade or business of providing substantial services, other than (I) as an employee or (II) as a director of a corporation; and (b) the service provider provides such services to two or more service recipients to which the service provider is not related and that are not related to one another. For purposes of the preceding sentence, a person is related to another person if (i) the persons bear a relationship to each other that is specified in § 267(b) or 707(b)(1), subject to the modifications that the language "20 percent" is used instead of "50 percent" each place it appears in §§ 267(b) and 707(b)(1), and § 267(c)(4) is applied as if the family of an individual includes the spouse of any member of the family; or (ii) the persons are engaged in trades or businesses under common control (within the meaning of § 52(a) and (b)). The Treasury Department and the Service intend to issue additional guidance addressing types of service providers not subject to § 409A.

Q-9 What constitutes a plan?

A-9 A plan includes any agreement, method or arrangement, including an agreement, method or arrangement that applies to one person or individual. A plan may be adopted unilaterally by the service recipient or may be negotiated among or agreed to by the service recipient and one or more service providers or service provider representatives. An agreement, method or arrangement may constitute a plan regardless of whether it is an employee benefit plan under § 3(3) of the Employee Retirement Income Security Act of 1974 (ERISA), as amended (29 U.S.C. 1002(3)). Unless otherwise specified in this notice, the requirements of § 409A are applied as if (a) a separate plan or plans is maintained for each service provider, and (b) all compensation deferred with respect to a particular service provider under an account balance plan (as defined in § 31.3121(v)(2)-1(c)(1)(ii)(A)) is treated as deferred under a single plan, all compensation deferred under a nonaccount balance plan (as defined in § 31.3121(v)(2)-1(c)(2)(i)) is treated as deferred under a separate single plan, and all compensation deferred under a plan that is neither an account balance plan nor a nonaccount balance plan (for example, discounted stock options, stock appreciation rights or other equity-based compensation described in § 31.3121(v)(2)-1(b)(4)(ii)) is treated as deferred under a separate single plan. For these purposes a severance plan is either an account balance plan or a nonaccount balance plan, determined in accordance with the rules of this A-9.

Q-10 When is an amount subject to a substantial risk of forfeiture?

A-10 (a) Definition. Compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. For purposes of this A-10, a condition related to a purpose of the compensation must relate to the service provider's performance for the service recipient or the service recipient's business activities or organizational goals (for example, the attainment of a prescribed level of earnings, equity value or a liquidity event). Any addition of a substantial risk of forfeiture after the beginning of the service period to which the compensation relates, or any extension of a period during which compensation is subject to a substantial risk of forfeiture, in either case whether elected by the service provider, service recipient or other person (or by agreement of two or more of such persons), is disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture. An amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from performance of services. For purposes of § 409A, an amount will not be considered subject to a substantial risk of forfeiture beyond the date or time at which the recipient otherwise could have elected to receive the amount of compensation, unless the amount subject to a substantial risk of forfeiture (ignoring earnings) is materially greater than the amount the recipient otherwise could have elected to receive. For example, a salary deferral generally may not be made subject to a substantial risk of forfeiture. However, where an election is granted to receive a materially greater bonus amount in a future year rather than a materially lesser bonus amount in an earlier year, the materially greater bonus may be made subject to a substantial risk of forfeiture.

(b) Enforcement of forfeiture condition. In determining whether the possibility of forfeiture is substantial in the case of rights to compensation granted to a service provider by the service recipient corporation, where the service provider owns a significant amount of the total combined voting power or value of all classes of stock of the service recipient corporation or of its parent corporation, there will be taken into account (i) the service provider's relationship to other stockholders and the extent of their control, potential control and possible loss of control of the corporation, (ii) the position of the service provider in the corporation and the extent to which the service provider is subordinate to other service providers, (iii) the service provider's relationship to the officers and directors of the corporation, (iv) the person or persons who must approve the service provider's discharge, and (v) past actions of the service recipient in enforcing the restrictions. For example, if a service provider would be considered as having deferred compensation subject to a substantial risk of forfeiture, but for the fact that the service provider owns 20 percent of the single class of stock in the transferor corporation, and if the remaining 80 percent of the class of stock is owned by an unrelated individual (or members of such an individual's family) so that the possibility of the corporation enforcing a restriction on such rights is substantial, then such rights are subject to a substantial risk of forfeiture. On the other hand, if 4 percent of the voting power of all the stock of a corporation is owned by the president of such corporation and the remaining stock is so diversely held by the public that the president, in effect, controls the corporation, then the possibility of the corporation enforcing a restriction on the right to deferred compensation of the president is not substantial, and such rights are not subject to a substantial risk of forfeiture.

B. Change in Control Events

Q-11 Under what circumstances will payments be permitted upon a change in the ownership or effective control of a corporation, or a change in the ownership of a substantial portion of the assets of a corporation?

A-11 (a) In general. Pursuant to § 409A(a)(2)(A)(v), a plan may permit a payment upon the occurrence of a change in the ownership of the corporation (as defined in Q&A 12), a change in effective control of the corporation (as defined in Q&A 13), or a change in the ownership of a substantial portion of the assets of the corporation (as defined in Q&A 14) (collectively referred to as a Change in Control Event). To qualify as a Change in Control Event, the occurrence of the event must be objectively determinable and any requirement that any other person, such as a plan administrator or board of directors compensation committee, certify the occurrence of a Change in Control Event must be strictly ministerial and not involve any discretionary authority. For purposes of this paragraph (a), a payment also will be treated as occurring upon a Change in Control Event if the right to the payment arises due to the corporation's exercise of discretion under the terms of the plan to terminate the plan and distribute the compensation deferred thereunder within 12 months of the Change in Control Event. The plan may provide for a payment on any Change in Control Event, and need not provide for a payment on all such events, provided that each event upon which a payment is provided qualifies as a Change in Control Event.

(b) Identification of relevant corporation(s). To constitute a Change in Control Event as to the plan participant, the Change in Control Event must relate to (i) the corporation for whom the participant is performing services at the time of the Change in Control Event, (ii) the corporation that is liable for the payment of the deferred compensation (or all corporations liable for the payment if more than one corporation is liable), or (iii) a corporation that is a majority shareholder of a corporation identified in (i) or (ii), or any corporation in a chain of corporations in which each corporation is a majority shareholder of another corporation in the chain, ending in a corporation identified in (i) or (ii). For example, assume Corporation A is a majority shareholder of Corporation B, which is a majority shareholder of Corporation C. A change in ownership of Corporation B will constitute a Change in Control Event to plan participants performing services for Corporation B or Corporation C, and to plan participants for which Corporation B or Corporation C is solely liable for payments under the plan (for example, former employees), but will not constitute a Change in Control Event as to Corporation A or any other corporation of which Corporation A is a majority shareholder. Notwithstanding the foregoing, a sale of Corporation B may constitute an independent Change in Control Event for Corporation A, Corporation B and Corporation C if the sale constitutes a change in the ownership of a substantial portion of Corporation A's assets (see Q&A 14). For purposes of this paragraph, a majority shareholder is a shareholder owning more than 50% of the total fair market value and total voting power of such corporation.

(c) Attribution of stock ownership. For purposes of this A-11, Q&A 12, Q&A 13 and Q&A 14, § 318(a) applies to determine stock ownership. Stock underlying a vested option is considered owned by the individual who holds the vested option (and the stock underlying an unvested option is not considered owned by the individual who holds the unvested option). For purposes of the preceding sentence, however, if a vested option is exercisable for stock that is not substantially vested (as defined by §§ 1.83-3(b) and (j)), the stock underlying the option is not treated as owned by the individual who holds the option. In addition, mutual and cooperative corporations are treated as having stock for purposes of this paragraph (c).

Q-12 What is a change in the ownership of a corporation?

A-12 (a) Change in the ownership of a corporation. For purposes of § 409A, a change in the ownership of a corporation occurs on the date that any one person, or more than one person acting as a group (as defined in paragraph (b)), acquires ownership of stock of the corporation that, together with stock held by such person or group, constitutes more than 50 percent of the total fair market value or total voting power of the stock of such corporation. However, if any one person or more than one person acting as a group, is considered to own more than 50 percent of the total fair market value or total voting power of the stock of a corporation, the acquisition of additional stock by the same person or persons is not considered to cause a change in the ownership of the corporation (or to cause a change in the effective control of the corporation (within the meaning of Q&A 13)). An increase in the percentage of stock owned by any one person, or persons acting as a group, as a result of a transaction in which the corporation acquires its stock in exchange for property will be treated as an acquisition of stock for purposes of this section. This A-12 applies only when there is a transfer of stock of a corporation (or issuance of stock of a corporation) and stock in such corporation remains outstanding after the transaction (see Q&A 14 for rules regarding the transfer of assets of a corporation).

(b) Persons acting as a group. For purposes of paragraph (a), persons will not be considered to be acting as a group solely because they purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation. See § 1.280G-1, Q&A 27(d), Example 4.

(c) Stock ownership. For purposes of determining stock ownership, see Q&A 11.

Q-13 What is a change in the effective control of a corporation?

A-13 (a) Change in the effective control of the corporation. For purposes of § 409A, notwithstanding that a corporation has not undergone a change in ownership under Q&A 12, a change in the effective control of a corporation occurs on the date that either –

(i) Any one person, or more than one person acting as a group (as determined under paragraph (iv)), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) ownership of stock of the corporation possessing 35 percent or more of the total voting power of the stock of such corporation; or

(ii) a majority of members of the corporation's board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation's board of directors prior to the date of the appointment or election, provided that for purposes of this paragraph (ii) the term corporation refers solely to the relevant corporation identified in Q&A 11, paragraph (b) for which no other corporation is a majority shareholder for purposes of that paragraph (for example, if Corporation A is a publicly held corporation with no majority shareholder, and Corporation A is the majority shareholder of Corporation B, which is the majority shareholder of Corporation C, the term corporation for purposes of this paragraph (ii) would refer solely to Corporation A).

In the absence of an event described in paragraph (i) or (ii), a change in the effective control of a corporation will not have occurred.

(b) Multiple Change in Control Events. A change in effective control also may occur in any transaction in which either of the two corporations involved in the transaction has a Change in Control Event under A-12 or A-14. Thus, for example, assume Corporation P transfers more than 40 percent of the total gross fair market value of its assets to Corporation O in exchange for 35 percent of O's stock. P has undergone a change in ownership of a substantial portion of its assets under A-14 and O has a change in effective control under this A-13.

(c) Acquisition of additional control. If any one person, or more than one person acting as a group, is considered to effectively control a corporation (within the meaning of this A-13), the acquisition of additional control of the corporation by the same person or persons is not considered to cause a change in the effective control of the corporation (or to cause a change in the ownership of the corporation within the meaning of Q&A 12).

(d) Persons acting as a group. Persons will not be considered to be acting as a group solely because they purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only with respect to the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(e) Stock ownership. For purposes of determining stock ownership, see Q&A 11.

Q-14 What is a change in the ownership of a substantial portion of a corporation's assets?

A-14 (a) Change in the ownership of a substantial portion of a corporation's assets. For purposes of § 409A, a change in the ownership of a substantial portion of a corporation's assets occurs on the date that any one person, or more than one person acting as a group (as determined in paragraph (c)), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) assets from the corporation that have a total gross fair market value equal to or more than 40 percent of the total gross fair market value of all of the assets of the corporation immediately prior to such acquisition or acquisitions. For this purpose, gross fair market value means the value of the assets of the corporation, or the value of the assets being disposed of, determined without regard to any liabilities associated with such assets.

(b) Transfers to a related person. There is no Change in Control Event under this A-14 when there is a transfer to an entity that is controlled by the shareholders of the transferring corporation immediately after the transfer, as provided in this paragraph (b). A transfer of assets by a corporation is not treated as a change in the ownership of such assets if the assets are transferred to –

(i) A shareholder of the corporation (immediately before the asset transfer) in exchange for or with respect to its stock;

(ii) An entity, 50 percent or more of the total value or voting power of which is owned, directly or indirectly, by the corporation;

(iii) A person, or more than one person acting as a group, that owns, directly or indirectly, 50 percent or more of the total value or voting power of all the outstanding stock of the corporation; or

(iv) An entity, at least 50 percent of the total value or voting power of which is owned, directly or indirectly, by a person described in paragraph (iii).

For purposes of this paragraph (b) and except as otherwise provided, a person's status is determined immediately after the transfer of the assets. For example, a transfer to a corporation in which the transferor corporation has no ownership interest before the transaction, but which is a majority-owned subsidiary of the transferor corporation after the transaction is not treated as a change in the ownership of the assets of the transferor corporation.

(c) Persons acting as a group. Persons will not be considered to be acting as a group solely because they purchase assets of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of assets, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only to the extent of the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(d) Stock ownership. For purposes of determining stock ownership, see Q&A 11.

C. Acceleration of Payments

Q-15 Under what conditions may a plan permit the acceleration of the time or schedule of any payment under the plan?

A-15 (a) In general. Except as provided in paragraphs (b) through (f) below, a plan may not permit the acceleration of the time or schedule of any payment under the plan. It is not an acceleration of the time or schedule of payment of a deferral of compensation if a service recipient waives or accelerates the satisfaction of a condition constituting a substantial risk of forfeiture applicable to such deferral of compensation, provided that the requirements of § 409A are otherwise satisfied with respect to such deferral of compensation. For example, if a nonqualified deferred compensation plan provides for a lump sum payment of the vested benefit upon separation from service, and the benefit vests under the plan only after 10 years of service, it is not a violation of the requirements of § 409A if the service recipient reduces the vesting requirement to 5 years of service, even if a service provider becomes vested as a result and qualifies for a payment in connection with a separation from service.

(b) Domestic relations order. A plan may permit such acceleration of the time or schedule of a payment under the plan to an individual other than the plan participant as may be necessary to fulfill a domestic relations order (as defined in § 414(p)(1)(B)).

(c) Conflicts of interest. A plan may permit such acceleration of the time or schedule of a payment under the plan as may be necessary to comply with a certificate of divestiture (as defined in § 1043(b)(2)).

(d) Section 457 plans. A plan subject to § 457(f) may permit an acceleration of the time or schedule of a payment to a participant to pay income taxes due upon a vesting event, provided that the amount of such payment is not more than an amount equal to the income tax withholding that would have been remitted by the employer if there had been a payment of wages equal to the income includible by the participant under § 457(f) at the time of the vesting.

(e) De minimis and specified amounts. A plan that does not otherwise provide for de minimis cashout payments may be amended to permit the acceleration of the time or schedule of a payment to a participant under the plan, provided that (i) the payment accompanies the termination of the entirety of the participant's interest in the plan; (ii) the payment is made on or before the later of (A) December 31 of the calendar year in which occurs the participant's separation from service from the service recipient or (B) the date 2 ½ months after the participant's separation from service from the service recipient; and (iii) the payment is not greater than $10,000. Such an amendment may be made with respect to previously deferred amounts under the plan as well as amounts to be deferred in the future. In addition, a nonqualified deferred compensation plan that otherwise complies with § 409A may be amended with regard to future deferrals to provide that, if a participant's interest under the plan has a value below an amount specified by the plan at the time that amounts are payable under the plan, then the participant's entire interest under the plan shall be distributed as a lump sum payment.

(f) Payment of employment taxes. A plan may permit the acceleration of the time or schedule of a payment to pay the Federal Insurance Contributions Act (FICA) tax imposed under § 3101 and § 3121(v)(2) on compensation deferred under the plan (the FICA Amount). Additionally, a plan may permit the acceleration of the time or schedule of a payment to pay the income tax at source on wages imposed under § 3401 on the FICA Amount, and to pay the additional income tax at source on wages attributable to the pyramiding § 3401 wages and taxes. However, the total payment under this acceleration provision must not exceed the aggregate of the FICA Amount, and the income tax withholding related to such FICA amount.

(g) Definition of plan. For purposes of this A-15, the term plan has the meaning provided in Q&A 9, except that the provisions treating all account balance plans under which compensation is deferred as a single plan, all nonaccount balance plans under which compensation is deferred as a separate single plan, and all other nonqualified deferred compensation plans as a separate single plan, does not apply.

D. Effective Dates and Transition Guidance

Q-16 When does section 409A become effective?

A-16 (a) In general. Except as provided in Q&As 19 through 23, § 409A is effective with respect to (i) amounts deferred in taxable years beginning after December 31, 2004; and (ii) amounts deferred in taxable years beginning before January 1, 2005 if the plan under which the deferral is made is materially modified after October 3, 2004. Section 409A is effective with respect to earnings on amounts deferred only to the extent that § 409A is effective with respect to the amounts deferred. Accordingly, § 409A is not effective with respect to earnings on amounts deferred before January 1, 2005 unless § 409A is effective with respect to the amounts deferred.

(b) Date of deferral for effective date purposes. For purposes of determining whether § 409A is effective with respect to an amount, the amount is considered deferred before January 1, 2005 if (i) the service provider has a legally binding right to be paid the amount and (ii) the right to the amount is earned and vested. For purposes of this A-16, a right to an amount is earned and vested only if the amount is not subject to either a substantial risk of forfeiture (as defined in § 1.83-3(c)) or a requirement to perform further services. Accordingly, amounts to which the service provider does not have a legally binding right before January 1, 2005 (for example because the service recipient retains discretion to reduce the amount), will not be considered deferred before January 1, 2005. In addition, amounts to which the service provider has a legaly binding right before January 1, 2005, but the right to which is subject to a substantial risk of forfeiture or a requirement to perform further services after December 31, 2004 are not considered deferred before January 1, 2005 for purposes of the effective date. Notwithstanding the foregoing, an amount to which the service provider has a legally binding right before January 1, 2005, but for which the service provider must continue performing services to retain the right only through the completion of the payroll period (as defined in Q&A 4) which includes December 31, 2004, shall not be treated as subject to a requirement to perform further services (or a substantial risk of forfeiture) for purposes of the effective date.

Q-17 For purposes of the effective date, how is the amount of compensation deferred under a nonqualified deferred compensation plan before January 1, 2005 determined?

A-17 (a) Nonaccount balance plans. The amount of compensation deferred before January 1, 2005 under a nonqualified deferred compensation plan that is a nonaccount balance plan (as defined in § 31.3121(v)(2)-1(c)(2)(i)) equals the present value as of December 31, 2004 of the amount to which the participant would be entitled under the plan if the participant voluntarily terminated services without cause on December 31 of that taxable year, and received a full payment of benefits from the plan on the earliest possible date allowed under the plan following the termination of services, to the extent the right to the benefit is earned and vested (as defined in Q&A 16) as of December 31, 2004. For purposes of determining the present value of the benefit, the actuarial assumptions contained within the plan are used provided such assumptions are reasonable; otherwise, reasonable actuarial assumptions must be used. Amounts to which the participant would not be entitled upon termination, such as early retirement subsidies for which the participant would not have attained sufficient service if he or she terminated services on December 31, 2004, are not includible as compensation deferred under the plan as of December 31, 2004.

(b) Account balance plans. The amount of compensation deferred before January 1, 2005 under a nonqualified deferred compensation plan that is an account balance plan (as defined in § 31.3121(v)(2)-1(c)(1)(ii)) equals the portion of the participant's account balance as of December 31, 2004 the right to which is earned and vested (as defined in Q&A 16) as of December 31, 2004.

(c) Equity-based compensation plans. For purposes of determining the amounts deferred before January 1, 2005 under an equity-based compensation plan, the rules of paragraph (b) governing account balance plans are applied except that the account balance is deemed to be the amount of the payment available to the participant on December 31, 2004 (or that would be available to the participant if the right were immediately exercisable) the right to which is earned and vested (as defined in Q&A 16) as of December 31, 2004. For this purpose, the payment available to the participant excludes any exercise price or other amount which must be paid by the participant.

(d) Earnings. Earnings on amounts deferred under a plan before January 1, 2005 include only income (whether actual or notional) attributable to the amounts deferred under a plan as of December 31, 2004 or such income. For example, notional interest earned under the plan on amounts deferred in an account balance plan as of December 31, 2004 generally will be treated as earnings on amounts deferred under the plan before January 1, 2005. Similarly, an increase in the amount of payment available under a stock option, stock appreciation right or other equity-based compensation above the amount of payment available as of December 31, 2004, due to appreciation in the underlying stock after December 31, 2004, is treated as earnings on the amount deferred. In the case of a nonaccount balance plan, earnings include the increase, due solely to the passage of time, in the present value of the future payments to which the service provider has obtained a legally binding right, the present value of which constituted the amounts deferred under the plan before January 1, 2005. Thus, for each year, there will be an increase (determined using the same interest rate used to determine the amounts deferred under the plan before January 1, 2005) resulting from the shortening of the discount period before the future payments are made, plus, if applicable, an increase in the present value resulting from the service provider's survivorship during the year. However, an increase in the potential benefits under a nonaccount balance plan due to, for example, an application of an increase in compensation after December 31, 2004 to a final average pay plan or subsequent eligibility for an early retirement subsidy, does not constitute earnings on the amounts deferred under the plan before January 1, 2005.

(e) Definition of plan. For purposes of this A-17, the term plan has the same meaning provided in Q&A 9, except that the provisions treating all nonaccount balance plans under which compensation is deferred as a single plan does not apply for purposes of the actuarial assumptions used in paragraph (b). Accordingly, different reasonable actuarial assumptions may be used to calculate the amounts deferred by a participant in two different arrangements each of which constitutes a nonaccount balance plan.

Q-18 When is a plan materially modified?

A-18 (a) In general. Except as otherwise provided in this A-18 and Q&A 19, a modification of a plan is a material modification if a benefit or right existing as of October 3, 2004 is enhanced or a new benefit or right is added. Such benefit enhancement or addition is a material modification whether it occurs pursuant to an amendment or the service recipient's exercise of discretion under the terms of the plan. For example, an amendment to a plan to add a provision that payments may be allowed upon request if participants are required to forfeit 10 percent of the amount of the payment (a "haircut") would be a material modification to the plan. Similarly, a material modification would occur if a service recipient exercised discretion to accelerate vesting of a benefit under the plan to a date on or before December 31, 2004. However, it is not a material modification for a service recipient to exercise discretion over the time and manner of payment of a benefit to the extent such discretion is provided under the terms of the plan as of October 3, 2004. Also, it is not a material modification to change a notional investment measure to, or to add, an investment measure that qualifies as a predetermined actual investment within the meaning of § 31.3121(v)(2)-1(d)(2). It is not a material modification for a participant to exercise a right permitted under the plan as in effect on October 3, 2004. The amendment of a plan to bring the plan into compliance with the provisions of § 409A will not be treated as a material modification. However, a plan amendment or the exercise of discretion under the terms of the plan that enhances an existing benefit or right or adds a new benefit or right will be considered a material modification even if the enhanced or added benefit would be permitted under § 409A. For example, the addition of a right to a payment upon an unforeseeable emergency would be considered a material modification. The reduction of an existing benefit is not a material modification. For example, the removal of a "haircut" provision generally would not constitute a material modification.

(b) Adoption of new arrangement. It is presumed that the adoption of a new arrangement or the grant of an additional benefit under an existing arrangement after October 3, 2004 will constitute a material modification of a plan. However, the presumption may be rebutted by demonstrating that the adoption of the arrangement or grant of the additional benefit is consistent with the service recipient's historical compensation practices. For example, the presumption that the grant of a stock appreciation right on November 1, 2004 is a material modification of a plan may be rebutted by demonstrating that the grant was consistent with the historic practice of granting substantially similar stock appreciation rights (both as to terms and amounts) each November for a significant number of years. Notwithstanding paragraph (a) and this paragraph (b), the grant of an additional benefit under an existing arrangement that consists solely of a deferral of additional compensation not otherwise provided under the plan as of October 3, 2004 will be treated as a material modification of the plan only as to the additional deferral of compensation, if the plan explicitly identifies the additional deferral of compensation and provides that the additional deferral of compensation is subject to § 409A. A plan may be amended to comply with the provisions of the preceding sentence in accordance with the rules of Q&A 19.

(c) Suspension or termination of a plan. Amending an arrangement to stop future deferrals thereunder is not a material modification of the arrangement or the plan. Amending an arrangement on or before December 31, 2005 to terminate the arrangement and distribute the amounts of deferred compensation thereunder will not be treated as a material modification, provided that all amounts deferred under the plan are included in income in the taxable year in which the termination occurs.

(d) Equity-based compensation. Provided that the cancellation and reissuance occurs on or before December 31, 2005, it will not be a material modification to replace a stock option or stock appreciation right otherwise providing for a deferral of compensation under Q&A 4 with a stock option or stock appreciation right that would not have constituted a deferral of compensation under § 409A if it had been granted upon the original date of grant of the replaced stock option or stock appreciation right. The preceding sentence only applies if (i) the number of shares which form the basis of the new stock option or new stock appreciation right corresponds directly to the number of shares subject to the original stock option or stock appreciation right; and (ii) the new stock option or new stock appreciation right does not provide any additional benefit to the service recipient (other than the benefit directly due to a change in form of the award to a form not treated as a deferral of compensation). A replacement stock option or replacement stock appreciation right will be treated as meeting the requirements of clause (i) of the preceding sentence if the new grant is made in accordance with the principles of § 1.424-1(a)(5) except to the extent necessary to ensure that the new grant does not violate § 409A. For example, a stock option originally issued with an exercise price discounted below the value of the shares subject to the option on the date of grant could be amended, without causing a material modification of the option, to be excluded from the definition of deferral of compensation by eliminating the discount on the exercise price below the value of the shares subject to the option on the original date of grant. Similarly, a stock appreciation right could be converted to a stock option or stock appreciation right that, based on its terms, would be excluded from the definition of deferral of compensation.

(e) Definition of plan. For purposes of this A-18, the term plan has the same meaning provided in Q&A 9, except that the provision treating all account balance plans under which compensation is deferred as a single plan, all nonaccount balance plans under which compensation is deferred as a separate single plan, and all other nonqualified deferred compensation plans as a separate single plan, does not apply.

Q-19 Under what conditions may a plan adopted before December 31, 2005 be operated and amended without violating the requirements of section 409A(a)(2), (3) and (4)?

A-19 (a) In general. A plan adopted before December 31, 2005 will not be treated as violating § 409A(a)(2), (3) or (4) only if (i) the plan is operated in good faith compliance with the provisions of § 409A and this notice during the calendar year 2005, and (ii) the plan is amended on or before December 31, 2005 to conform to the provisions of § 409A with respect to amounts subject to § 409A.

(b) Good faith compliance. A plan will be treated as operated in good faith compliance during the calendar year 2005 if it is operated in accordance with the terms of this notice and, to the extent an issue is not addressed in this notice, a good faith, reasonable interpretation of § 409A, and, to the extent not inconsistent therewith, the plan's terms, provided that the plan sponsor does not exercise discretion under the terms of the plan, or that a participant does not exercise discretion with respect to that participant's benefits, in a manner that causes the plan to fail to meet the requirements of § 409A. For example, if an employer retains the discretion under the terms of the plan to delay or extend payments under the plan and exercises such discretion, the plan will not be considered to be operated in good faith compliance with § 409A with regard to any plan participant. However, an exercise of a right under the terms of the plan by a plan participant solely with respect to that participant's benefits under the plan, in a manner that causes the plan to fail to meet the requirements of § 409A, will not be considered to result in the plan failing to be operated in good faith compliance with respect to other participants. For example, the request for and receipt of an immediate payment permitted under the terms of the plan if the participant forfeits 10% of the participant's benefits (a "haircut") will be considered a failure of the plan to meet the requirements of § 409A with respect to that participant, but not with respect to all participants under the plan.

(c) Payment elections. With respect to amounts subject to § 409A, the plan may be amended to provide for new payment elections with respect to amounts deferred prior to the election and the election will not be treated as a change in the form and timing of a payment under § 409A(a)(4) or an acceleration of a payment under § 409A(a)(3), provided that the plan is so amended and the participant makes the election on or before December 31, 2005. Similarly, an outstanding stock option or stock appreciation right that provides for a deferral of compensation subject to § 409A may be amended to provide for fixed payment terms consistent with § 409A, or to permit holders of such rights to elect fixed payment terms consistent with § 409A, and such amendment or election will not be treated as a change in the form and timing of a payment under § 409A(a)(4) or an acceleration of a payment under § 409A(a)(3), provided that the option or right is so amended and any elections are made, on or before December 31, 2005.

(d) Severance plans. Provided that the plans are otherwise amended in compliance with paragraph (a), a plan that provides severance pay benefits, and that is either (i) a collectively bargained plan or (ii) covers no service providers who are key employees (as defined in § 416(i) and the regulations thereunder), is not required to meet the requirements of § 409A during the calendar year 2005 with respect to such severance pay benefits. Benefits that are provided under a severance pay arrangement (within the meaning of § 3(2)(B)(i) of ERISA (29

U.S.C. § 1002(2)(B)(i)) that satisfies the conditions in 29 CFR § 2510.3-2(b)(1)(i) through (iii) are considered severance pay for purposes of this paragraph (d). Benefits provided under a severance pay arrangement (within the meaning of § 3(2)(B)(i) of ERISA) are in all cases severance pay within the meaning of this paragraph (d) if the benefits payable under the plan upon an employee's termination of employment are payable only if that termination is involuntary.

Q-20 Under what conditions may a plan adopted before December 31, 2005 provide a participant a right to terminate participation in the plan, or cancel an outstanding deferral election with regard to amounts subject to § 409A, and receive a payment of amounts subject to the termination or cancellation, without violating the requirements of § 409A(a)(2), (3) and (4)?

A-20 (a) Plan amendment. A plan adopted before December 31, 2005 may be amended to allow a participant during all or part of the calendar year 2005 to terminate participation in the plan or cancel a deferral election, without causing the plan to fail to conform to the provisions of § 409A(a)(2), (3) or (4), provided that (i) the amendment is enacted and effective on or before December 31, 2005, and (ii) the amounts subject to the termination or cancellation are includible in income of the participant in the calendar year 2005 or, if later, in the taxable year in which the amounts are earned and vested (as defined in Q&A 16). Solely for purposes of effecting the relief provided in this A-20, neither the availability of the election to the participant nor the making of the election by the participant will be treated as resulting in a violation of the requirements of § 409A(a)(2), (3) or (4) or causing amounts the participant continues to defer to be includible in income under § 451 or the doctrine of constructive receipt (although these provisions may still apply for other reasons). There is no requirement that the opportunity to terminate participation in a plan or to cancel a deferral election be granted, or that if granted, be granted to all plan participants. A termination or cancellation may be made with respect to elective or nonelective deferred compensation and may be undertaken by the service recipient or at the election of the participant. A termination or cancellation under this paragraph may apply in whole or in part to one or more plans in which a participant participates and to one or more outstanding deferral elections the participant has made with regard to amounts subject to § 409A.

(b) Payments. Provided that the plan amendment is adopted in accordance with paragraph (a), a provision permitting a payment to a participant during calendar year 2005 or, if later, the taxable year in which the amount is earned and vested (as defined in Q&A 16), upon a termination of participation in the plan or the cancellation of a deferral election with regard to amounts subject to § 409A, will not be treated as causing a plan to violate the provisions of § 409A(a)(2), (3) or (4), and a payment from a plan pursuant to such an amendment will not be treated as a violation of the provision of § 409A(a)(2), (3) or (4), provided that the full amount of the distribution is included in the participant's income in calendar year 2005 or, if later, the participant's taxable year in which the amount is earned and vested (as defined in Q&A 16).

(c) Partial terminations and cancellations. For purposes of this Q&A 20, the termination of participation in the plan or the cancellation of an outstanding deferral election with regard to amounts subject to § 409A includes a termination or cancellation that results in a lower amount of deferrals for the period, without a complete elimination of the deferrals.

(d) Definition of plan. For purposes of this A-20, the definition of plan under Q&A 9 applies, except that the rule requiring the aggregation of all account balance plans, all nonaccount balance plans, and all other plans does not apply.

Q-21 Under what conditions will deferral elections under a plan in existence on or before December 31, 2004, made with respect to deferrals relating all or in part to services performed on or before December 31, 2005, be exempt from the requirements of § 409A(a)(4)(B) relating to the timing of elections?

A-21 With respect to deferrals subject to § 409A that relate all or in part to services performed on or before December 31, 2005, the requirements of § 409A(a)(4)(B) relating to the timing of elections will not be applicable to any elections made on or before March 15, 2005, provided that (a) the amounts to which the deferral election relate have not been paid or become payable at the time of election, (b) the plan under which the deferral election is or was made was in existence on or before December 31, 2004, (c) the elections to defer compensation are made in accordance with the terms of the plan in effect on or before December 31, 2005 (other than a requirement to make a deferral election after March 15, 2005), (d) the plan is otherwise operated in accordance with § 409A with respect to deferrals subject to § 409A and (e) the plan is amended to comply with the requirements of § 409A in accordance with Q&A 19. For purposes of this A-21, a nonqualified deferred compensation plan will be treated as in existence before December 31, 2004 only if a written plan document (a) identifies a specific amount or type of compensation that is subject to the plan and not otherwise payable at the time of the deferral election, and (b) provides that a participant in the plan may elect to defer the compensation beyond the taxable year in which the amount otherwise would have been payable. Solely for purposes of effecting the relief provided in this A-21, neither the availability of the election to the participant nor the making of the election by the participant will be treated as causing amounts the participant defers to be includible in income under § 451 or the doctrine of constructive receipt.

Q-22 Until additional guidance is issued, under what conditions may deferral elections be made with respect to bonus compensation?

A-22 Section 409A(a)(4)(B)(iii) provides that in the case of any performance-based compensation based on services performed over a period of at least 12 months, an election to defer such compensation may be made no later than 6 months before the end of the period. The Treasury Department and the Service anticipate issuing guidance that sets forth the requirements for compensation to qualify as performance-based compensation. The Treasury Department and the Service anticipate that those requirements will be more restrictive than the requirements outlined in this A-22. Until additional guidance is issued, a deferral election with respect to bonus compensation based on services performed over a period of at least 12 months will be treated as meeting the requirements of § 409A(a)(4) if the election is made at least 6 months before the end of the service period. For purposes of this transition relief, the term bonus compensation refers to compensation where (i) the payment of the compensation or the amount of the compensation is contingent on the satisfaction of organizational or individual performance criteria, and (ii) the performance criteria are not substantially certain to be met at the time a deferral election is permitted. Bonus compensation may include payments based upon subjective performance criteria, but (i) any subjective performance criteria must relate to the performance of the participant service provider, a group of service providers that includes the participant service provider, or a business unit for which the participant service provider provides services (which may include the entire organization); and (ii) the determination that any subjective performance criteria have been met must not be made by the participant service provider or a family member of the participant service provider (as defined in § 267(c)(4) applied as if the family of an individual includes the spouse of any member of the family). Bonus compensation may also include payments based on performance criteria that are not approved by a compensation committee of the board of directors (or similar entity in the case of a non-corporate service recipient) or by the stockholders or members of the service recipient. Notwithstanding the foregoing, bonus compensation does not include any amount or portion of any amount that will be paid either regardless of performance, or based upon a level of performance that is substantially certain to be met at the time the criteria is established, or that is based solely on the value of, or appreciation in value of, the service recipient or the stock of the service recipient.

Q-23 Under what circumstances will payments be permitted based upon elections under a qualified plan for periods ending on or before December 31, 2005.

A-23 For periods ending on or before December 31, 2005, an election as to the timing and form of a payment under a nonqualified deferred compensation plan that is controlled by a payment election made by the participant under a qualified plan will not violate § 409A, provided that the determination of the timing and form of the payment is made in accordance with the terms of the nonqualified deferred compensation plan as of October 3, 2004 that govern payments. For purposes of this paragraph, a qualified plan means a retirement plan qualified under § 401(a). For example, where a nonqualified deferred compensation plan provides as of October 3, 2004 that the time and form of payment to a participant will be the same time and form of payment elected by the participant under a related qualified plan, it will not be a violation of § 409A for the plan administrator to make or commence payments under the nonqualified deferred compensation plan on or after January 1, 2005 and on or before December 31, 2005 pursuant to the payment election under the related qualified plan. Notwithstanding the foregoing, other provisions of the Code and common law tax doctrines continue to apply to any election as to the timing and form of a payment under a nonqualified deferred compensation plan.

E. Information Reporting Requirements for Deferred Amounts

Q-24 What information reporting requirements are imposed by § 885(b) of the Act?

A-24 The Act adds §§ 6041(g)(1) and 6051(a)(13), which require that all deferrals for the year under a nonqualified deferred compensation plan be separately reported on a Form 1099 (Miscellaneous Income) or a Form W-2 (Wage and Tax Statement), respectively. The Act requires annual reporting of all compensation deferred under the plan for the year regardless of whether such compensation is includible in gross income pursuant to § 409A(a)(1)(A). However, neither § 6041(g)(1) nor § 6051(a)(13) requires the reporting of deferrals under a nonqualified deferred compensation plan that benefit a person with respect to whom a Form 1099-MISC or a Form W-2 is not required to be filed.

Q-25 What constitutes deferrals for the year under a nonqualified deferred compensation plan for purposes of §§ 6041(g)(1) and 6051(a)(13)?

A-25 Deferrals for the year under a nonqualified deferred compensation plan for purposes of §§ 6041(g)(1) and 6051(a)(13) generally include all deferrals of compensation within the meaning of § 409A that occur during the year and that are made under a nonqualified deferred compensation plan within the meaning of § 409A(d). <u>See</u> Q&A 4 (definition of a deferral of compensation) and Q&A 3 (definition of a nonqualified deferred compensation plan). The Treasury Department and the Service anticipate issuing additional guidance that will provide a method for calculating the amount of deferrals for the year.

Q-26 Do the information reporting requirements imposed by §§ 6041(g)(1) and 6051(a)(13) apply with respect to amounts deferred under a nonqualified deferred compensation plan that is a nonaccount balance plan?

A-26 Yes. The information reporting requirements imposed by §§ 6041(g)(1) and 6051(a)(13) generally apply with respect to amounts deferred under a nonqualified deferred compensation plan that is a nonaccount balance plan (as defined in § 31.3121(v)(2)-1(c)(2)). However, amounts deferred that are not reasonably ascertainable (as defined in § 31.3121(v)(2)-1(e)(4)) are not required to be reported until such deferrals become reasonably ascertainable (regardless of whether the service provider is an employee). The Treasury Department and the Service anticipate issuing additional guidance that will provide a method for calculating the amount of deferrals for the year under a nonqualified deferred compensation plan.

Q-27 Is there a minimum amount of aggregate deferrals for the year with respect to an individual employee below which the information reporting requirement imposed by § 6051(a)(13) does not apply?

A-27 Yes. The Act authorizes the Secretary of the Treasury, through regulations, to establish a minimum amount of deferrals below which the information reporting requirement imposed by § 6051(a)(13) does not apply. The Treasury Department and the Service anticipate providing the authorized guidance in future regulations. Until such guidance is provided, however, employers may rely on this notice to exclude from the information reporting requirement imposed by § 6051(a)(13) all deferrals for the year with respect to an individual employee under one or more nonqualified deferred compensation plans if the aggregate amount of such deferrals does not exceed $600.

Q-28 What is the effective date for the information reporting requirements imposed by §§ 6041(g)(1) and 6051(a)(13)?

A-28 The information reporting requirements imposed by §§ 6041(g)(1) and 6051(a)(13) are effective for amounts actually deferred in calendar years beginning after December 31, 2004. Additionally, such information reporting requirements apply to income (whether actual or notional) attributable to amounts actually deferred in calendar years beginning after December 31, 2004. For purposes of §§ 6041(g)(1) and 6051(a)(13), amounts are considered actually deferred at the time the service provider has a legally binding right to the compensation as described in Q&A 4. Thus, the information reporting requirements are not effective for amounts actually deferred in calendar years beginning before January 1, 2005, (or for income attributable to such amounts) notwithstanding that § 885(d) of the Act may treat such amounts as having been deferred in a calendar year beginning on or after such date under the general effective date provisions.

Q-29 How should an employer report to an employee the total amount of deferrals for the year under a nonqualified deferred compensation plan as required by § 6051(a)(13)?

A-29 An employer should report to an employee the total amount of deferrals for the year under a nonqualified deferred compensation plan in box 12 of Form W-2 using code Y. The instructions for Form W-2 provide additional information relating to this reporting requirement. However, see Q&A 38 for interim guidance with respect to an employer's reporting requirements where the employer furnishes an expedited Form W-2 prior to the issuance of additional guidance that will provide a method for calculating the amount of deferrals for the year. Neither § 6051(a)(13) nor this notice affect the rules for reporting deferred compensation in Box 11 of Form W-2.

Q-30 How should a payer report to a nonemployee the total amount of deferrals for the year under a nonqualified deferred compensation plan as required by § 6041(g)(1)?

A-30 A payer should report to a nonemployee the total amount of deferrals for the year under a nonqualified deferred compensation plan in box 15a of Form 1099-MISC. The instructions for Form 1099-MISC provide additional information relating to this reporting requirement. However, the information reporting requirement imposed by § 6041(g)(1) does not apply to deferrals that are required to be reported under § 6051(a)(13) (without regard to any de minimis exception). Additionally, § 6041(g)(1) does not require the reporting of deferrals under a nonqualified deferred compensation plan that benefit a person with respect to whom a Form 1099-MISC is not required to be filed.

F. Wage Withholding for Employees

Q-31 What wage withholding requirements are imposed by § 885(b) of the Act?

A-31 The Act amends § 3401(a) (defining wages for income tax withholding purposes) to provide that the term "wages" includes any amount includible in gross income of an employee under § 409A. The amount is treated as a payment of wages in the taxable year in which the amount is includible in the employee's gross income. The Treasury Department and the Service anticipate issuing additional guidance that will provide a method for computing the amount includible in gross income of an employee under § 409A.

Q-32 When are amounts that are includible in gross income under § 409A treated as a payment of wages for income tax withholding purposes?

A-32 For the calendar year 2005, amounts includible in gross income under § 409A but neither actually nor constructively received by an employee may be treated as having been paid by an employer for income tax withholding purposes on any date on or before December 31, 2005. However, nothing in § 409A prevents the inclusion of amounts in gross income and in wages for income tax withholding purposes under any other provision or rule of law on a date earlier than December 31, 2005. Thus, amounts includible in gross income under § 409A and either actually or constructively received by an employee during the calendar year 2005 are considered a payment of wages when received by the employee for purposes of withholding, depositing, and reporting the income tax at source on wages.

Q-33 How should an employer report to an employee amounts includible in gross income under § 409A and in wages under § 3401(a) as required by § 6051(a)(3)?

A-33 An employer should report amounts includible in gross income under § 409A and in wages under § 3401(a) in box 1 of Form W-2 as part of the total wages, tips, and other compensation paid to the employee during the year. Additionally, an employer should report such amounts in box 12 of Form W-2 using code Z. The amount reported in box 12 using code Z should include all amounts deferred under the plan for the taxable year and all preceding taxable years that are currently includible in gross income under § 409A and in wages under § 3401(a). The instructions for Form W-2 provide additional information relating to this reporting requirement. However, see Q&A 38 for interim guidance with respect to an employer's reporting requirements relating to an employee or business that is terminated prior to the issuance of additional guidance that will provide a method for calculating the amounts includible in gross income under § 409A and in wages under § 3401(a).

G. Reporting Nonemployee Compensation

Q-34 What reporting requirements relating to nonemployee compensation are imposed by § 885(b) of the Act?

A-34 The Act adds § 6041(g)(2), which requires a payer to report to a nonemployee any amount includible in gross income under § 409A that is not treated as wages under § 3401(a). However, § 6041(g)(2) does not require the reporting of amounts includible in gross income under § 409A that are treated as having been paid to a person with respect to whom a Form 1099-MISC is not required to be filed.

Q-35 How should a payer report to a nonemployee amounts includible in gross income under § 409A and not treated as wages under § 3401(a) as required by § 6041(g)(2)?

A-35 A payer should report the amounts includible in gross income under § 409A and not treated as wages under § 3401(a) in box 7 (nonemployee compensation) of Form 1099-MISC. Additionally, a payer should report such amounts in box 15b of Form 1099-MISC. The amount reported in box 15b should include only the amounts includible in gross income under § 409A and not included in wages under § 3401(a). The instructions for Form 1099-MISC provide additional information relating to this reporting requirement.

Q-36 What are the SECA tax consequences of a failure to satisfy the requirements of § 409A?

A-36 Gross income of a self-employed individual (for example, a nonemployee director, partner, or independent contractor) derived by the individual from any trade or business is generally subject to tax in accordance with the Self-Employment Contributions Act (SECA) when includible in gross income. See §§ 1401, 1402(a). Accordingly, an amount derived from an individual's trade or business that is includible in the self-employed individual's gross income under § 409A is generally subject to the application of SECA taxes at the time such amount is includible in gross income.

Q-37 Does § 885 of the Act affect the imposition of the employee tax and the employer tax under the Federal Insurance Contributions Act (FICA) with respect to wages paid and received for employment under a nonqualified deferred compensation plan within the meaning of § 409A(d)?

A-37 No. Section 885 of the Act does not affect the imposition of the employee tax and the employer tax under FICA with respect to wages paid and received for employment under a nonqualified deferred compensation plan within the meaning of § 409A(d). Thus, remuneration for employment constituting wages within the meaning of § 3121(a) is taken into account for FICA tax purposes in accordance with the rules for wage inclusion under §§ 3121(a) and 3121(v)(2).

H. Interim Reporting for Expedited Form W-2

Q-38 What are an employer's withholding and reporting obligations where an employee is terminated or a business files a final Form 941 prior to the issuance of further guidance providing methods for calculating the amount of deferrals for the year and the amounts includible in gross income under § 409A and in wages under § 3401(a)?

A-38 An employer is generally required to issue a Form W-2 reporting compensation paid during a calendar year no later than January 31 of the succeeding calendar year. However, if an employee's employment is terminated before the close of the calendar year, an employer must furnish an expedited Form W-2 if requested to do so by the employee. Additionally, an employer may, at its option, furnish a Form W-2 to such an employee at any time after the termination but no later than January 31 of the succeeding calendar year. See § 31.6051-1(d)(i). In addition, if an employer makes a final return on Form 941, the employer must furnish expedited Form W-2s to employees and file expedited Form W-2s with the Social Security Administration. See §§ 31.6051-1(d)(ii), 31.6071(a)-1. If an employer furnishes an expedited Form W-2 before the issuance of additional guidance providing methods for determining the amount of deferrals for the year or the amounts includible in gross income under § 409A and in wages under § 3401(a), the employer need not report an amount described in Q&A-25 (deferrals for the year) or in Q&A-31 (amounts includible in gross income and wages) on the Form W-2. However, if an employer furnishes an expedited Form W-2 prior to the issuance of additional guidance that requires the employer to report a deferral for the year or an amount includible in gross income and wages, then the employer must subsequently furnish a corrected Form W-2. See § 31.6051(c).

IV. Drafting Information

The principal author of this notice is Stephen Tackney of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) and, regarding the employment tax and information reporting requirements, Neil D. Shepherd of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the Treasury Department and the Service participated in its development. For further information regarding this notice, contact Stephen Tackney (202) 927-9639; or for further information regarding the employment tax and information reporting requirements, Neil D. Shepherd (202) 622-6040; or regarding the submission of comments, contact Lanita Van Dyke (202) 622-7180 (not toll-free calls).

FROM THE OFFICE OF PUBLIC AFFAIRS

January 7, 2005
js-2181

Statement by Treasury Secretary John Snow on the President's Panel on Federal Tax Reform

"The President's bipartisan panel on tax reform, announced today, brings together some of our nation's brightest minds. Reforming our tax code to give Americans a tax system that fosters economic growth and is fairer and simpler will be a historic effort. I look forward to working with this group of extraordinarily distinguished individuals to make recommendations to help achieve this important goal."

FROM THE OFFICE OF PUBLIC AFFAIRS

January 7, 2005
js-2182

Statement by Treasury Secretary John Snow on the Resignation of Carole Brookins, U.S. Executive Director of the World Bank

"I deeply appreciate the work Carole Brookins has done in representing the Bush Administration on the executive board of the World Bank for nearly four years. In this role, Carole has been a tireless and effective advocate for our reform efforts. Because of her work, World Bank programs are better able to serve the needs of the world's poorest citizens. I particularly want to recognize the role Carole played in encouraging the Bank to focus attention on private sector development and the creation of strong investment climates in developing countries. Carole played a leading role in developing collaborative programs between the World Bank's International Development Agency (IDA) and the International Finance Corporation, providing critical support to small enterprise development in sub-Saharan Africa. She also helped in achieving President Bush's initiatives to deliver IDA assistance in the form of grants instead of loans, and to adopt results-based measurement programs. In addition, Carole was a consistent advocate of partnering the private and public sectors to develop infrastructure in the poorest countries. Her service at the Bank on behalf of President Bush will be noted for her determination to ensure that scarce development resources are used effectively and efficiently to lift people out of poverty. I wish Carole the best as she moves on to new challenges."

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 7, 2005
js-2183

Statement of Treasury Secretary John W. Snow on December Employment Report

The creation of 157,000 new jobs in December shows the continuing good strength of the American economy. The past year was a very good one for our economy, and for workers seeking employment. December's report brings the total number of jobs created over the course of 2004 to 2.3 million. GDP growth was strong while business investment posted substantial gains, and the housing market turned in another exceptional performance, likely toppling a number of records in 2004.

The President's economic leadership is clearly having a lasting effect, and we are reminded by today's report that it remains critically important to keep pro-growth policies like lower tax rates in place. This type of steady economic expansion needs to continue, and making the President's tax cuts permanent will help ensure that job creation continues, providing opportunities and offering great prospects to all Americans who are seeking work.

-30-

FROM THE OFFICE OF PUBLIC AFFAIRS

January 7, 2005
js-2184

Statement by G7 Finance Ministers on Assisting Countries Devastated by the Indian Ocean Tsunami

Following the Asian earthquake and tsunami disaster which has had such a devastating effect on so many people, there is an urgent need for assistance. All G7 countries have already committed substantial finance, from governments, their publics, and companies, to help affected countries cope with the immediate humanitarian crisis. But their needs, both humanitarian and for reconstruction, are enormous. The international community must continue to work together to help meet those needs.

In response G7 Finance Ministers agreed that:

- we would not expect debt payments from affected countries that request it until the World Bank and IMF have completed a full needs assessment of their reconstruction and financing requirements, recognising that some countries may be unable to make debt payments. We will work, within the Paris Club, with other creditors to achieve a consensus for this approach;

- depending on the conclusions of the needs assessments, we also stand ready to consider all appropriate measures for further assistance;

- the IMF, World Bank, Asian Development Bank and other multilateral institutions should make the strongest efforts possible to provide financial assistance, including through emergency post-disaster facilities; and

- we support urgent consideration by relevant fora of the international community to put in place an effective tsunami early warning system in the Indian Ocean, and the infrastructure necessary to make it effective.

We ask creditors at the next Paris Club meeting on 12 January to positively consider assisting affected countries in this way. We call on the World Bank and IMF to complete their needs assessment this month. We will consider what further steps are necessary in the light of this assessment, at our meeting on 4-5 February. All the actions and expectations set forth in this statement will be implemented consistent with the national laws of creditor countries.

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 7, 2005
js-2185

MEDIA ADVISORY: Secretary Snow on Wall Street Next Week

Secretary John W. Snow will travel to New York City January 10-12 to promote President Bush's second-term economic agenda. During three days of meetings with Wall Street leaders, Secretary Snow will discuss a wide array of economic issues while placing special emphasis on President Bush's plan to reform America's Social Security system for future generations.

"One of the tests of leadership is to confront problems before they become a crisis. President Bush came to Washington to solve problems, not pass them on to future Presidents and future generations," Secretary Snow said.

Throughout the week Secretary Snow will discuss the benefits of voluntary personal accounts which, as part of a comprehensive bipartisan solution, will give younger workers the option to save some payroll taxes in a personal account – a nest egg they can call their own, government cannot take away, and they can pass on to their children.

The following events are open to credentialed media. Please note RSVP requirements:

Monday, January 10

Closing of the NASDAQ
4:00 p.m. EDT
4 Times Square
NASDAQ Events Studio, 2nd Floor
New York, NY
** Media must RSVP to Silvia Davi, 646-441-5014
** A brief press availability will take place at the conclusion of the event.

Wednesday, January 12

Opening bell at New York Stock Exchange
9:30 a.m. EDT
18 Broad Street
New York, NY
** Media must RSVP to Danielle Martinez, 212-656-2268
** A brief press availability will take place at the conclusion of the event.

-30-

federal financing bank NEWS
WASHINGTON, D.C. 20220
Press 202-622-2960
FFB 202-622-2450

FEDERAL FINANCING BANK December 2004

Brian D. Jackson, Chief Financial Officer, Federal Financing Bank (FFB) announced the following activity for the month of November 2004.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $27.6 billion on November 30, 2004, posting a decrease of $197.4 million from the level on October 31, 2004. This net change was the result of a decrease in holdings of agency debt (U.S. Postal Service) of $200.0 million and an increase in net holdings of government-guaranteed loans of $2.6 million. The FFB made 51 disbursements and received 10 prepayments during the month of November.

Attached to this release are tables presenting FFB November loan activity and FFB holdings as of November 30, 2004.

JS-2186

FEDERAL FINANCING BANK
NOVEMBER 2004 ACTIVITY

Borrower	Date	Amount of Advance	Final Maturity	Interest Rate
GOVERNMENT-GUARANTEED LOANS				
GENERAL SERVICES ADMINISTRATION				
San Francisco Bldg Lease	11/03	$500.00	8/01/05	2.384% S/A
San Francisco OB	11/08	$161,878.93	8/01/05	2.477% S/A
San Francisco OB	11/19	$69,070.26	8/01/05	2.535% S/A
San Francisco Bldg Lease	11/22	$3,289,943.30	8/01/05	2.564% S/A
San Francisco OB	11/26	$20,000.00	8/01/05	2.601% S/A
DEPARTMENT OF EDUCATION				
*Tuskegee Univ.	11/01	$2,000,000.00	5/02/05	2.134% S/A
Livingstone College	11/05	$39,868.42	7/01/31	4.622% S/A
Tuskegee Univ.	11/05	$1,197,920.37	1/02/32	4.634% S/A
Miles College	11/15	$1,316,010.43	7/03/34	4.773% S/A
Tuskegee Univ.	11/17	$307,299.84	11/02/26	4.578% S/A
RURAL UTILITIES SERVICE				
East Kentucky Power #753	11/01	$6,700,000.00	12/31/30	4.547% Qtr.
Mecklenburg Electric #882	11/02	$2,000,000.00	12/31/36	4.718% Qtr.
Empire Electric #627	11/05	$3,452,000.00	1/03/34	4.645% Qtr.
Orcas Power and Light #775	11/05	$463,464.00	12/31/35	4.636% Qtr.
Union County Elec. #614	11/05	$320,000.00	12/31/29	4.553% Qtr.
Federal Rural Elec. #728	11/08	$1,000,000.00	4/02/07	2.890% Qtr.
Federal Rural Elec. #728	11/08	$2,000,000.00	1/02/35	4.767% Qtr.
Meriwether Lewis Elec. #2006	11/08	$5,000,000.00	12/31/36	4.797% Qtr.
REA Energy Cooperative #772	11/08	$1,200,000.00	12/31/35	4.782% Qtr.
Chibardun Tele. Coop. #2073	11/09	$2,000,000.00	1/02/24	4.442% Qtr.
Coastal Electric #2082	11/09	$1,700,000.00	12/31/37	4.817% Qtr.
Darien Telephone Co. #719	11/09	$550,000.00	3/31/05	2.220% Qtr.
Delaware County Elec. #682	11/09	$1,056,000.00	1/02/35	4.778% Qtr.
Northern Electric Coop. #827	11/09	$392,000.00	12/31/36	4.805% Qtr.
Sangre De Cristo Elec. #732	11/10	$500,000.00	12/31/14	4.149% Qtr.
Swan's Island Electric #2037	11/12	$45,000.00	12/31/36	4.852% Qtr.
Yellowstone Valley Elec. #847	11/12	$1,350,000.00	4/02/07	2.917% Qtr.
Brazos Electric #2086	11/15	$5,000,000.00	3/31/05	2.217% Qtr.
Brazos Electric #2086	11/15	$5,000,000.00	3/31/05	2.217% Qtr.
Brazos Electric #2086	11/15	$5,000,000.00	3/31/05	2.217% Qtr.
Brazos Electric #2086	11/15	$5,000,000.00	3/31/05	2.217% Qtr.
Brazos Electric #2086	11/15	$5,000,000.00	3/31/05	2.217% Qtr.
Brazos Electric #2086	11/15	$3,200,000.00	3/31/05	2.217% Qtr.

FEDERAL FINANCING BANK
NOVEMBER 2004 ACTIVITY

Borrower	Date	Amount of Advance	Final Maturity	Interest Rate
East Kentucky Power #753	11/16	$3,240,000.00	12/31/30	4.670% Qtr.
East Kentucky Power #828	11/16	$5,644,000.00	12/31/24	4.452% Qtr.
Red River Rural Tel. #2113	11/16	$400,000.00	3/31/05	2.247% Qtr.
South Miss. Elec. #2109	11/16	$1,758,000.00	1/03/34	4.738% Qtr.
Lighthouse Elec. #2090	11/17	$1,840,000.00	12/31/37	4.794% Qtr.
Hemingford Co-operative #2105	11/18	$351,740.00	12/31/35	4.700% Qtr.
Coop. Power Assoc. #722	11/19	$5,644,000.00	1/02/29	4.422% Qtr.
Fox Islands Elec. Coop. #2106	11/19	$24,000.00	12/31/37	4.696% Qtr.
Great River Energy #739	11/19	$1,000,000.00	12/31/30	4.471% Qtr.
Mountrail-Williams #665	11/19	$1,684,000.00	1/02/35	4.657% Qtr.
Navopache Electric #2100	11/19	$1,443,000.00	1/02/35	4.658% Qtr.
United Power Assoc. #721	11/19	$9,100,000.00	12/31/30	4.471% Qtr.
CARTERET-CRAVEN ELECTR #2033	11/22	$2,000,000.00	1/03/33	4.697% Qtr.
Endless Mtns. Wireless #2103	11/23	$1,041,000.00	12/31/09	3.551% Qtr.
Navopache Electric #2021	11/23	$5,000,000.00	12/31/09	3.531% Qtr.
Associated Electric #894	11/26	$2,002,000.00	1/03/33	4.665% Qtr.
South Slope Cooperative #741	11/26	$1,274,083.00	1/02/18	4.032% Qtr.
Canoochee Elec. #2112	11/29	$400,000.00	12/31/37	4.783% Qtr.
Victory Electric #782	11/30	$629,000.00	12/31/35	4.850% Qtr.

S/A is a Semiannual rate.
Qtr. is a Quarterly rate.
* maturity extension or interest rate reset

FEDERAL FINANCING BANK HOLDINGS
(in millions of dollars)

Program	November 30, 2004	October 31, 2004	Monthly Net Change 11/1/04-11/30/04	Fiscal Year Net Change 10/1/04-11/30/04
SOT				
Agency Debt:				
U.S. Postal Service	$0.0	$200.0	-$200.0	-$1,800.0
Subtotal*	$0.0	$200.0	-$200.0	-$1,800.0
Agency Assets:				
FmHA-RDIF	$200.0	$200.0	$0.0	$0.0
FmHA-RHIF	$680.0	$680.0	$0.0	$0.0
Rural Utilities Service-CBO	$4,270.2	$4,270.2	$0.0	$0.0
Subtotal*	$5,150.2	$5,150.2	$0.0	$0.0
Government-Guaranteed Lending:				
DOD-Foreign Military Sales	$1,449.3	$1,462.3	-$12.9	-$15.6
DoEd-HBCU+	$120.7	$117.8	$2.8	$2.7
DHUD-Community Dev. Block Grant	$0.2	$0.2	$0.0	-$0.2
DHUD-Public Housing Notes	$971.9	$1,054.8	-$82.9	-$82.9
General Services Administration+	$2,140.7	$2,145.5	-$4.7	-$0.6
DOI-Virgin Islands	$7.6	$7.6	$0.0	$0.0
DON-Ship Lease Financing	$498.6	$498.6	$0.0	$0.0
Rural Utilities Service	$17,161.7	$17,059.3	$102.4	$200.7
SBA-State/Local Development Cos.	$52.9	$55.0	-$2.1	-$3.6
DOT-Section 511	$2.9	$2.9	$0.0	$0.0
Subtotal*	$22,406.6	$22,404.0	$2.6	$100.4
Grand total*	$27,556.8	$27,754.2	-$197.4	-$1,699.6

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

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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January 10, 2005
JS-2187

Statement of Treasury Secretary John W. Snow on the Resignation of Treasury Assistant Secretary for Financial Institutions Wayne A. Abernathy

"The Treasury Department is preparing to say farewell to one of the more dedicated, passionate public servants whom I have had the pleasure to work with. Wayne Abernathy has given generously of his time and his heart for the past two years, serving the Bush Administration extremely well. His leadership in the fight against identity theft, expanding access to financial services, promoting the resilience of the financial sector, and financial education stand out in particular. In each case, Wayne identified the need for change, worked with his staff on thoughtful solutions, and moved the ball down the field effectively. He has done terrific work here and he will be missed. On behalf of the Department, I wish him all the best in his future endeavors."

REPORTS

- Assistant Secretary Wayne A. Abernathy Resignation Letter

January 10, 2005

Dear Mr. President,

I hereby resign from the office of Assistant Secretary of the Treasury for Financial Institutions, effective after January 31, 2005.

It has been my great honor and privilege to serve you and the people of this nation for a little over two years as a member of your Administration. I look back with deep satisfaction on the achievements of this Administration, including those with which I have been involved. Under your leadership, we have worked to promote expanded access to financial services for ever more Americans, while strengthening the resilience of our financial institutions to provide those services despite threats from terrorists or dangers from natural disasters. Our nation's financial institutions are stronger and more prepared today, and our citizens have greater tools to save, invest, and build for their families' future.

It is with confidence that I leave government service to enter work in the private sector, knowing of your continued dedication to good government that recognizes that private initiative and innovation and freedom are the engines for growth and progress. Thank you for the opportunity that I have had to serve with you. I in turn pledge my continued dedication to the principles of freedom and good government that will make for progress in the days ahead.

Yours respectfully,

Wayne A. Abernathy
Assistant Secretary for Financial Institutions

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 10, 2005
JS-2188

Assistant Secretary Wayne A. Abernathy Resignation Letter

Dear Mr. President,

I hereby resign from the office of Assistant Secretary of the Treasury for Financial Institutions, effective after January 31, 2005.

It has been my great honor and privilege to serve you and the people of this nation for a little over two years as a member of your Administration. I look back with deep satisfaction on the achievements of this Administration, including those with which I have been involved. Under your leadership, we have worked to promote expanded access to financial services for ever more Americans, while strengthening the resilience of our financial institutions to provide those services despite threats from terrorists or dangers from natural disasters. Our nation's financial institutions are stronger and more prepared today, and our citizens have greater tools to save, invest, and build for their families' future.

It is with confidence that I leave government service to enter work in the private sector, knowing of your continued dedication to good government that recognizes that private initiative and innovation and freedom are the engines for growth and progress. Thank you for the opportunity that I have had to serve with you. I in turn pledge my continued dedication to the principles of freedom and good government that will make for progress in the days ahead.

Yours respectfully,

Wayne A. Abernathy
Assistant Secretary for Financial Institutions

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 10, 2005
2005-1-10-16-15-25-16639

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $85,289 million as of the end of that week, compared to $87,104 million as of the end of the prior week.

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

	December 31, 2004			January 7, 2005		
TOTAL		87,104			85,289	
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	12,354	15,319	27,673	11,934	14,991	26,925
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	12,137	3,079	15,216	11,715	3,013	14,728
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]			19,544			19,203
3. Special Drawing Rights (SDRs) [2]			13,628			13,390
4. Gold Stock [3]			11,043			11,043
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	December 31, 2004			January 7, 2005		
	Euro	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
1. Foreign currency loans and securities			0			0
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the U.S. dollar:						
2.a. Short positions			0			0
2.b. Long positions			0			0
3. Other			0			0

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

	December 31, 2004			January 7, 2005		
	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

January 10, 2005
JS-2189

Statement by Assistant Secretary Juan Zarate Before the United Nations Security Council 1267 Sanctions Committee

Chairman Mayoral and distinguished members of the 1267 al Qaida and Taliban Sanctions Committee, thank you for inviting us to discuss the United States' ongoing campaign to combat terrorist financing. It is truly an honor to be here. This Committee has distinguished itself as one of the most potent bodies in the world in combating terrorist financing. Faced with a deadly enemy that recognizes no borders, any nation's unilateral efforts to combat terrorism are bound to fail. Our greatest hope lies in bodies like this, which are uniquely empowered to take swift and global action directing countries around the world to freeze terrorist accounts, prevent facilitators from traveling, and stop the flow of arms to terrorist groups.

I will focus my remarks on the development and implementation of financial sanctions against those parties designated by the U.S. Government and this Committee.

Specifically I would like to address the following four themes:

1) the importance of this Committee and the UN process in developing a worldwide, targeted, terrorist financing sanctions regime.

2) the importance of targeted financial sanctions in the global campaign against terrorist financing and the war on terrorism more generally;

3) the development and implementation of targeted terrorist financing sanctions in U.S.; and

4) measures to protect the civil liberties and rights of designees and other effected parties.

The importance of the 1267 Committee and the UN process in developing a worldwide, targeted, terrorist financing sanctions regime

The importance of this Committee's work and the UN generally in our global campaign against terrorist financing stems from the international nature of the financial system and fact that terrorism knows no borders. The great majority of terrorist financiers and facilitators operate and store their money outside the United States. For designations to have a maximum impact, we must work collaboratively with countries from around the world to develop, implement and apply effective terrorist financing sanctions programs against high value targets.

This is not a simple task. In some cases there is a failure of will, and in others there are insufficient means to take effective action. In either case, we must continue to apply political pressure or provide needed technical assistance to make sure that our designations are more than just words on paper.

Over the past three years, we have all labored tirelessly in this cause, and its persistent work has yielded promising initial results: dozens of countries have joined us in submitting 296 al Qaida-linked targets for designation by this Committee; scores of 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 several countries have joined the U.S. to provide technical assistance and training to help front-line states develop counter-terrorist financing and anti-money laundering regimes.

However, this must be the beginning, and not the end, of our efforts. The U.S and all countries can and must improve our individual and collective efforts to develop and implement effective terrorist financing sanctions regimes.

The importance of targeted financial sanctions in the global CFT campaign

Targeted financial sanctions are the cornerstone of our campaign against terrorist financing. In addition to its primary function of swiftly freezing funds and keeping them out of the hands of terrorists, if used properly and implemented comprehensively, designations can be invaluable 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 the targeted individual or organization can never in the future act as a conduit of funds to terrorists. Indeed, if fully implemented, a designation isolates supporters of terrorism from the formal financial system, incapacitating them or driving them to more expensive, more cumbersome, and riskier channels.

The effective implementation of designations can also uncover invaluable information about terrorist financing networks. Investigation of accounts and transactions frozen or blocked in accordance with UN member state obligations can lead to terrorist financiers, intermediaries and operatives for further action. In the U.S., authorities can quietly gather this information through the application of a new tool under Section 314(a) of the USA PATRIOT Act. Section 314 allows the Treasury Department, through our Financial Intelligence Unit (FIU), the Financial Crimes Enforcement Network (FinCEN), to circulate requests for information about specific targets throughout our banking system. Banks having any such information report back to FinCEN, which then passes this along to appropriate law enforcement authorities for follow up action. This invaluable tool allows us to identify and unravel terrorist networks without alerting them to ongoing investigations. However, for states that lack this capability, designations may be the best way to discover and immediately interdict terrorist financial activity occurring within their financial systems.

Developing and implementing terrorist financing designations in U.S.

The effectiveness of designations largely depends upon broader systemic reforms by UN member states to combat terrorist financing and financial crimes more generally. These broader systemic reforms are evident in the development and implementation of global anti-money laundering and counter-terrorist financing standards, promulgated by the UN and other international bodies such as the Financial Action Task Force (FATF). These standards promote the financial transparency and accountability that provide a necessary foundation for the development of effective terrorist financing sanctions regimes.

Fully utilizing targeted financial sanctions to identify, disrupt and dismantle terrorist financing networks also requires a comprehensive terrorist financing sanctions regime. In the U.S., we have developed a legal framework and devoted significant attention and resources to create such a regime.

The legal authority for our terrorist financing sanctions regime is described comprehensively in the reports that we have submitted to this Committee and the UN 1373 Counter-Terrorism Committee. This legal framework gives us the ability to impose terrorist financing sanctions on those parties whom we have reason to believe are providing support to terrorists.

Employing our terrorist financing sanctions regime begins with the full dedication of analysts from several agencies to develop potential designation targets. Targets are selected based on threat assessments and the vulnerability of these threats to the effects of designation. We identify high value targets that serve critical functions in terrorist financing networks. Designating such targets cripples and disables terrorist groups and their support networks not only by cutting off financial flows, but also by impeding key capabilities such as recruitment, training, logistical, technological or organizational support, and leadership. This targeting approach focuses our designation investigative resources where we can be most effective in identifying, preventing, disrupting and dismantling terrorists and their support networks.

In addition to a robust targeting process, our terrorist financing sanctions regime relies upon the development of evidentiary records to fully support a legal basis for designation. Importantly, these evidentiaries can include critically important information from law enforcement and classified sources. A team of interagency lawyers rigorously reviews these evidentiaries in order to ensure legal sufficiency.

Actual decisions to designate a party under our terrorist financing sanctions regime are made pursuant to an Executive Order in which the President directs the Secretary of the Treasury, or the Secretary of State, in consultation with the Attorney General and the Secretary of the Department of Homeland Security, to designate those parties that meet the specific criteria set forth in the Order. These decisions are taken in close consultation with the interagency community, led by a Terrorist Financing Policy Coordination Committee as described by Assistant Secretary Wayne. This Committee meets on a regular basis to review prospective targets for designation and the evidentiaries that support such action. The Committee consists of representatives from multiple U.S. governmental agencies engaged in the global war on terrorism, and considers and coordinates any decision to designate with other actions that are or can be taken against the prospective target. This interagency deliberative process is essential to ensure that designations advance the larger counter-terrorism mission.

Upon a determination that a designation action against a proposed target is appropriate, the Treasury Department and the State Department work with the interagency community to draft an unclassified Statement of the Case. This Statement of the Case represents the factual bases for the public announcement of a designation and serves several purposes, including:

1) allowing the U.S. government to consult in advance with those countries that are directly impacted by a proposed designation;

2) enabling the U.S government to pre-notify the UN and other countries before formal submitting a proposed designation before this Committee; and

3) providing identifier information about the designated party to enable effective implementation by financial sectors and the general public.

The process of developing adequate identifiers is particularly important and is a common challenge. We welcome and rely on other countries to help us uncover identifier information about proposed designees in order to ensure effective implementation. Without adequate identifiers, designations simply cannot work. We strongly encourage more assistance and international cooperation in developing this information, not only in our ongoing designation efforts, but also with respect to those parties that have already been designated.

Over the past three years, we have made great strides to improve the quality and quantity of this identifier information. The overwhelming majority of designations issued over this period have included essential identifier information. And we are constantly improving our efforts in this regard. The question of sufficiency is difficult to measure, because it will depend on the target, and additional identifier information is always beneficial. But we cannot allow identifiers to serve as an excuse for jurisdictions to avoid implementation when essential identifier information is available.

Only after exhausting this intensive pre-designation process do we actually issue and implement a terrorist financing designation. We then initiate the post-designation implementation processes of our terrorist financing sanctions regime.

Because all U.S. persons are obligated to observe our terrorist financing sanctions, our post-designation implementation process begins with active notification and dissemination to our financial sectors, high risk industries, and general public. Such notification occurs through a number of specific processes, and ensures that vulnerable industries and organizations -- such as banks, charities, money service businesses – are alerted when designations are issued. These notification processes include:

1) updating the list of Specially Designated Nationals (the SDN List) on the website of Treasury's Office of Foreign Assets Control (OFAC);

2) incorporating designations into several downloadable versions of OFAC's targeting list posted on the OFAC website so that they can be immediately incorporated into software screening programs at banks and other businesses;

3) updating sanctions program and industry brochures distributed by OFAC;

4) delivering priority electronic notification to all federal banking regulatory agencies, which then distribute this information to their examiners and institutions under their supervision;

5) delivering a systems bulletin to the member banks of the Clearing House Interbank Payment System (CHIPS);

6) emailing over 15,000 individual subscribers to on OFAC's Internet listserv;

7) faxing through a broadcast system and e-Alert system more than 300 financial and securities associations, which in turn, transmit this notice to their members;

8) emailing new designation information to various points of contact among several law enforcement agencies; and

9) publishing official notice in the U.S. Government's *Federal Register*.

This comprehensive notification system ensures that the private sector and general public, in addition to the regulatory and law enforcement communities, are actively made aware of our terrorist financing designations.

Such notification is essential in promoting compliance by all U.S. persons, and particularly the financial sectors and other high risk industries. U.S. banks and other businesses have developed sanction compliance programs to immediately run checks and block accounts upon the designation of a new name. In the banking industry, federal regulators work with OFAC to provide guidance for the development of effective compliance programs. In addition, OFAC maintains a Compliance Division of personnel dedicated to educating the private sector and promoting compliance through a number of avenues, including industry outreach, a comprehensive website with answers to frequently asked questions, and telephone and email hotlines.

All U.S. persons freezing property and blocking transactions are required to report those actions in writing to OFAC within ten business days. This allows OFAC to record and administer all blocked accounts and transactions under our terrorist financing sanctions regime.

A critical component to our success in implementing terrorist financing sanctions is compliance enforcement. OFAC includes Enforcement and Civil Penalties Divisions that work closely with the Compliance Division to investigate, audit and penalize as appropriate U.S. persons that fail to comply with terrorist financing sanctions. In response to such violations, OFAC may take any one of several actions, including issuing a cease and desist order, a warning letter or cautionary letter, or assessing a civil penalty. For willful violations, OFAC makes referrals to the Department of Justice for criminal charges. OFAC also works with the regulatory community concerning potential violations by supervised institutions to promote adequate oversight of sanctions compliance.

Finally, OFAC works with law enforcement agencies to facilitate investigative follow-up whenever funds or transactions implicating a terrorist financing designation are identified or blocked. This advances ongoing investigations and can initiate new investigations into potential terrorist financing activity.

Clearly, all of this activity requires a substantial commitment of resources and sustained political will. It also requires accountability for administering, implementing and enforcing terrorist financing sanctions. And, it requires constant and close communication and collaboration across the U.S. government, and with the private sector. We believe that such an investment of time, attention and resources is imperative to making targeted terrorist financing sanctions effective. And, for all of the reasons that I stated earlier, we know that this investment is worthwhile.

The delisting process, licensing and the protection of civil liberties

In order to be effective, our terrorist financing sanctions regime must also be fair. We expend additional considerable resources to ensure that our terrorist financing sanctions program respects the civil liberties and rights of designated parties and others affected by our terrorist financing sanctions. Federal regulation affords all designated parties with a right to seek delisting. On two occasions in 2002, Treasury's former Under Secretary Gurule appeared before this Committee to discuss and explain the U.S. delisting process, which assisted in the development of a delisting process eventually adopted by this Committee. Both our U.S delisting process and that of this Committee have been successfully utilized by petitioners who have demonstrated that circumstances underlying their designations no longer applied. It is important to recognize that these delisting actions not only demonstrated an appropriate consideration of the rights of designated parties, but they also validated the effectiveness of designations as a tool in our overall efforts to combat terrorist financing. In those instances, our designations, and those of this Committee, eliminated a terrorist financing threat by changing behavior of parties previously presenting such a threat.

Licensing represents another important element of our terrorist financing sanctions regime that addresses the rights of designees and other effected parties. OFAC maintains a Licensing Division that reviews licensing requests and issues and administers licenses authorizing activities otherwise prohibited by our sanctions programs. Parties designated under our terrorist financing sanctions program have successfully petitioned for licenses to access funds for a number of purposes, including contesting their designations by OFAC in U.S. federal courts.

In addition to the administrative delisting process, a designated party may challenge its designation in federal court. Several organizations have sought judicial relief and, to date, none of their designations has been overturned.

These elements of our terrorist financing sanctions regime that protect the rights of designated and other effected parties also require a significant investment of resources. This investment is essential to preserving the integrity and credibility of our sanctions regime.

As we move forward in our global campaign to combat terrorist financing, it is encouraging to realize the progress that we have made together. This progress is evident not only from the accomplishments that I have described, but also in effects that our collective efforts are having on the terrorist organizations we are at war against. In this respect, intelligence often 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 a terrorist group like al Qaida is 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.

Assistant Secretary Tony Wayne, my colleague and friend from the State Department, will share just a few of the many ways in which we can build from this promising beginning. I look forward to continuing our work together and welcome our discussion here today. Thank you again for the opportunity to meet with you all on these vitally important issues of international security.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 12, 2005
JS-2190

The Honorable John W. Snow
Statement on Social Security Reform
New York, NY
January 12, 2004

It's terrific to be in New York, to see our great financial markets in action and spend time with the people who make Wall Street run. I've spent the last two days talking with the financial community about how much the continued strength of our economy will be dependent on a successful re-vamping of our Social Security system. Leaders here on Wall Street share this view, and our conversations have been extremely productive.

Social Security is a great American institution. The President is committed to keeping its promise for today's retirees and those nearing retirement, and to strengthening Social Security for our children and grandchildren. But the current system is financially unsustainable and needs to be fixed.

The demographics that led to this fate were becoming apparent by the 1970s – not enough babies born to support the baby boom generation when they retire – and life expectancy was already increasing.

We've gone from a program in 1950 that was adequately paid for by 16 workers for every one beneficiary, to one that is now paid for by about three workers for every one beneficiary today. Those numbers will soon be two-to-one.

Because of this demographic reality, the current social security system will pay out more in benefits than it brings in revenue beginning in 2018 and shortfalls will grow larger with each passing year. And, by 2042, when workers in their 20's begin to retire, the system will be bankrupt.

What this means is that people who are now retired or near retirement will be taken care of. They will receive their full benefits. But in order to pay the scheduled benefits for future generations the government would need to find massive amounts of additional money. This could be done through additional borrowing, raising taxes, or cutting other federal spending. Each option would have a very negative impact on our economy and our financial markets. This is something Wall Street understands, and it is why they are interested in credible reform.

As these leaders know, the United States has an expensive problem on our hands, and waiting to fix it would be financially foolish. Given the repercussions that denial and delayed action would have on both domestic and global financial markets – and on future beneficiaries -- it would be irresponsible to leave this problem to another day.

From Wall Street's leaders, I'm hearing broad consensus for the need to reduce Social Security's long-term structural deficit - currently forecast to be more than a $10 trillion shortfall. The people behind the institutions of Wall Street understand that if we fix the system and put it on a sustainable course, it will benefit our country's financial future.

During my time here in New York, we've had discussions about the President's belief that the establishment of personal retirement accounts should be one part of a comprehensive plan to fix Social Security for future generations. People here on Wall Street understand that the structure of those accounts would be designed to benefit retirees, not Wall Street investment firms. They welcome a sincere solution to Social Security for the right reasons, for the broader financial stability that a solution will bring to our economy and to our markets.

A bi-partisan effort in the 109th Congress can achieve the goal of preserving Social Security benefits for retirees and near-retirees, while modernizing the program, without increasing payroll taxes. As I have expressed to the financial community here this week, the Bush Administration is dedicated to achieving that goal. We look forward to working with both sides of the aisle in Congress on Social Security solutions, based on our shared understanding that not acting would be irresponsible.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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January 12, 2005
js-2191

Treasury Designates Mexican Money Laundering Cell

The U.S. Department of the Treasury today identified 15 companies and 24 individuals associated with a money laundering cell of the Arellano Felix Organization (AFO), a violent drug trafficking ring operating out of Mexico.

"Over a three year period, this cell laundered more than $120 million in illicit proceeds from the sale of narcotics," said Robert Werner, Director of the Treasury's Office of Foreign Assets Control (OFAC). "By freezing these individuals and companies out of the U.S. financial system, we are dealing a significant blow to the fiscal underbelly fueling the notorious drug trade of the Arellano Felix Organization."

OFAC added the names of these 39 entities to its list of persons designated pursuant to the Foreign Narcotics Kingpin Designation Act (Kingpin Act). AFO, which was named as a drug kingpin by President Bush on June 1, 2004, is based in Tijuana, a large city in the Mexican state of Baja California which borders the United States.

This money laundering cell was developed by Ivonne Soto Vega, also known as "*La Pantera*" (the Panther), and Jose Manuel Ruelas Martinez, who were designated today. The cell is involved in an AFO money laundering scheme centered on the use of *casas de cambio*, or currency exchange houses. These front companies launder U.S. currency illicitly earned through narcotics sales in the United States and bulk smuggled into Mexico. Soto Vega and Ruelas Martinez are both in the custody of Mexican authorities awaiting trial on charges stemming from their involvement with the AFO.

In Tijuana, the cell consisted of several currency exchange houses including *Centro Cambiario Kino, S.A. de C.V.*, *GS Plus Consultores S.A. de C.V.*, and *Multiservicios Gamal S.A. de C.V.* The cell also has a presence in Guadalajara with *Grupo Gamal, S.A. de C.V.* In addition to currency exchange houses, the cell also includes *Casa de Empeno Rio Tijuana, S.A. de C.V.*, a pawn shop in Tijuana, and *Hacienda de Don Jose Restaurant Bar, S.A. de C.V.*, a restaurant and bar supply company also located in Tijuana.

"Today's action is a testament to our collaboration with the San Diego office of Immigration and Customs Enforcement (ICE)," said Werner. "OFAC remains committed to working with our partners in the U.S. Government and our foreign law enforcement counterparts to expose front companies controlled by drug cartels in Mexico and around the globe."

This action prohibits U.S. persons from engaging in financial and commercial transactions with the designees and freezes any assets of the designees found in the United States.

The action taken today follows the designation of six lieutenants of the AFO in November 2004. The 39 new names bring the total number of Tier I and Tier II Kingpins under the Kingpin Act to 160: 48 drug kingpins worldwide, 30 companies in Mexico, Peru, and the Caribbean, and 82 other individuals in Mexico, Colombia and the Caribbean.

This action is part of the ongoing interagency effort of the Treasury, Justice, State, Defense and Homeland Security Departments, the Central Intelligence Agency, the Federal Bureau of Investigation and the Drug Enforcement Administration to carry out the Kingpin Act. Signed into law on December 3, 1999, the Kingpin Act applies economic sanctions against narcotics traffickers on a worldwide basis. The Kingpin Act was modeled after Executive Order 12978, which applies economic sanctions against narcotics traffickers centered in Colombia and which is also administered by OFAC.

For a complete list of the entities designated today, please visit:
http://www.treas.gov/offices/enforcement/ofac/actions/20050112.shtml

REPORTS

- A diagram of the individuals and companies named by OFAC

ARELLANO FELIX ORGANIZATION (AFO)
January 2005

Foreign Narcotics Kingpin Designation Act

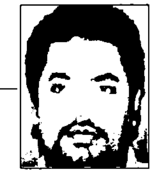
U.S. Department of the Treasury
Office of Foreign Assets Control

All individuals and companies shown on this chart are Mexican.

AFO Money Laundering Cell

Ivonne "La Pantera" SOTO VEGA

In the custody of Mexican authorities



Jose Manuel RUELAS MARTINEZ

Ruelas Martinez Currency Exchange Houses

- CENTRO CAMBIARIO KINO SA DE CV, Tijuana, Mexico
- CONSULTORIA DE INTERDIVISAS SA DE CV, Tijuana, Mexico
- CONSULTORIA DE OCCIDENTE SA DE CV, Tijuana, Mexico; Guadalajara, Mexico
- GRUPO GAMAL SA DE CV, Guadalajara, Mexico
- GS PLUS CONSULTORES SA DE CV, Tijuana, Mexico
- M Q CONSULTORES SA DE CV, Tijuana, Mexico
- MULTISERVICIOS ALPHA SA DE CV, Tijuana, Mexico
- MULTISERVICIOS GAMAL SA DE CV, Tijuana, Mexico
- MULTISERVICIOS SIGLO SA DE CV, Tijuana, Mexico

Ruelas Martinez Family Members

- Felipe RUELAS MARTINEZ
- Jose De La Cruz RUELAS MARTINEZ
- Carlos Antonio RUELAS TOPETE
- Eduardo RUELAS TOPETE
- Jose Luis RUELAS TOPETE
- Sandra Angelica ESCOBEDO MORALES
- Miguel Angel QUINTERO HERNANDEZ
- Silvia Patricia SANCHEZ CURIEL

Ruelas Martinez Business Associates

- Evangelina AGUILAR TORRES
- Maria Teresa ALVAREZ HERNANDEZ
- Arnoldo ARMENTA ZAVALA
- Mario Alberto BECERRA RODRIGUEZ
- Mario Alberto CARRILLO CUEVAS
- Elias DELGADO GUTIERREZ
- Edman Manuel DONO MORALES
- Daniel GONZALEZ MUNOZ
- Omar Axel MARTINEZ PLAZA
- Luis Miguel PEREIRA BERUMEN
- Sofia PEREZ ELIAS
- Carlos Alberto SANCHEZ OSUNA
- Juan Gabriel VELASQUEZ HERNANDEZ
- Jorge Miguel VILLASENOR COVARRUBIAS

Other Ruelas Martinez Companies

- CASA DE EMPENO RIO TIJUANA SA DE CV, Tijuana, Mexico
- HACIENDA DE DON JOSE RESTAURANT BAR SA DE CV, Tijuana, Mexico
- GLOBAL FILMS SA DE CV, Tijuana, Mexico

Associated Companies

- MULTISERVICIOS DEL NOROESTE DE MEXICO SA DE CV, Tijuana, Mexico
- MEGA DOLAR SA DE CV, Tijuana, Mexico
- MULTISERVICIOS BRAVIO SA DE CV, Tijuana, Mexico

AFO Money Laundering Cell's Methodology

Narcotics are smuggled into the United States from Mexico → U.S. currency from narcotics sales in the United States is bulk smuggled to Mexico → The smuggled currency is then brought back across the U.S. border in the names of currency exchange houses; Declaring the currency in the name of currency exchange houses hides the illegal origin of the money → The currency is then deposited into U.S. bank accounts held in the name of the currency exchange companies → Wire transfers are sent from these accounts to banks around the world to complete the laundering of drug money

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 12, 2005
JS-2192

Financial Literacy and Education Commission to Hold Fourth Meeting

Treasury Assistant Secretary for Financial Institutions Wayne Abernathy will open the fourth meeting of the Financial Literacy and Education Commission tomorrow in the Treasury Department's Cash Room. U.S. Mint Director Henrietta Holsman Fore, Rep. Judy Biggert (IL), and Deputy Assistant Secretary for Financial Education Dan Iannicola, Jr. will deliver remarks to representatives of the Financial Literacy and Education Commission. The Commission will also hear from guest speakers on best practices for financial education.

Treasury's Office of Financial Education coordinates the efforts of the Financial Literacy and Education Commission, which is composed of representatives from 20 federal departments, agencies and commissions. The Commission works to improve financial literacy and education throughout the United States.

WHAT: Fourth Meeting of the Financial Literacy and Education Commission

WHO: Wayne Abernathy, Assistant Secretary for Financial Institutions, Treasury Department
Henrietta Holsman Fore, Director, United States Mint
Judy Biggert, Member, U.S. House of Representatives
Dan Iannicola, Jr., Deputy Assistant Secretary for Financial Education, Treasury Department

WHEN:
January 13, 2005
10:30 a.m. (EST)

WHERE:
Treasury Department
Cash Room
1500 Pennsylvania Avenue
Washington, D.C.

News media without Treasury press credentials planning to attend should contact Frances Anderson in Treasury's Office of Public Affairs at (202) 622-2960 by 3 p.m. today with the following information: name, social security number and date of birth. This information may also be faxed to (202) 622-1999 or emailed to frances.anderson@do.treas.gov.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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January 12, 2005
JS-2193

Treasury and IRS Announce Clarifications to Handling of Taxpayer Information by Subcontractors

-- Today the Treasury Department and the IRS announced a proposed regulation to clarify the restrictions that apply to confidential tax return information that the IRS releases to contractors and, in turn, subcontractors, performing tax administration services. The proposed regulation clarifies that subcontractors must comply with the same strict protocols as contractors in handling return information. The proposed regulation clarifies that subcontractors, like contractors, are subject to civil and criminal penalties for improper disclosure.

The Internal Revenue Code protects the privacy of return information, but permits disclosure for tax administration purposes to IRS employees and IRS contractors. Under the Code, an IRS contractor may see return information if access to the information is necessary to process returns, program equipment, or perform other contractual services. The IRS and its contractors must comply with strict protocols in handling return information, and are subject to civil and criminal penalties for improper disclosure.

The proposed regulation clarifies the treatment of subcontractors, who may perform services similar to the services performed by contractors.

While contractors have long been used to perform specific services for Federal agencies, including the IRS, today's proposed regulation clarifies that IRS privacy protections apply to all contractors and subcontractors.

REPORTS

- A copy of the proposed regulations

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 301

[REG-148867-03]

RIN 1545-BC92

Disclosure of Returns and Return Information in Connection with Written Contracts or Agreements for the Acquisition of Property and Services for Tax Administration Purposes

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the disclosure of returns and return information pursuant to section 6103(n) of the Internal Revenue Code (Code). The proposed regulations describe the circumstances under which officers or employees of the Treasury Department, a State tax agency, the Social Security Administration, or the Department of Justice may disclose returns and return information to obtain property or services for tax administration purposes, pursuant to a written contract or agreement. The proposed regulations clarify the existing regulations with respect to redisclosures of returns or return information by contractors, especially with regard to redisclosures by contractors to agents or subcontractors, and clarify that the civil and criminal penalties of sections 7431, 7213, and 7213A apply to the agents or subcontractors. The proposed regulations also clarify that section 6103(n) applies to written contracts or agreements that are entered into to obtain property or services for

purposes of tax administration, including contracts that are not awarded under the Federal Acquisition Regulations (FAR), 48 CFR pts. 1-53.

The proposed regulations will affect officers and employees of the Treasury Department, a State tax agency, the Social Security Administration, or the Department of Justice who disclose returns or return information in connection with a written contract or agreement for the acquisition of property or services for tax administration purposes. The proposed regulations will also affect any person, or officer, employee, agent, or subcontractor of the person, or officer or employee of the agent or subcontractor, who receives returns or return information in connection with a written contract or agreement for the acquisition of property or services.

DATES: Written or electronic comments and requests for a public hearing must be received by April 12, 2005.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-148867-03), 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-148867-03), 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 (indicate IRS and REG-148867-03). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Helene R. Newsome, 202-622-4570 (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 collections of information should be received by March 14, 2005. Comments are specifically requested concerning:

Whether the proposed collections of information are 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 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 service to provide information.

The collections of information in this proposed regulation are in §§ 301.6103(n)-1(d) and 301.6103(n)-1(e)(3). This information is required and will be used to ensure compliance with the internal revenue laws and regulations, and to protect the privacy of American taxpayers. The collections of information are required to obtain a benefit. The likely respondents are state or local governments, business or other for-profit institutions, federal agencies, and/or small businesses or organizations.

Estimated total annual reporting burden: 250 hours. Estimated average annual burden per respondent: 6 minutes.

Estimated number of respondents: 2500.

Estimated annual 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 return information are confidential, as required by 26 U.S.C. 6103.

Background

Under section 6103(a), returns and return information are confidential unless the Code authorizes disclosure. Section 6103(n) authorizes, pursuant to regulations prescribed by the Secretary, returns and return information to be disclosed to any person, including any person described in section 7513(a), for purposes of tax administration, to the extent necessary in connection with: (1) the processing, storage, transmission, and reproduction of returns and return information; (2) the programming, maintenance, repair, testing, and procurement of equipment; and (3) the providing of other services.

Clarification is needed with respect to whether the existing regulations permit redisclosures by persons authorized to receive the returns and return information to their agents or subcontractors, and if so, whether certain penalty provisions, written notification requirements, and safeguard requirements are applicable to these agents and subcontractors. The proposed regulations make these clarifications. The existing regulations provide that any person, or officer or employee of the person, who receives returns or return information under the existing regulations, may redisclose the returns or return information when authorized in writing by the IRS. The proposed regulations clarify that redisclosures to agents or subcontractors are permissible provided that the IRS authorizes the redisclosures in writing. The proposed regulations clarify that agents and subcontractors are persons described in section 6103(n) and, accordingly, are subject to the civil and criminal penalty provisions of sections 7431, 7213, and 7213A for the unauthorized inspection or disclosure of returns or return information. The proposed regulations clarify that agents and subcontractors are required to comply with any written notification requirements and safeguard restrictions that may be imposed by the IRS.

Finally, the proposed regulations clarify that section 6103(n) applies to written contracts or agreements that are entered into to obtain property or services for tax administration purposes, including contracts that are not awarded under the FAR.

Explanation of Provisions

The structure of the proposed regulations is very similar to that of the existing regulations, with the exception of modifications to clarify: the redisclosure authority of contractors, especially to agents or subcontractors; the applicability to agents and subcontractors of written notification requirements, safeguard requirements, and the civil and criminal penalty provisions of sections 7431, 7213, and 7213A; and the applicability of section 6103(n) to written contracts or agreements for tax administration purposes, including contracts that are not awarded under the FAR. The proposed regulations also elaborate on the safeguard protections that the IRS may require. Finally, the proposed regulations contain other minor changes for organizational and clarity purposes.

Redisclosures to Agents or Subcontractors

The proposed regulations, at §301.6103(n)-1(a)(2)(ii), provide that any person, or officer or employee of the person, who receives returns or return information under the proposed regulations, may further disclose the returns or return information, when authorized in writing by the IRS, to the extent necessary to carry out the purposes of the written contract or agreement. To eliminate any ambiguity as to whether this provision applies to agents and subcontractors, the proposed regulation states that disclosures may include redisclosures to a person's agent or subcontractor, or officer or employee of the agent or subcontractor. The proposed regulations, at §301.6103(n)-1(a)(3), provide guidance applicable if agents or subcontractors, or officers or employees of the agents or subcontractors, who receive returns or return information under §301.6103(n)-1(a)(2)(ii), are to exercise the authority to redisclose the returns or return information to another officer or employee of the agent or subcontractor whose duties or responsibilities require the returns or return information for a purpose described in the proposed regulations. The proposed regulations, at §301.6103(n)-1(c), set forth the civil and criminal penalties to which agents, subcontractors, and their officers or employees, are subject for unauthorized inspection or disclosure of returns or return information. The proposed regulations, at §301.6103(n)-1(d), extend the written notification requirements to agents and subcontractors. In particular, agents or subcontractors who receive returns or return information under the proposed regulations must provide written notice to their officers and employees of the purposes for which returns or return information may be used and of the potential civil and criminal penalties for unauthorized inspections or disclosures. The proposed regulations, at §301.6103(n)-1(e), clarify that agents or subcontractors who receive returns or return information under the proposed regulations are subject to all safeguard requirements described in the proposed regulations.

Section 6103(n) Applies to Written Tax Administration Contracts or Agreements, Including Contracts Not Awarded Under the FAR

The proposed regulations clarify that section 6103(n) applies to written contracts or agreements that are entered into to obtain property or services for purposes of tax administration, including contracts that are not awarded under the FAR. The existing regulations use the term contractual procurement to describe the acquisition of property or services. Clarification is needed as to whether this term is limited to the acquisition of property or services under the FAR or whether the term refers more broadly to any written contract or agreement to acquire property or services relating to tax administration. The FAR applies only to contracts involving acquisitions with appropriated funds. FAR 1.104 and 2.101, 48 CFR 1.104 and 2.101. The existing and proposed regulations under section 6103(n), however, are intended to apply to any written contract or agreement for tax administration that creates obligations that are enforceable or otherwise recognizable at law, regardless of the form of the contract (*e.g.*, interagency agreement, memorandum of understanding, purchase order), the statutory or regulatory authority for the contract, if any (*e.g.*, the FAR, the Contract Disputes Act, 41 U.S.C. 601 through 613, the Economy Act, 31 U.S.C. § 1535), or the nature of the consideration exchanged (monetary or non-monetary). Accordingly, the proposed regulations replace the term contractual procurement with the phrase "written contract or agreement" in all instances where the term appeared.

Other Changes to the Existing Regulations

The proposed regulations, at §301.6103(n)-1(a)(4), clarify that any person, or officer, employee, agent or subcontractor of the person, or officer or employee of the agent or subcontractor, who receives returns or return information under the proposed regulations, may redisclose the returns or return information pursuant to §301.6103(p)(2)(B)-1 (concerning disclosures by a Federal, State, or local agency, or its agents or contractors, for a purpose authorized, and subject to all applicable conditions imposed, by section 6103). The proposed regulations, at §301.6103(n)-1(e), add the requirement that any person, or agent or subcontractor of the person, who may receive returns or return information under the proposed regulations, must agree, before the disclosure of any returns or return information to the person, agent, or subcontractor, to an IRS inspection of his, her, or its site or facilities. Finally, the proposed regulations, at §301.6103(n)-1(e)(3), set forth the condition that before the execution of a contract or subcontract for the acquisition of property or services under which returns or return information will be disclosed in accordance with the proposed regulations, the contract must be made available to the IRS.

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 collections 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 any burden on taxpayers is minimal in that the estimated average burden per respondent for complying with the collections of information imposed by these regulations is 6 minutes. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f), this notice of proposed rulemaking will be submitted to the Chief Counsel of the Small Business Administration for comment on its impact on small businesses.

Comments and Request for a Public Hearing

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

Drafting Information

The principal author of these regulations is Helene R. Newsome, Office of the Associate Chief Counsel (Procedure & Administration), Disclosure & Privacy Law Division.

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 ADMINSTRATION

Paragraph 1. The authority citation for part 301 continues to read, in part, as follows:

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

Par. 2 Section 301.6103(n)-1 is revised to read as follows:

§301.6103(n)-1 Disclosure of returns and return information in connection with written contracts or agreements for the acquisition of property and services for tax administration purposes.

(a) General rule. (1) Pursuant to the provisions of section 6103(n) of the Internal Revenue Code and subject to the conditions of this section, officers and employees of the Treasury Department, a State tax agency, the Social Security Administration, or the Department of Justice, are authorized to disclose returns and return information (as defined in section 6103(b)) to any person (including, in the case of the Treasury Department, any person described in section 7513(a)), or to an officer or employee of the person, for purposes of tax administration (as defined in section 6103(b)(4)), to the extent necessary in connection with a written contract or agreement for the acquisition of--

(i) Equipment or other property; or

(ii) Services relating to the processing, storage, transmission, or reproduction of returns or return information, the programming, maintenance, repair, or testing of equipment or other property, or the providing of other services.

(2) Any person, or officer or employee of the person, who receives returns or return information under paragraph (a)(1) of this section, may--

(i) Further disclose the returns or return information to another officer or employee of the person whose duties or responsibilities require the returns or return information for a purpose described in this paragraph; or

(ii) Further disclose the returns or return information, when authorized in writing by the Internal Revenue Service (IRS), to the extent necessary to carry out the purposes described in this paragraph. Disclosures may include disclosures to an agent or subcontractor of the person, or officer or employee of the agent or subcontractor.

(3) An agent or subcontractor, or officer or employee of the agent or subcontractor, who receives returns or return information under paragraph (a)(2)(ii) of this section, may further disclose the returns or return information to another officer or employee of the agent or subcontractor whose duties or responsibilities require the returns or return information for a purpose described in this paragraph (a).

(4) Any person, or officer, employee, agent or subcontractor of the person, or officer or employee of the agent or subcontractor, who receives returns or return information under this paragraph, may, subject to the provisions of §301.6103(p)(2)(B)-1 (concerning disclosures by a Federal, State, or local agency, or its agents or contractors), further disclose the returns or return information for a purpose authorized, and subject to all applicable conditions imposed, by section 6103.

(b) Limitations. (1) Disclosure of returns or return information in connection with a written contract or agreement for the acquisition of property or services described in paragraph (a) of this section will be treated as necessary only if the performance of the contract or agreement cannot otherwise be reasonably, properly, or economically carried out without the disclosure.

(2) Disclosure of returns or return information in connection with a written contract or agreement for the acquisition of property or services described in paragraph (a) of this section shall be made only to the extent necessary to reasonably, properly, or economically perform the contract. For example, disclosure of returns or return information to employees of a contractor for purposes of programming, maintaining, repairing, or testing computer equipment used by the IRS or a State tax agency shall be made only if the services cannot be reasonably, properly, or economically performed without the disclosure. If it is determined that disclosure of returns or return information is necessary, and if the services can be reasonably, properly, and economically performed by disclosure of only parts or portions of a return or if deletion of taxpayer identity information (as defined in section 6103(b)(6)) reflected on a return would not seriously impair the ability of the employees to perform the services, then only the parts

or portions of the return, or only the return with taxpayer identity information deleted, may be disclosed.

(c) Penalties. Any person, or officer, employee, agent or subcontractor of the person, or officer or employee of the agent or subcontractor, who receives returns or return information under paragraph (a) of this section, is subject to the civil and criminal provisions of sections 7431, 7213, and 7213A for the unauthorized inspection or disclosure of the returns or return information.

(d) Notification requirements. Any person, or agent or subcontractor of the person, who receives returns or return information under paragraph (a) of this section shall provide written notice to his, her, or its officers and employees receiving the returns or return information that--

(1) Returns or return information disclosed to the officer or employee may be used only for a purpose and to the extent authorized by paragraph (a) of this section;

(2) Further inspection of any returns or return information for a purpose or to an extent not authorized by paragraph (a) of this section constitutes a misdemeanor, punishable upon conviction by a fine of as much as $1,000, or imprisonment for as long as 1 year, or both, together with costs of prosecution;

(3) Further disclosure of any returns or return information for a purpose or to an extent not authorized by paragraph (a) of this section constitutes a felony, punishable upon conviction by a fine of as much as $5,000, or imprisonment for as long as 5 years, or both, together with the costs of prosecution;

(4) Further inspection or disclosure of returns or return information by any person who is not an officer or employee of the United States for a purpose or to an extent not

authorized by paragraph (a) of this section may also result in an award of civil damages against that person in an amount not less than $1,000 for each act of unauthorized inspection or disclosure, or the sum of actual damages sustained by the plaintiff as a result of the unauthorized inspection or disclosure plus, in the case of a willful inspection or disclosure or an inspection or disclosure that is the result of gross negligence, punitive damages. In addition, costs and reasonable attorneys fees may be awarded; and

(5) A conviction for an offense referenced in paragraph (c)(2) or (3) of this section shall, in addition to any other punishment, result in dismissal from office or discharge from employment if the person convicted is an officer or employee of the United States.

(e) Safeguards. (1) Any person, or agent or subcontractor of the person, who may receive returns or return information under paragraph (a) of this section, shall agree, before disclosure of any returns or return information to the person, agent, or subcontractor, to permit an inspection by the IRS of his, her, or its site or facilities.

(2) Any person, or officer, employee, agent or subcontractor of the person, or officer or employee of the agent or subcontractor, who receives returns or return information under paragraph (a) of this section, shall comply with all applicable conditions and requirements as the IRS may prescribe from time to time (prescribed requirements) for the purposes of protecting the confidentiality of returns and return information and preventing disclosures or inspections of returns or return information in a manner not authorized by this section.

(3) The terms of any written contract or agreement for the acquisition of property or services as described in paragraph (a) of this section shall provide, or shall be amended to provide, that any person, or officer, employee, agent or subcontractor of the person, or officer or employee of the agent or subcontractor, who receives returns or return information under paragraph (a) of this section, shall comply with the prescribed requirements. Any contract or agreement shall be made available to the IRS before execution of the contract or agreement. For purposes of this paragraph (e)(3), a written contract or agreement shall include any contract or agreement between a person and an agent or subcontractor of the person to provide the property or services described in paragraph (a) of this section.

(4) If the IRS determines that any person, or officer, employee, agent or subcontractor of the person, or officer or employee of the agent or subcontractor, who receives returns or return information under paragraph (a) of this section, has failed to, or does not, satisfy the prescribed requirements, the IRS may take any actions it deems necessary to ensure that the prescribed requirements are or will be satisfied, including--

(i) Suspension of further disclosures of returns or return information by the IRS to the State tax agency, the Social Security Administration, or the Department of Justice, until the IRS determines that the conditions and requirements have been or will be satisfied;

(ii) Suspension of further disclosures by the Treasury Department otherwise authorized by paragraph (a) of this section; and

(iii) Suspension or termination of any duty or obligation arising under a contract or agreement with the Treasury Department.

(f) Definitions. For purposes of this section--

(1) The term Treasury Department includes the IRS, the Office of the Chief Counsel for the IRS, and the Office of the Treasury Inspector General for Tax Administration;

(2) The term State tax agency means an agency, body, or commission described in section 6103(d); and

(3) The term Department of Justice includes offices of the United States Attorneys.

(g) Effective date. This section is applicable on or after the date final regulations are published in the **Federal Register**.

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 13, 2005
JS-2194

MEDIA ADVISORY:
Treasury and IRS to Hold Background Briefing on Repatriation Guidance

WHAT: Press Background briefing on repatriation guidance under the American Jobs Creation Act

WHEN:1:30 PM Today

WHERE:U.S. Treasury Department
Room 5116
CALL-IN: 202-927-2255; Pass Code: 363344#

COVERAGE: Pen and Pad Only

Please e-mail dates of birth and social security numbers for clearance to Treasury to Frances Anderson at frances.anderson@do.treas.gov by 12:30 PM.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

January 13, 2005
JS-2195

Treasury and IRS Announce Guidance on Repatriation of Foreign Earnings Under the American Jobs Creation Act

WSHINGTON DC – The Treasury Department and IRS today announced the first in a series of notices that will provide guidance for U.S. companies planning to repatriate earnings from overseas subsidiaries subject to the temporary reduced tax rate available under the American Jobs Creation Act (AJCA).

Internal Revenue Code Section 965, enacted as part of the AJCA in October 2004, allows U.S. companies to repatriate earnings from their foreign subsidiaries at a reduced tax rate. Section 965 provides that U.S. companies may elect, for one taxable year, an 85% dividends received deduction for eligible dividends from their foreign subsidiaries.

Section 965 contains several limitations on the repatriated dividends that are eligible for the reduced tax rate. One key requirement is that the repatriated funds must be invested by the company in the United States pursuant to a domestic reinvestment plan approved by company management before the funds are repatriated.

Today's notice provides detailed guidance regarding the parameters for a domestic reinvestment plan and the kinds of investments in the United States for which repatriated funds may be used under this provision. The notice also provides guidance on the requirement that the repatriation be in the form of a cash dividend. In addition, the notice provides guidance on electing application of the provision and on required information reporting regarding repatriated dividends and associated U.S. investments, and provides a safe harbor mechanism for taxpayers to use in establishing that the domestic reinvestment plan requirement is satisfied.

"Given the importance of the new repatriation provision to U.S. companies, coupled with the immediate effective date of the provision and its temporary nature, issuance of prompt guidance was a major priority," said Eric Solomon, Treasury's Acting Deputy Assistant Secretary for Tax Policy. "In today's notice we focused on addressing the most urgent questions, particularly the required U.S. investment of the repatriated earnings."

"This guidance will allow taxpayers to be able to comply with the new provision regarding the repatriation of earnings while at the same time giving the IRS examination function the necessary roadmap to ensure compliance with the new rules," said IRS Chief Counsel Don Korb.

REPORTS

- Repatriation Notice N 2005 10
- Repatriation Fact Sheet Final

Part III - Administrative, Procedural, and Miscellaneous

Domestic reinvestment plans and other guidance under section 965

Notice 2005-10

SECTION 1. OVERVIEW

This notice provides guidance concerning new section 965 of the Internal Revenue Code (Code). It sets forth general principles and specific guidance on domestic reinvestment plans and on investments in the United States described in section 965(b)(4)(B). The Treasury Department and the Internal Revenue Service (IRS) intend to issue additional notices providing guidance concerning section 965, including rules relating to the foreign tax credit and expense allocation, rules for adjusting the calculation of the base period amounts to take into account mergers, acquisitions and spin-offs, and rules regarding controlled groups. The Treasury Department and the IRS expect to issue regulations that incorporate the guidance provided in this and the subsequent notices.

The remainder of this notice is divided into eleven sections. Section 2 provides background information with respect to section 965. Section 3 addresses the meaning of the term "cash dividends." Section 4 sets forth general guidance concerning domestic reinvestment plans. Section 5 lists certain expenditures that, if made pursuant to a domestic reinvestment plan, are investments in the United States described in section 965(b)(4)(B) (permitted investments). Section 6 lists certain expenditures that are not permitted investments. Section 7 describes how a taxpayer elects to apply section 965 to a taxable year. Section 8 provides guidance on reporting requirements and on how a taxpayer may, under the facts and circumstances, establish to the satisfaction of the Commissioner that the dividend proceeds are invested in the United States pursuant to a domestic reinvestment plan, including a safe harbor for making such a demonstration. Section 9 provides transition rules that apply to certain taxpayers that, prior to the issuance of this notice, either adopted a domestic reinvestment plan and received a dividend, or filed a tax return for a taxable year to which section 965 applies. Section 10 provides the effective date of this notice. Section 11 provides information required under the Paperwork Reduction Act of 1995. Finally, section 12 provides drafting information.

This notice provides guidance on several of the requirements for eligibility for the deduction provided under section 965(a). Section 965 contains additional requirements, which are briefly outlined in section 2 of this notice but which are not addressed in detail in this notice, that must be satisfied in order for a cash dividend to be eligible for the deduction provided under section 965(a).

SECTION 2. BACKGROUND

The American Jobs Creation Act of 2004 (P.L. 108-357) (the Act), enacted on October 22, 2004, added new section 965 to the Code. In general, and subject to limitations discussed below, section 965(a) provides that a corporation that is a U.S. shareholder[1] of a controlled foreign corporation (CFC) may elect, for one taxable year, an 85 percent dividends received deduction (DRD) with respect to certain cash dividends it receives from its CFCs. For this purpose, all U.S. shareholders that are members of an affiliated group filing a consolidated return under section 1501 are treated as one U.S. shareholder. Section 965(c)(5).

For purposes of section 965, the term "dividends" includes cash amounts included in gross income as dividends under sections 302 and 304, but does not include amounts treated as dividends under section 78 or 1248 or, in certain cases, section 367.[2] H.R. Conf. Rep. No. 108-755, at 314-15. For this purpose a cash dividend also includes a cash distribution from a CFC that is excluded from gross income under section 959(a) to the extent of inclusions under section 951(a)(1)(A) as a result of a cash dividend during the election year to: (1) such CFC from another CFC in a section 958(a) chain of ownership; or (2) any other CFC in such chain of ownership to the extent of cash distributions described in section 959(b) made during such year to the CFC from which such U.S. shareholder received such distribution.

The DRD under section 965(a) is subject to several limitations. First, section

[1] The term U.S. shareholder means, with respect to any foreign corporation, a U.S. person who owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. Section 951(b).

[2] Dividends resulting from liquidations qualifying under section 332 to which section 367(b) applies qualify as cash dividends to the extent the U.S. shareholder receives cash as part of the liquidation. Section 965(c)(3). A deemed liquidation effectuated through an election under §301.7701-3(c), however, does not result in an actual distribution of cash as required under section 965. See H.R. Conf. Rep. No. 108-755, at 315, footnote 108.

965(b)(1) limits the amount of dividends eligible for the deduction to the greatest of the following three amounts: (1) $500 million; (2) the amount shown on the taxpayer's applicable financial statement[3] as earnings permanently reinvested outside the United States; or (3) in the case of an applicable financial statement that does not show a specific amount of earnings permanently reinvested outside the United States and that shows a specific amount of tax liability attributable to such earnings, the amount of such liability divided by 0.35.

Second, section 965(b)(2) limits the amount of dividends eligible for the deduction to the excess (if any) of the dividends received during the taxable year by the U.S. shareholder from CFCs over the annual average for the base period years of: (1) the dividends received during each base period year by such shareholder from CFCs; (2) the amounts includible in such shareholder's gross income for each base period year under section 951(a)(1)(B) with respect to CFCs; and (3) the amounts that would have been included for each base period year but for section 959(a) with respect to CFCs. The base period years are the three taxable years which are among the five most recent taxable years ending on or before June 30, 2003, determined by disregarding the year for which such total amount is highest and the year for which such total amount is lowest among such five years. Section 965(c)(2).

Third, section 965(b)(3) provides that the amount of dividends eligible for the

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[3] The term "applicable financial statement" means the most recently audited financial statement which is certified on or before June 30, 2003, as being prepared in accordance with generally accepted accounting principles, which is used for the purposes of a statement or report to creditors or shareholders or for any other substantial nontax purpose, and, if the taxpayer is required to file with the SEC, is so filed on or before June 30, 2003. Section 965(c)(1).

deduction is reduced by any increase in related-party indebtedness of the CFC between October 3, 2004, and the close of the election year. For this purpose, all CFCs with respect to which the taxpayer is a U.S. shareholder are treated as a single CFC.

Finally, section 965(b)(4) provides that the amount of the dividend must be invested in the United States pursuant to a domestic reinvestment plan that is approved by the taxpayer's president, chief executive officer, or comparable official before the payment of the dividend, and that is subsequently approved by the taxpayer's board of directors, management committee, executive committee, or similar body. The domestic reinvestment plan must provide for the investment of the dividend in the United States (other than as a payment for executive compensation), including as a source for the funding of worker hiring and training, infrastructure, research and development, capital investments, or the financial stabilization of the corporation for the purposes of job retention or creation. This list is not intended to be exclusive. H.R. Conf. Rep. No. 108-755, at 316.

Section 965(c) provides definitions and special rules, including rules for adjusting the calculation of the base period amounts to take into account mergers, acquisitions and spin-offs. Sections 965(d) and (e) provide special rules limiting foreign tax credits and expense deductions and limiting the attributes available to offset the nondeductible portion of dividends, respectively.

Section 965(f) provides that taxpayers may elect the application of section 965 for either the taxpayer's last taxable year which begins before October 22, 2004, or the taxpayer's first taxable year which begins during the one-year period beginning on

October 22, 2004.

SECTION 3. CASH DIVIDENDS

.01 *In General*

The DRD under section 965(a) applies only to cash dividends[4] received by a corporate U.S. shareholder from CFCs with respect to which it is a U.S. shareholder. For this purpose, the term "cash" includes both U.S. dollars and foreign currency. A CFC may effect distributions of cash by wire transfer or check.

The Treasury Department and the IRS anticipate that, in some cases, a CFC will liquidate investments in cash equivalents in order to pay a cash dividend as required under section 965. It is also anticipated that the U.S. shareholder that receives such a cash dividend from the CFC may temporarily invest all or a portion of the dividend proceeds in cash equivalents, which may be similar in nature to those that had been held by the CFC. For purposes of section 965, the mere fact that the CFC held cash equivalents prior to the payment of a cash dividend and the U.S. shareholder holds cash equivalents after the payment of such dividend will not itself cause the Commissioner to recharacterize the dividend as a distribution by the CFC of the cash equivalents (rather than as a required distribution of cash), under the step transaction doctrine, or other similar authorities. For purposes of this paragraph, the term "cash equivalents" has the meaning provided in §1.897-7T(a).

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[4] For purposes of section 965, a cash dividend includes cash amounts treated as a dividend pursuant to section 356(a)(2).

.02 *Treatment of Distributions to Intermediary Pass-Through Entities*

To qualify as a cash dividend within the meaning of section 965, cash must be distributed from a CFC to the U.S. shareholder in the taxable year for which an election under section 965 applies. For purposes of section 965(a), a cash dividend paid by a CFC to a pass-through entity (a partnership or disregarded entity) that is owned by a U.S. shareholder shall be treated as received by such U.S. shareholder only if and to the extent that such shareholder receives cash in the amount of the CFC dividend during the taxable year for which such election is in effect. In addition, in the case of a partnership, a cash dividend is treated as received by a U.S. shareholder that is a partner in such partnership only if the amount of the dividend is: (i) allocated to the U.S. shareholder-partner under the rules of sections 702 and 704 and the regulations thereunder; and (ii) separately stated to the partner under §1.702-1(a)(8)(ii).

For example, if a U.S. shareholder owns a disregarded entity that, in turn, owns a CFC that pays a cash dividend to the disregarded entity, such dividend will qualify as a cash dividend received by the U.S. shareholder within the meaning of section 965 only to the extent the disregarded entity distributes cash in the amount of the dividend proceeds to the U.S. shareholder during the taxable year to which an election under section 965 applies. A loan of cash from the disregarded entity to the U.S. shareholder would not be considered a distribution of cash for this purpose because, even though the loan would not otherwise be regarded for tax purposes, there would be a legal obligation for the U.S. shareholder to repay the cash to the disregarded entity.

.03 *Amount of Cash Dividend Not Reduced by Related Deductions or Expenses*

The amount otherwise qualifying as a cash dividend is not reduced by expenses or deductions of the taxpayer related to such cash dividend, including any foreign withholding tax and U.S. federal, state or local income tax imposed thereon. Taxpayers must invest the gross amount of the dividend (not reduced by expenses or deductions related to such dividend) in order for the total cash dividend to qualify under section 965(b)(4). Thus, for example, if a CFC distributes $100x of cash to its U.S. shareholder with respect to its stock that is treated as a dividend, and such distribution is subject to a foreign withholding tax of $5x (such that the U.S. shareholder receives a net amount of $95x), the amount of the cash dividend is $100x. Accordingly, the taxpayer must invest $100x in the United States pursuant to a domestic reinvestment plan in order for the $100x cash dividend to satisfy the requirements of section 965(b)(4).

.04 *Interaction with Section 959*

Except as provided in section 965(a)(2), the term "dividends" does not include amounts that are not included in gross income pursuant to section 959(a). In other words, distributions by a CFC to its U.S. shareholder with respect to its stock out of its earnings and profits described in section 959(c)(1) and (c)(2) do not qualify as dividends (except to the extent provided in section 965(a)(2)). Thus, for example, if a CFC has earnings and profits described in section 959(c)(1) of 100u and earnings and profits described in section 959(c)(3) of 50u, under the ordering rules of section 959(c) the CFC must distribute 150u to its U.S. shareholder with respect to its stock in order to be considered to have paid a 50u dividend within the meaning of section 965.

SECTION 4. DOMESTIC REINVESTMENT PLANS

01. *In General*

A domestic reinvestment plan is a written plan prepared by the taxpayer that describes the planned investment in the United States of the amount of the dividend otherwise qualifying for the deduction under section 965(a) in reasonable detail and specificity. It may encompass more than one cash dividend from one or more CFCs. A taxpayer may adopt separate domestic reinvestment plans to apply to different cash dividends made during the taxable year to which it elects to apply section 965. Under section 965, amounts invested in the United States pursuant to the domestic reinvestment plan are not required to exceed investments made in prior years or investments that were planned by the taxpayer prior to the enactment of section 965.

02. *Procedural Requirements*

Pursuant to section 965(b)(4)(A), a domestic reinvestment plan must be approved by the taxpayer's president, chief executive officer, or an official exercising comparable authority over the taxpayer before the cash dividend to which it relates is paid. The taxpayer's board of directors, management committee, executive committee, or the body which exercises similar authority over the taxpayer must subsequently approve the domestic reinvestment plan. Such approval may be granted after the payment of the dividend subject to the domestic reinvestment plan, and no special meeting of the board or other body is required to grant this approval. Where the U.S.

shareholder of a CFC is a member of a consolidated group within the meaning of §1.1502-1(h), the domestic reinvestment plan must be approved by the president, chief executive officer, or comparable official, and by the board of directors, management committee, executive committee, or similar body, of the common parent of the consolidated group. In such a case, the domestic reinvestment plan need not be separately approved by other members of the consolidated group, even if such members make permitted investments pursuant to such plan.

03. *Specificity*

The domestic reinvestment plan must describe specific anticipated investments in the United States. The Treasury Department and the IRS do not intend to provide a template for a domestic reinvestment plan. The composition of a taxpayer's domestic reinvestment plan may vary depending on the type of permitted investments contemplated by the plan (for example, research and development or capital improvements to plant and facility), the time period over which permitted investments will be made, and whether factors beyond the taxpayer's control could affect its ability to make the contemplated investment. These and other relevant facts and circumstances should be taken into account in applying the reasonable specificity standard set forth in this notice.

In general, the domestic reinvestment plan must provide sufficient detail to enable the taxpayer to demonstrate upon examination that the expenditures that subsequently occur were of the kind that were in fact contemplated at the time of the adoption of such plan. Thus, a domestic reinvestment plan that merely recites the statutory language without further detail, or that merely refers generically to expenditures on whatever uses may be permitted for purposes of section 965, will not be considered to have met the statutory requirements.

The domestic reinvestment plan need not indicate precise dollar amounts expected to be incurred for each specific component of an investment, but must state the total dollar amount that will be invested for each respective principal investment in the United States pursuant to such plan (e.g., a total dollar amount for expenditures for research and development on product lines A, B and C and a total dollar amount for expenditures for advertising for brands D and E). A taxpayer may shift expenditures between investments specified in the plan without amending the plan and, to that extent, the additional amounts spent on one investment would be considered an alternative investment (as described below). For example, if a $100x dividend reinvestment plan calls for expenditures of $30x on research and development and $70x on advertising, and the taxpayer in fact expends $90x on the advertising, the additional $20x expenditures on advertising is an alternative investment.

The domestic reinvestment plan must state a reasonable time period, taking into account the nature of the investments to be made in the United States and other facts and circumstances, during which the taxpayer anticipates completing all such investments pursuant to such plan.

The Treasury Department and the IRS recognize that, after a domestic reinvestment plan is approved, certain investments specified in such plan may no longer be practicable or desirable for various reasons. This may occur, for example, if an investment is dependent on actions of other persons, or upon reasonably anticipated business conditions that subsequently change. For example, a taxpayer's domestic reinvestment plan may contemplate as a principal investment a plant in the United States the construction of which cannot proceed absent certain governmental approvals and, subsequent to the adoption of the plan, the necessary governmental approvals are denied. Accordingly, the domestic reinvestment plan may provide alternative investments, which are themselves permitted investments, for investing the amount of the dividend in the United States in cases where principal investments are subsequently delayed or rejected. Such alternative investments must be described in the domestic reinvestment plan under the same standard of specificity provided above. The domestic reinvestment plan need not, however, set forth the conditions under which the alternative investments will be substituted for the principal investments.

.04 *Amending the Domestic Reinvestment Plan*

In general, the taxpayer is not permitted to modify or amend a domestic reinvestment plan after payment of the dividend to which such plan relates. See section 9.02 of this notice for a special transition rule in the case of certain dividends paid prior to January 13, 2005.

.05 *Tracing or Segregating Funds*

A taxpayer is not required to trace or segregate the specific dividend proceeds it receives to demonstrate that it has properly invested the amount of the dividend in the

United States pursuant to the domestic reinvestment plan. Moreover, provided a sufficient amount of funds is properly invested in the United States pursuant to the domestic reinvestment plan (and such plan otherwise satisfies the requirements under section 965(b)(4) and this notice), the fact that other non-permitted investments are made during the period covered by such plan generally will not affect the eligibility of the dividend under section 965.

For example, if, pursuant to a domestic reinvestment plan, a taxpayer plans to invest an amount equal to the dividend in infrastructure over a three-year period, the taxpayer is not required to trace or otherwise account for the specific funds that were distributed to the taxpayer and ensure that the same specific funds are invested in the infrastructure over the three-year period. Rather, the taxpayer must demonstrate to the satisfaction of the Commissioner that an amount equal to the dividend is invested in infrastructure pursuant to the domestic reinvestment plan.

In certain cases, however, the fulfillment of a domestic reinvestment plan may be subject to greater scrutiny by the Commissioner because the plan provides that the investment in the United States will only occur over the course of many years, and during such period the taxpayer also is making expenditures that would not be permitted investments. In that case, a segregated account in the amount of the dividend proceeds, with disbursements from the account expended for the permitted investments described in the domestic reinvestment plan, would be a positive factor in establishing that the requirements of section 965(b)(4) are satisfied.

A domestic reinvestment plan may include an investment that, prior to the adoption of the plan, was anticipated to be made by the taxpayer. This is the case even if, prior to the adoption of the domestic reinvestment plan, such investment was budgeted and expected to be made with other funds.

.06 *Expenditures in Taxable Year of Election*

In general, expenditures made during the taxable year for which the taxpayer elects to apply section 965 may be considered to be made pursuant to the domestic reinvestment plan, regardless of when they are made during such year. Thus, for example, expenditures on permitted investments made in the election year but prior to the payment of the cash dividend described in section 965(a) (or prior to the adoption of the domestic reinvestment plan) may qualify as permitted investments made pursuant to the domestic reinvestment plan. Expenditures made during taxable years prior to the taxable year to which the taxpayer elected section 965 to apply, however, will not qualify as permitted investments made pursuant to the domestic reinvestment plan.

.07 *Partially Completed Domestic Reinvestment Plans*

A cash dividend that would otherwise qualify for the DRD under section 965(a) is considered to qualify pursuant to section 965(b)(4) only to the extent the amount of the dividend is expended on permitted investments pursuant to the domestic reinvestment plan. If the domestic reinvestment plan provides for expenditures on permitted investments of the full amount of the dividend, but the U.S. shareholder in fact expends less than the full amount of the dividend on such permitted investments, the dividend satisfies the requirements of section 965(b)(4) only to the extent of the amount so expended. Thus, for example, assume a CFC pays a cash dividend of $100x to its U.S. shareholder pursuant to a domestic reinvestment plan that properly specifies $100x of permitted investments pursuant to section 4 of this notice (and the dividend otherwise qualifies for the DRD under section 965(a)), but the U.S. shareholder in fact only makes $90x of the permitted investments provided for under the plan. In such a case, $10x of the $100x cash dividend does not qualify for the DRD under section 965(a); the remaining $90x qualifies for the DRD under section 965(a).

SECTION 5. EXPENDITURES THAT ARE INVESTMENTS IN THE UNITED STATES PURSUANT TO SECTION 965(b)(4)

.01 *In General*

(a) *Scope.* Except as provided in sections 5.01(b) and (c) of this notice, expenditures described in section 5 of this notice that are made pursuant to a domestic reinvestment plan, as provided under section 965(b)(4) and this notice, are permitted investments. Because this list of permitted investments is not an exclusive list, other investments in the United States made pursuant to a domestic reinvestment plan may also be permitted investments.

(b) *Payments to Unrelated Persons.* Expenditures described in this section 5 are permitted investments only if they are made to a person that is not related to the taxpayer (within the meaning of section 267(b), other than section 267(b)(8) in the case of an expenditure with respect to a qualified plan pursuant to section 5.02 or 5.05(b)).

(c) *Cash Payments.* In general, permitted investments must be made in the form of cash. If a taxpayer issues a note in payment for what would otherwise be a permitted investment, the permitted investment is considered to be made only as the taxpayer satisfies its obligation under the note in cash.

Stock may not be used to make permitted investments. Thus, for example, if a taxpayer issues stock to acquire a target corporation, such acquisition is not a permitted investment (unless, and only to the extent that, cash also is paid for the target company).[5] Similarly, compensation in the form of stock grants or stock options is not a permitted investment.

.02 *Funding of Worker Hiring, Training, and Other Compensation*

Expenditures incurred in connection with the funding of worker hiring and training (other than as provided in section 6.02 of this notice) are permitted investments. In general, the funding of worker hiring and training includes expenditures incurred in connection with hiring new workers and training both existing and newly-hired workers and expenditures incurred on compensation and benefits (including the funding of a qualified plan within the meaning of section 401(a)) of existing and newly-hired workers.

Expenditures do not qualify, however, to the extent described in section 6.02 of this notice, related to executive compensation. In addition, expenditures qualify only to the extent attributable to services performed by the workers within the United States. If the services are performed partly within and partly without the United States, the amount of permitted investments shall be determined under the principles of §1.861-

[5] This is the case even if the acquisition of the target would qualify, in whole or in part, as a permitted investment under section 5.06 of this notice if cash, rather than taxpayer stock, were used to make the acquisition.

4(b)(1). Expenditures in this case may be permitted investments even if the workers are not employees of the taxpayer, provided such expenditures are borne by the taxpayer and the activities are performed in the United States.

In the case of funding a qualified plan, a taxpayer may use a reasonable method to apportion the funding between amounts related to executive compensation and non-executive compensation, and between amounts related to services performed within and without the United States. See also section 5.05(b) of this notice (relating to the qualification of satisfaction of an obligation to fund a qualified plan as financial stabilization for the purposes of job retention or creation in the United States).

.03 *Infrastructure and Capital Investments*

Expenditures incurred in connection with the funding of infrastructure and capital investments are permitted investments. Expenditures for infrastructure and capital investments include physical installations and facilities that support the taxpayer's business, and other assets integral to the conduct of a business, provided that the infrastructure and capital investments are located and used in the United States. Such expenditures also include payments for services performed in the United States that are related to, or provided in connection with, otherwise qualified infrastructure or capital investments described in this section.

Infrastructure and capital investments include plant, property and equipment, communications and distribution systems, computer hardware and software, databases, and supporting equipment. Improvements to the items described above also are qualified expenditures.

Expenditures are incurred for infrastructure and capital investments as described above regardless of whether incurred to construct, develop, purchase, rent, or license such items.

If the infrastructure or capital investment is partly within and partly without the United States, the amount of the expenditure that constitutes a permitted investment with respect to such item is limited to amounts attributable to assets that are located and used within the United States. Similarly, if services related to, or provided in connection with, qualified infrastructure or capital investments are performed partly within and partly without the United States, the amount of the expenditure that constitutes a permitted investment shall be determined under the principles of §1.861-4(b)(1).

.04 *Research and Development*

Expenditures incurred in connection with the funding of research and development are permitted investments. In general, expenditures for research and development are expenditures that are described in §1.174-2, provided that the research and development activities are performed in the United States. In addition, if the research and development is performed partly within and partly without the United States, the amount of the expenditure that constitutes a permitted investment shall be determined under the principles of §1.861-4(b)(1).

Expenditures for research and development constitute a permitted investment only to the extent they are borne by the taxpayer. Thus, for example, expenditures incurred on research and development performed by employees of the taxpayer within the United States are not permitted investments to the extent the taxpayer is reimbursed by another party for such activities pursuant to a cost sharing arrangement under §1.482-7.

Expenditures for research and development may be permitted investments even if the research and development is not performed by employees of the taxpayer, provided such expenditures are borne by the taxpayer and the activities are performed in the United States.

.05 *Financial Stabilization of the Corporation for the Purposes of Job Retention or Creation*

(a) *Repayment of debt.* The repayment by the taxpayer of debt, regardless of whether the lender or holder is a U.S. person, is a permitted investment so long as the repayment contributes to the financial stabilization of the taxpayer for the purposes of job retention or creation in the United States. The repayment of debt ordinarily will be considered to contribute to the financial stabilization of the taxpayer because it improves the taxpayer's debt-equity ratio and reduces the taxpayer's obligations for debt service. An increase in the taxpayer's credit rating due to the debt repayment is not required. Such an increase, however, would be an indication of a contribution to financial stabilization. The requirement that financial stabilization be for the purposes of job retention or creation in the United States is satisfied if, at the time the domestic reinvestment plan is approved by the taxpayer's president, chief executive officer, or comparable official, the taxpayer's reasonable business judgment is that the resulting financial stabilization will be a positive factor in its ability to retain and create jobs in the United States. In this regard, a plan developed by the taxpayer as part of its strategic planning process that evidences expected use of savings attributable to reduced debt service principally for expenditures incurred in connection with permitted investments is one method of demonstrating a purpose of job retention or creation in the United States because such expenditures likely would have direct or indirect positive effects on employment in the United States.

A repayment of debt is not a permitted investment to the extent, at the time of the repayment, the taxpayer has a plan or intent to incur additional debt on substantially the same terms following the date of the dividend, and the taxpayer in fact incurs such additional debt. In that case, the additional debt, in effect, replaces the repaid debt. Such a temporary or transitory reduction in taxpayer indebtedness is not a permitted investment. The determination of whether the taxpayer had such a plan or intent shall be determined based on all the relevant facts and circumstances, taking into account all relevant provisions and general principles of tax law, including the substance over form doctrine. See, e.g., Rev. Rul. 89-73, 1989-1 C.B. 258.

The taxpayer is not required to demonstrate that there has been a net global reduction in indebtedness of the taxpayer's corporate group in order for the repayment of debt to be a permitted investment. Thus, for example, if a CFC incurs debt (and is treated as the obligor on such debt) to fund a cash dividend it pays to its U.S. shareholder, and the U.S. shareholder uses the dividend proceeds to repay debt owed to an unrelated party, the U.S. shareholder may be able to demonstrate that such repayment is a permitted investment even though the total debt of the taxpayer and its CFCs, taken in the aggregate, is not reduced. If, however, the facts and circumstances are such that, in substance, the taxpayer (rather than the CFC) is the obligor of the debt nominally incurred by the CFC,[6] then the taxpayer simply incurred debt to repay other debt. In such a case, the repayment of the existing debt is transitory and not a permitted investment.

The repayment or acquisition of an intercompany obligation between members of the same consolidated group does not qualify as the repayment of debt for purposes of this section. However, if the consolidated group member receiving funds equal to the repayment or acquisition amount also makes a permitted investment of such amount, such investment may qualify under section 5 of this notice. See section 6.03 of this notice.

(b) *Qualified Plan Funding.* The satisfaction of an obligation to fund a qualified plan (within the meaning of section 401(a)) ordinarily will contribute to the financial stabilization of the taxpayer. The taxpayer is not required to demonstrate the extent to which the plan covers current employees or the extent to which those covered by the plan perform (or performed) services within the United States. The requirement that financial stabilization be for the purposes of job retention or creation in the United States is satisfied if, at the time the domestic reinvestment plan is approved by the taxpayer's

[6] *See, e.g., Plantation Patterns v. Comm'r*, 462 F.2d 712 (5th Cir. 1972), *cert. denied*, 409 U.S. 1076 (1972).

president, chief executive officer, or comparable official, the taxpayer's reasonable business judgment is that the resulting financial stabilization will be a positive factor in its ability to retain and create jobs in the United States. See also section 5.02 of this notice (relating to the qualification of expenditures for worker hiring, training and other compensation in the United States as permitted investments).

(c) *Other Expenditures.* Expenditures other than those described in sections 5.05(a) or (b) of this notice also are permitted investments if such expenditures contribute to the financial stabilization of the taxpayer for the purposes of job retention or creation in the United States. Whether such an expenditure contributes to the financial stabilization of the taxpayer for the purposes of job retention or creation in the United States will be determined based on all the facts and circumstances. Such an expenditure generally will be considered to be a permitted investment if the expenditure reduces financial constraints on the taxpayer's U.S. operations and if, at the time the domestic reinvestment plan is approved by the taxpayer's president, chief executive officer, or comparable official, the taxpayer's reasonable business judgment is that such reduction in financial constraints will be a positive factor in its ability to retain and create jobs in the United States.

.06 Acquisitions of Interests in Business Entities

(a) *General Rule.* Except as provided in section 5.06(b) of this notice, the acquisition of an ownership interest in a business entity (such as a corporation or a partnership), regardless of whether such entity is domestic or foreign, is a permitted investment to the extent of the percentage of the total value of the assets owned (directly or indirectly) by the business entity that, if acquired directly, would be permitted investments as described in this notice. The direct or indirect acquisition of an interest in a business entity is a permitted investment only if the taxpayer directly or indirectly owns an interest representing at least 10 percent of the value of such business entity after the acquisition. For purposes of determining whether a taxpayer indirectly owns a 10-percent interest in a business entity, and for purposes of determining whether business entities indirectly own interests in other entities, rules similar to the rules of section 267(c) shall apply.

In general, amounts expended to acquire a direct interest in a business entity shall be allocated between permitted and non-permitted investments on the basis of the relative values of the business entity's assets that, if acquired directly, would be permitted or non-permitted investments. If a business entity owns an interest in another business entity in which the taxpayer indirectly owns a 10-percent interest, the assets taken into account for this purpose are the upper-tier entity's share of the assets held by the lower-tier entity, not the upper-tier entity's interest in the lower-tier entity. In valuing assets for this purpose, the taxpayer must use the same methodology under §1.861-9T(g) (i.e., tax book value, alternative tax book value or fair market value) that the taxpayer uses for purposes of allocating and apportioning interest expense for the taxable year under section 864(e). In applying this section 5.06, however, asset amounts shall be characterized as permitted or non-permitted investments based on whether the assets are located and used within the United States, and not on the basis of the source of the income generated by the assets.

(b) *De Minimis Rule*. If a taxpayer acquires an interest in a business entity as described in section 5.06(a) of this notice, and more than 95 percent of such expenditure would be a permitted investment or a non-permitted investment as determined under section 5.06(a) of this notice, the entire acquisition shall be treated as a permitted investment or a non-permitted investment, respectively.

.07 Advertising and Marketing Expenditures

Expenditures incurred on advertising or marketing with respect to trademarks, trade names, brand names, or similar intangible property are permitted investments, provided the advertising or marketing activities are performed in the United States. If the advertising or marketing activities are performed partly within and partly without the United States, the amount that constitutes a permitted investment shall be determined under the principles of §1.861-4(b)(1). As is the case with research and development (discussed in section 5.04 of this notice), the advertising or marketing expenditures must be borne by the taxpayer, but the advertising or marketing activities need not be performed by employees of the taxpayer.

.08 *Intangible Property*

Expenditures to acquire the rights to intangible property, through purchase or license, are permitted investments to the extent the rights to the intangible property are used in the United States.

SECTION 6. EXPENDITURES THAT ARE NOT INVESTMENTS IN THE UNITED STATES PURSUANT TO SECTION 965(b)(4)

.01 *In General*

The expenditures described in this section 6 are not permitted investments by the taxpayer in the United States within the meaning of section 965(b)(4). Section 965(b)(4) explicitly provides that executive compensation is not a permitted investment. The other non-permitted investments listed in this section are not reasonably expected to maintain or add to the value of the taxpayer as a going concern. Because this list of non-permitted investments is not an exclusive list, other expenditures may also be non-permitted investments.

.02 *Executive Compensation*

Executive compensation is not a permitted investment. Executive compensation is defined as compensation paid, directly or indirectly, by or on behalf of, the taxpayer, to any employee or former employee, in exchange for services (past, present, or future) performed for the taxpayer, if: (a) the individual is an employee who is subject to the requirements of section 16(a) of the Securities Exchange Act of 1934 with respect to the taxpayer; (b) the individual is an employee who would be subject to such requirements if the taxpayer were an issuer of equity securities referred to in such section; or (c) the individual is a former employee who was described in clauses (a) or (b) of this section 6.02 at the time of his or her severance from employment. A taxpayer may treat the ten employees who received the highest wages in the most recently ended calendar year as being the individuals described in clause (b) of this section

6.02.

.03 *Intercompany Distributions, Obligations, and Transactions*

For purposes of section 965, all U.S. shareholders that are members of an affiliated group filing a consolidated return under section 1501 are treated as one U.S. shareholder. Section 965(c)(5). Therefore, intercompany distributions, intercompany obligations, and intercompany transactions (all as defined in §1.1502-13) between corporations that are members of the same consolidated group are disregarded for purposes of section 965 and cannot be permitted investments under section 5 of this notice. However, if a consolidated group member initially receives a cash dividend from its CFC, an investment of an amount equal to such dividend amount made by another consolidated group member may be a permitted investment under section 5 of this notice.

.04 *Dividends and Other Distributions With Respect to Stock*

Dividends and other distributions made by the taxpayer to its shareholders with respect to its stock, without regard to how such distributions are treated under section 301, are not permitted investments because they do not constitute investments by the taxpayer for purposes of section 965.

Moreover, although intercompany distributions between members of a consolidated group are disregarded for purposes of section 965, a distribution with respect to the stock of a consolidated group member that is held by a person that is not a member of the same consolidated group is not a permitted investment.

.05 *Stock Redemptions*

The redemption of outstanding stock of a taxpayer or, through one or more steps as part of a plan, of a corporation related to the taxpayer (within the meaning of section 267(b)) without regard to whether such redemption is treated as an exchange in part or full payment for the stock under section 302(b), is not a permitted investment. As is the case with dividends, such expenditures do not constitute investments by the taxpayer for purposes of section 965.

Moreover, although an intercompany transaction in which a consolidated group member acquires its own stock from another consolidated group member is disregarded for purposes of section 965, a redemption of shares of stock of a consolidated group member that are held by a person that is not a member of the same consolidated group is not a permitted investment.

.06 *Portfolio Investments in Business Entities*

Except as provided in section 5.06 of this notice, the acquisition of an interest in a business entity is not a permitted investment.

.07 *Debt Instruments or other Evidences of Indebtedness*

The acquisition of a debt instrument or other evidence of indebtedness, including an acquisition of such instrument or indebtedness from the debtor, is not a permitted investment.

.08 *Tax Payments*

Payments of federal, state, local or foreign taxes, and associated interest and penalties, including foreign withholding tax and U.S. federal, state or local income tax imposed on distributions that qualify as cash dividends under section 965(a), are not permitted investments.

SECTION 7. ELECTION TO APPLY SECTION 965 TO A TAXABLE YEAR

In general, a taxpayer elects to apply section 965 to a taxable year by filing Form 8895 with its timely-filed tax return (including extensions) for such taxable year. If, however, a taxpayer files its tax return for the taxable year to which the taxpayer intends to elect section 965 to apply prior to the issuance of Form 8895, the election must be made on a statement that is attached to its timely-filed tax return (including extensions) for such taxable year. See section 9.03 for a special transition rule for certain tax returns filed prior to January 13, 2005.

SECTION 8. REPORTING AND OTHER ADMINISTRATIVE REQUIREMENTS

.01 *In General*

The determination of whether the dividend has been invested in the United States pursuant to the domestic reinvestment plan as provided under section 965(b)(4) is generally made under the facts and circumstances of the particular taxpayer, as described in section 8.04 of this notice. However, section 8.03 of this notice provides a safe harbor method under which the taxpayer will be considered to have established to the satisfaction of the Commissioner that the amount of the dividend has been invested in the United States pursuant to the domestic reinvestment plan.

Section 8.02 of this notice sets forth reporting and documentation requirements with respect to section 965.

.02 *Reporting and Documentation Requirements*

(a) *Annual Reporting.* The taxpayer shall attach a statement which includes the items described below to its timely-filed tax return (including extensions) for the taxable year to which the taxpayer's election under section 965 applies and for each subsequent taxable year at the beginning of which the taxpayer has not made all investments required to be made under one or more of its domestic reinvestment plans (unless the annual reporting requirement is terminated earlier pursuant to sections 8.03(c)(i) or 8.04(c)(ii) of this notice):

(i) A statement that the document is submitted pursuant to section 965(b)(4) and this notice.

(ii) A general description of any permitted investment made during the taxable year pursuant to the domestic reinvestment plan and a reconciliation over the entire term of such plan through the last day of the taxable year for which the statement is filed of the specific expenditures made with respect to each such investment. The description must include a calculation of the percentage of completion of the domestic reinvestment plan. The percentage of completion of the plan is calculated as the sum of the expenditures made and amounts subject to a binding contract or commitment (as described in section 8.03(b)(i) of this notice) through such last day, divided by the total amount to be invested pursuant to the plan.

(iii) A statement indicating whether any of the permitted investments that have been made pursuant to the domestic reinvestment plan are alternative investments.

(iv) Such additional items, as applicable, pursuant to sections 8.03 and 8.04 of this notice.

(b) *Documentation and Production.* The taxpayer shall, with respect to each of its domestic reinvestment plans, prepare, maintain, and, upon a request by the Commissioner, make available within 30 days of such request, the following:

(i) Records that display in reasonable detail the amount invested in the United States pursuant to the domestic reinvestment plan as required under section 965(b)(4)(B). The documentation must also include an allocation between permitted investments and non-permitted investments and, as relevant, a demonstration that the methodology used is consistent with the principles prescribed in this notice. For example, if the taxpayer acquires a 10-percent interest in a business entity that directly or indirectly owns assets that, if acquired directly, would consist of both permitted and non-permitted investments, an analysis of the allocation of the expenditure between permitted and non-permitted assets under the principles described in section 5.06 of this notice is required.

(ii) A copy of the domestic reinvestment plan and any supporting documents.

(iii) In the case of a cash dividend that is effectuated through an intermediary partnership (as described in section 3.02 of this notice) that is foreign and is not required under section 6031 to file an information return, substantiation that the applicable requirements set forth in section 3.02 of this notice (regarding allocations under sections 702 and 704, and the separate statement of items pursuant to §1.702-1(a)(8)(ii)) were met.

.03 *Safe Harbor*

(a) *In General.* If a taxpayer meets the requirements under sections 8.03(b), 8.03(c), and 8.03(d) of this notice, then the taxpayer will have established to the satisfaction of the Commissioner that the amount of the dividend has been invested in the United States pursuant to the domestic reinvestment plan as required under section 965(b)(4). This safe harbor is not the exclusive method of satisfying the Commissioner. If the safe harbor is not met, the determination will be made under a facts and circumstances analysis described in section 8.04 of this notice.

(b) *Substantive Requirements*. Expenditures comprising at least 60 percent of the amount of total funds with respect to permitted investments to be made pursuant to the domestic reinvestment plan meet both of the following requirements:

(i) Such expenditures have been made, or are the subject of a binding contract or commitment entered into with persons unrelated to the taxpayer (within the meaning of section 267(b), other than section 267(b)(8)), by the end of the second taxable year following the taxable year for which the taxpayer elected to apply section 965; and --

(ii) Such expenditures constitute permitted investments listed in section 5 of this notice (other than investments described in section 5.05(c) of this notice).

(c) *Annual Reporting.* The taxpayer satisfies the reporting requirements of section 8.02(a) of this notice for the taxable year for which the taxpayer elected section 965 to apply and each of the two subsequent taxable years (unless all investments have been made pursuant to the domestic reinvestment plan prior to the beginning of either such taxable year) and includes in such reporting the representations set forth below, as applicable:

(i) In an annual report filed for a taxable year no later than the second taxable year following the taxable year to which the taxpayer elected to apply section 965, representations --

(A) that the requirements of section 8.03(b) of this notice have been met; and

(B) that the taxpayer intends to make the remaining amount of investments, if any, pursuant to the domestic reinvestment plan no later than the end of the fourth taxable year following the taxable year to which the taxpayer elected to apply section 965.

A taxpayer may cease annual reporting pursuant to section 8.02(a) and this section 8.03(c) after such statement including such representations is filed.

(ii) If the repayment of debt during the taxable year is intended to qualify as a permitted investment pursuant to section 5.05(a) of this notice, representations --

(A) That such repayment of debt contributes to the financial stabilization of the taxpayer in the United States in accordance with section 5.05(a) of this notice;

(B) That at the time the domestic reinvestment plan was approved by the taxpayer's president, chief executive officer, or comparable official, the taxpayer's reasonable business judgment was that the financial stabilization resulting from such repayment of debt will be a positive factor in its ability to retain and create jobs in the United States in accordance with section 5.05(a) of this notice; and

(C) That, at the time of the repayment, the corporation had no plan or intent to incur additional debt under substantially the same terms in accordance with section 5.05(a) of this notice.

(iii) If the satisfaction of an obligation to fund a qualified plan (within the meaning of section 401(a)) is intended to qualify as a permitted investment pursuant to section 5.05(b) of this notice, representations --

(A) That such satisfaction of a qualified plan funding obligation contributes to the financial stabilization of the taxpayer in accordance with section 5.05(b) of this notice; and

(B) That at the time the domestic reinvestment plan was approved by the taxpayer's president, chief executive officer, or comparable official, the taxpayer's reasonable business judgment was that the financial stabilization resulting from such satisfaction of a qualified plan funding obligation will be a positive factor in its ability to retain and create jobs in the United States in accordance with section 5.05(b) of this notice.

(d) *Documentation and Production.* The taxpayer satisfies the documentation and production requirements of section 8.02(b) of this notice.

.04 *Facts and Circumstances*

(a) *In General.* If a taxpayer does not satisfy the safe harbor described in section 8.03 of this notice, the taxpayer must establish to the satisfaction of the Commissioner that, taking into account the facts and circumstances, the amount of the dividend has been, or will be, invested in the United States pursuant to the domestic reinvestment plan as required under section 965(b)(4). The fact that the safe harbor has not been satisfied, however, is not relevant in determining whether the dividend has been invested in the United States pursuant to the domestic reinvestment plan as required under section 965(b)(4). Among the facts and circumstances that may be relevant in establishing to the satisfaction of the Commissioner that the amount of the dividend has been invested in the United States pursuant to the domestic reinvestment plan as required under section 965(b)(4) are those in sections 8.04(b), 8.04(c), and 8.04(d) of this notice.

(b) *Relevant Facts and Circumstances.* Relevant facts and circumstances for purposes of this section 8.04 include:

(i) The time period prescribed in the domestic reinvestment plan, taking into account the nature of the investments to be made in the United States and other facts and circumstances, during which the taxpayer anticipates completing all investments to be made pursuant to the domestic reinvestment plan. See section 4.03 of this notice.

(ii) The degree of specificity used in the domestic reinvestment plan describing anticipated permitted investments. See section 4.03 of this notice.

(iii) The extent to which the taxpayer has completed the investment of the dividend in the United States as required under section 965(b)(4), taking into account the nature of the investments to be made in the United States and other facts and circumstances.

(c) *Annual Reporting.* Relevant facts and circumstances also include the extent to which the taxpayer has complied with the reporting requirements described in section 8.02(a) of this notice, and whether the taxpayer includes in an annual report filed for the taxable year no later than the second taxable year following the taxable year to which the taxpayer elected to apply section 965 the following representations:

(i) that the taxpayer will agree, upon a request by the Commissioner, to enter into an agreement to extend the statute of limitations on assessment and collection with respect to the DRD claimed under section 965(a) for the taxable year to which the taxpayer elected to apply section 965; and

(ii) that the taxpayer will agree, upon a request by the Commissioner, to enter into a multi-year agreement with respect to the taxpayer's completion of the domestic reinvestment plan.

An agreement entered into with the Commissioner may determine the extent of any continuing reporting and documentation requirements pursuant to this section 8.04(c) and section 8.04(d) of this notice.

(d) *Documentation and Production.* Relevant facts and circumstances also include the extent to which the taxpayer satisfies the documentation and production requirements of section 8.02(b) of this notice.

SECTION 9: TRANSITION RULES

.01 *In General.*

All domestic reinvestment plans are subject to the guidance provided in this notice. Thus, for example, expenditures described in Section 6 of this notice are non-permitted investments, even if such expenditures were made prior to the issuance of this notice.

.02 *Dividends Paid Prior to January 13, 2005.*

If a domestic reinvestment plan approved prior to January 13, 2005 is not in conformity with the guidance provided in this notice, the taxpayer may modify such plan to comply with the guidance herein not later than March 14, 2005, even if the dividend (or dividends) to which the plan relates has already been paid. Any domestic reinvestment plan that is so modified must be subsequently approved by the taxpayer's president, chief executive officer, or comparable official, and by the taxpayer's board of directors, management committee, executive committee, or similar body.

.03 *Tax Returns Filed Prior to January 13, 2005.*

A taxpayer that has filed its tax return for the taxable year for which it elects section 965 to apply prior to January 13, 2005 may satisfy the reporting requirements of sections 8.02(a), 8.03(c) or 8.04(c) of this notice on an amended tax return that is filed by the due date (including extensions) of the tax return for such taxable year.

SECTION 10: EFFECTIVE DATE

This notice is effective for the taxable year for which taxpayers have elected section 965 to apply, and subsequent taxable years as relevant.

SECTION 11: PAPERWORK REDUCTION ACT

The collections of information contained in this notice have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1926.

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.

The collections of information are in sections 7, 8, and 9 of this notice. This information is required to provide the IRS sufficient information to determine whether a taxpayer has properly elected to apply section 965 to a taxable year, to determine whether a dividend has been invested in the United States pursuant to a domestic reinvestment plan under section 965(b)(4), and to determine whether a taxpayer has properly applied certain transition rules. The collections of information are required to obtain the benefit of section 965 for a taxable year. The likely respondents are business corporations.

Estimated total annual reporting and/or recordkeeping burden: 3,750,000 hours.

Estimated average annual burden hours per respondent: 150 hours.

Estimated number of respondents: 25,000.

Estimated annual frequency of responses: on occasion and annually.

The collections of information contained in this notice 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 received by February 14, 2005. Comments are specifically requested concerning:

Whether the proposed collections of information are 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 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.

Comments concerning the accuracy of the burden estimate and suggestions for reducing the burden of the final or temporary regulations 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, W:CAR:MP:T:T:SP, Washington DC 20224.

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.

SECTION 12: DRAFTING INFORMATION

The principal author of this notice is Jeffrey L. Vinnik of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in its development. For further information regarding this notice contact Mr. Vinnik at (202) 622-3840 (not a toll-free call).

DEPARTMENT OF THE TREASURY
Office of Public Affairs

January 13, 2005

FACT SHEET:

Guidance on Repatriation of Foreign Earnings Under the American Jobs Creation Act

Overview:
The Treasury Department and IRS today announced the first in a series of notices that will provide detailed guidance for U.S. companies planning to repatriate earnings from overseas subsidiaries subject to the temporary reduced tax rate available under the American Jobs Creation Act (AJCA). The notice released today gives guidance to companies on how to satisfy the domestic reinvestment plan requirement and on the kinds of investments in the United States for which the repatriated funds may be used under this provision.

Background:
Internal Revenue Code Section 965, enacted as part of the AJCA in October 2004, is a temporary provision that allows U.S. companies to repatriate earnings from their foreign subsidiaries at a reduced tax rate provided that the specified conditions and restrictions are satisfied. Section 965 provides that U.S. companies may elect, for one taxable year, an 85% dividends received deduction for eligible dividends from their foreign subsidiaries.

Section 965 contains several limitations on the repatriated dividends that are eligible for the reduced tax rate. One such requirement is that the repatriated funds must be invested by the company in the United States pursuant to a domestic reinvestment plan approved by company management before the funds are repatriated. Today's notice focuses on this requirement and provides detailed guidance to assist companies in satisfying this requirement.

How it works:
- Under the new law, for one year only, companies that repatriate earnings from foreign subsidiaries to the United States and meet the specified requirements are subject to a reduced tax rate on the repatriated earnings.
- Before repatriating the earnings, the company must have a domestic reinvestment plan for such earnings that is approved by the company's CEO or President and is subsequently approved by its board of directors.
- There are limits on what constitutes an investment in the United States as required under this provision.

Domestic Reinvestment Plan:
The domestic reinvestment plan must be approved by the company's president, CEO, or comparable official before the dividend is paid. The plan must also be approved

subsequently by the company's board of directors, management committee, executive committee, or similar body.

The plan must describe specific anticipated investments in the United States. There is no required form or template that must be used for the plan. The plan must describe the anticipated U.S. investments in reasonable detail and specificity.

The plan must state a reasonable time period during which the company anticipates completing the investments. The plan may provide for alternative investments to be made if the principal investments specified cannot be made. The plan must state the total dollar amount for each principal investment.

Permitted investments:
Section 965 identifies types of U.S. investments for which repatriated funds may be used under a domestic reinvestment plan.

Today's notice provides guidance on the following U.S. investments:
- ✓ Hiring and training workers
- ✓ Infrastructure and capital investments
- ✓ Research and development
- ✓ Financial stabilization for the purposes of U.S. job retention or creation
  - o This would include debt repayment and the funding of qualified benefit plan obligations
- ✓ Certain acquisitions of business entities with U.S. assets
- ✓ Advertising and marketing
- ✓ Acquisition of rights to intangible property, such as a patent rights

Expenditures that are not permitted investments:
Some expenditures do not constitute investments for which repatriated funds may be used under a domestic reinvestment plan.

Today's notice provides guidance on the following non-permitted investments:
- ✓ Executive compensation
- ✓ Intercompany transactions
- ✓ Dividends and other shareholder distributions
- ✓ Stock redemptions
- ✓ Portfolio investments
- ✓ Debt instruments
- ✓ Tax payments

Neither the list of permitted investments nor the list of non-permitted investments is exhaustive.

Administrative guidance:
The election to apply the section 965 repatriation provision is made by attaching an election form or statement to the tax return for the year.

Information must be reported to the IRS annually regarding investments made under a domestic reinvestment plan.

A safe harbor, based on a showing of progress toward completion of the planned U.S. investments, may be used to establish that the domestic reinvestment plan requirement has been satisfied.

QUESTIONS AND ANSWERS

When is the provision effective?
The provision generally applies to the first taxable year beginning on or after the October 22, 2004 enactment (which means 2005 for calendar-year taxpayers). Alternatively, the provision could be applied to the preceding taxable year (which means 2004 for calendar-year taxpayers).

Exactly what is the tax reduction to companies on the foreign earnings they repatriate?
The U.S. company is permitted to deduct 85% of the repatriated dividends. If the company is subject to the 35% corporate tax rate on the other 15% of the repatriated amount, that represents effectively a 5.25% tax rate on the total repatriated dividend.

Do firms have to use the tax break in 2005 or could they save it and use it in 2006 or in later years?
The provision applies only for the year specified and cannot be used in later years.

Are companies required to use the exact funds they repatriate to make the required U.S. investment?
No, companies are not required to trace or segregate the repatriated funds. Companies simply must demonstrate that an amount equal to the amount of repatriated funds is invested under the domestic reinvestment plan.

Do the investments have to be completed in a specific time frame? Do they have to be completed in the same year that the company takes the tax break?
No, there is no specific time limit for making the investments. Investments may be completed in a tax year after the year in which the funds are repatriated. The domestic reinvestment plan must state a reasonable time period anticipated for completion of the investments.

Does payment of tort liabilities qualify as a permitted use of repatriated funds?

Today's notice provides general guidance on the domestic investment of repatriated funds and provides specific guidance on several categories of permitted and non-permitted investments. The investments addressed in the guidance are illustrative and the guidance is not intended to provide an exhaustive list. The notice does not specifically address expenditures for tort liabilities. The notice does provide general guidance that expenditure for financial stabilization for domestic job retention or creation is a permitted use, which could encompass payments to satisfy a company's outstanding liabilities.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 13, 2005
JS-2196

Financial Literacy and Education Commission Holds Fourth Meeting

Treasury Assistant Secretary for Financial Institutions Wayne Abernathy today opened the fourth meeting of the Financial Literacy and Education Commission. Abernathy welcomed Commission representatives and thanked them for their hard work in establishing a national financial education toll-free hotline and Web site, as well as for working toward the development of the first ever national strategy for financial education. Abernathy was joined by Treasury's Deputy Assistant Secretary for Financial Education Dan Iannicola, as well as guest speakers and leaders in the financial services community including Rep. Judy Biggert (IL), United States Mint Director Henrietta Holsman Fore, National Credit Union Administration Chairman JoAnn Johnson, Commodity Futures Trading Commission Chairman Sharon Brown-Hruska, and Comptroller of the Currency Julie Williams.

"I'd like to commend the 20 agencies represented here for the continued commitment each has demonstrated to improving financial education, and in particular for successfully launching www.mymoney.gov and the 1-888-mymoney toll-free hotline," said Abernathy. "Special thanks to Chairman JoAnn Johnson and her staff at the National Credit Union Administration for hosting the MyMoney launch at NCUA headquarters this October."

Abernathy highlighted the Commission's important work in developing a national strategy for financial education, and thanked those who responded to a request for public comment on the national strategy. "The insightful comments we received from individuals, government, private, non-profit and local organizations have provided the Commission with valuable insights for developing the national strategy," he said.

In her address to the Commission, United States Mint Director Henrietta Holsman Fore remarked on the important work the Commission is undertaking and on the Mint's support through its financial education initiatives. "The Commission recognizes that a good credit rating, good money management and saving for the future sets a person on the road to a stable, prosperous life," said Director Fore. "At the United States Mint, we have an extensive educational outreach program for children, called H.I.P. Pocket Change, that not only uses coins to teach history, mathematics and geography, but also financial literacy."

Rep. Biggert expressed her commitment to raising levels of financial literacy and the need for solid personal finance skills to help improve lives. "If our young people learn how to manage money, credit, and debt, they can become responsible workers, heads of households, investors and business leaders," said Rep. Biggert. "But financial literacy is a lifelong process, and it's crucial that we continue our efforts to reach out to people of all ages and economic backgrounds."

The Commission heard from the toll-free hotline and Web site subcommittees on the launch of www.mymoney.gov and 1-888-mymoney in English and Spanish. Commodity Futures Trading Commission Chairman Sharon Brown-Hruska also presented comments on the Web site's launch, milestones and future enhancements.

Federal Deposit Insurance Corporation Deputy Director for Compliance and Consumer Protection Donna J. Gambrell presented comments on the launch of the toll-free hotline, caller feedback and continued promotion.

Treasury's Deputy Assistant Secretary for Financial Education Dan Iannicola also commented on behalf of the Commission's national strategy working group. Iannicola remarked on the Commission's progress to date in developing the national strategy. Iannicola stated that the national strategy working group is working diligently toward its completion in summer of 2005.

Other guest speakers also discussed financial education best practices in their organizations including: Securities and Exchange Commission's Director for Investor Education, Susan Ferris Wyderko; Citigroup's Office of Financial Education Director, Dara Duguay; Students In Free Enterprise President and CEO, Alvin Rohrs; and United Parcel Service Corporate Compensation Manager, Steven Nord.

The Financial Literacy and Education Commission was created by Title V of the Fair and Accurate Credit Transactions Act, signed by President Bush on December 4, 2003. The Commission is composed of the Secretary of the Treasury and the heads of the Office of the Comptroller of the Currency; the Office of Thrift Supervision; the Federal Reserve; the Federal Deposit Insurance Corporation; the National Credit Union Administration; the Securities and Exchange Commission; the Departments of Education, Agriculture, Defense, Health and Human Services, Housing and Urban Development, Labor, and Veterans Affairs; the Federal Trade Commission; the General Services Administration; the Small Business Administration; the Social Security Administration; the Commodity Futures Trading Commission; and the Office of Personnel Management.

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.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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January 11, 2005
JS-2197

Treasury and IRS Release Guidance Clarifying the Tax Treatment of HSA Contributions by Partnerships and S corporations

WASHINGTON, DC -- The Treasury Department and the IRS today issued guidance clarifying the tax treatment of a partnership's contributions to a partner's Health Savings Account (HSA) and an S corporation's contributions to a 2-percent (or greater) shareholder-employee's HSA. Generally, in such cases, the HSA contributions are treated as payments to the partner or shareholder and are not treated as excludable employer contributions. The contributions will be treated as the individual partner's or shareholder's contribution and allowed as above-the-line deductions on their individual income tax returns, similar to the treatment for any eligible individual who makes a contribution to an HSA directly with after-tax funds. The guidance also addresses the employment tax treatment of the contributions.

REPORTS

- A copy of the guidance

Part III - Administrative, Procedural, and Miscellaneous

Health Savings Accounts — Partnership contributions to a partner's Health Savings Account (HSA); S corporation contributions to a 2-percent shareholder-employee's HSA.

Notice 2005-8

PURPOSE

This notice provides guidance on a partnership's contributions to a partner's Health Savings Account (HSA) and an S corporation's contributions to a 2-percent shareholder-employee's HSA.

BACKGROUND

Section 1201 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, Pub. L. No. 108-173, added section 223 to the Internal Revenue Code to permit eligible individuals to establish Health Savings Accounts (HSAs) for taxable years beginning after December 31, 2003. Generally, contributions made to an HSA, within permissible limits, by or on behalf of a taxpayer who is an eligible individual are deductible by a taxpayer under section 223(a). The deduction is an adjustment to gross income (i.e., an above the line deduction) under section 62(a)(19). If an employer makes a contribution, within permissible limits, to the HSA on behalf of an employee who is an eligible individual, the contribution is excluded from the employee's gross income and wages. See section 106(d). A partnership may also contribute to a partner's HSA and an S corporation may contribute to the HSA of a 2-percent shareholder-employee (as defined below). The Questions and Answers below discuss the tax treatment of HSA contributions made on behalf of such partners and 2-percent shareholder-employees who are eligible individuals.

QUESTIONS AND ANSWERS

Q-1. What is the tax treatment of a partnership's contributions to a partner's HSA that are treated as distributions to the partner under section 731?

A-1. Contributions by a partnership to a bona fide partner's HSA are not contributions by an employer to the HSA of an employee. See Rev. Rul. 69-184, 1969-1.C.B. 256. Contributions by a partnership to a partner's HSA that are treated as distributions to the partner under section 731 are not deductible by the partnership and do not affect the distributive shares of partnership income and deductions. See Rev. Rul. 91-26, 1991-1 C.B. 184 (analysis of situation 1, last paragraph). The contributions are reported as distributions of money on Schedule K-1 (Form 1065). These distributions are not included in the partner's net earnings from self-employment under section 1402(a) because the distributions under section 731 do not affect a partner's distributive share of partnership income or loss under section 702(a)(8). The partner, if an eligible individual as defined in section 223(c)(1), is entitled under sections 223(a) and 62(a)(19) to deduct the amount of the contributions made to the partner's HSA during the taxable year as an adjustment to gross income on his or her federal income tax return.

Q-2. What is the tax treatment of a partnership's contributions to a partner's HSA that are treated as guaranteed payments under section 707(c), are derived from the partnership's trade or business, and are for services rendered to the partnership?

A-2. Contributions by a partnership to a bona fide partner's HSA are not contributions by an employer to the HSA of an employee. See Rev. Rul. 69-184. Contributions by a partnership to a partner's HSA for services rendered to the partnership that are treated as guaranteed payments under section 707(c) are deductible by the partnership under section 162 (if the requirements of that section are satisfied (taking into account the rules of section 263)) and are includible in the partner's gross income. The contributions are not excludible from the partner's gross income under section 106(d) because the contributions are treated as a distributive share of partnership income under Treas. Reg. § 1.707-1(c) for purposes of all Code sections other than sections 61(a) and 162(a). See Rev. Rul. 91-26. Contributions by a partnership to a partner's HSA that are treated as guaranteed payments under section 707(c), are reported as guaranteed payments on Schedule K-1 (Form 1065). Because the contributions are guaranteed payments that are derived from the partnership's trade or business, and are for services rendered to the partnership, the contributions are included in the partner's net earnings from self-employment under section 1402(a) on the partner's Schedule SE (Form 1040). The partner, if an eligible individual as defined in section 223(c)(1), is entitled under sections 223(a) and 62(a)(19) to deduct the amount of the contributions made to the partner's HSA during the taxable year as an adjustment to gross income on his or her federal income tax return.

The following example illustrates the answers in A-1 and A-2.

Example. Partnership is a limited partnership with three equal individual partners, A (a general partner), B (a limited partner), and C (a limited partner). C is to be paid $500 annually for services rendered to Partnership in his capacity as a partner and without regard to Partnership income (a section 707(c) guaranteed payment). The $500 payment to C is derived from Partnership's trade or business. Partnership has no employees. A, B, and C are eligible individuals as defined in section 223(c)(1) and each has an HSA. During Partnership's Year 1 taxable year, Partnership makes the following contributions: a $300 contribution to each of A's and B's HSAs which are treated by Partnership as section 731 distributions to A and B; and a $500 contribution to C's HSA in lieu of paying C the guaranteed payment directly.

Partnership's contributions to A's and B's HSAs are not deductible by Partnership and, therefore, do not affect Partnership's calculation of its taxable income or loss. See Rev. Rul. 91-26. A and B are entitled to an above the line deduction, under sections 223(a) and 62(a)(19), for the amount of the contributions made to their individual HSAs. The section 731 distributions to A's and B's individual HSAs are reported as cash distributions to A and B on A's and B's Schedule K-1 (Form 1065). The distributions to A's and B's HSAs are not includible in A's and B's net earnings from self employment under section 1402(a), because distributions under section 731 do not affect a partner's distributive share of the partnership's income or loss under section 702(a)(8).

Partnership's contribution to C's HSA that is treated as a guaranteed payment under section 707(c) for services rendered to the partnership is deductible by Partnership under section 162 (if the requirements of that section are satisfied (taking into account the rules of section 263)) and is includible in C's gross income. The contribution is not excludible from C's gross income under section 106(d) because the contribution is treated as a distributive share of partnership income for purposes of all Code sections other than sections 61(a) and 162(a), and a guaranteed payment to a partner is not treated as compensation to an employee. See Rev. Rul. 91-26. The payment to C's HSA should be reported as a guaranteed payment on Schedule K-1 (Form 1065). Because the contribution is a guaranteed payment that is derived from the partnership's trade or business and is for services rendered to the partnership, the contribution constitutes net earnings from self-employment to C under section 1402(a) which should be reported on Schedule SE (Form 1040). C is entitled under sections 223(a) and 62(a)(19) to deduct as an adjustment to gross income the amount of the contribution made to C's HSA.

Q-3. What is the tax treatment of an S corporation's contributions to the HSA of a 2-percent shareholder (as defined in section 1372(b)) who is also an employee (2-percent shareholder-employee) in consideration for services rendered to the S corporation?

A-3. Under section 1372, for purposes of applying the provisions of Subtitle A that relate to fringe benefits, an S corporation is treated as a partnership, and any 2-percent shareholder of the S corporation is treated as a partner of such partnership. Therefore, contributions by an S corporation to an HSA of a 2-percent shareholder-employee in consideration for services rendered are treated as guaranteed payments under section 707(c). Accordingly, the contributions are deductible by the S corporation under section 162 (if the requirements of that section are satisfied (taking into account the rules of section 263)) and are includible in the 2-percent shareholder-employee's gross income. In addition, the 2-percent shareholder-employee is not entitled to exclude the contribution from gross income under section 106(d). See Rev. Rul. 91-26.

For employment tax purposes, when contributions are made by an S corporation to an HSA of a 2-percent shareholder-employee, the 2-percent shareholder-employee is treated as an employee subject to Federal Insurance Contributions Act (FICA) tax and not as an individual subject to Self-Employment Contributions Act (SECA) tax. (See Announcement 92-16, 1992-5 I.R.B. 53, clarifying the FICA (Social Security and Medicare) tax treatment of accident and health premiums paid by an S corporation on behalf of a 2-percent shareholder-employee.) However, if the requirements for the exclusion under section 3121(a)(2)(B) are satisfied, the S corporation's contributions to an HSA of a 2-percent shareholder-employee are not wages subject to FICA tax, even though the amounts must be included in wages for income tax withholding purposes on the 2-percent shareholder-employee's Form W-2, Wage and Tax Statement. The 2-percent shareholder-employee, if an eligible individual as defined in section 223(c)(1), is entitled under sections 223(a) and 62(a)(19) to deduct the amount of the contributions made to the 2-percent shareholder-employee's HSA during the taxable year as an adjustment to gross income on his or her federal income tax return. See Notice 2004-2, Q&A 19, 2004-2 I.R.B. 269, for employment tax rules for employer contributions to HSAs of employees other than 2-percent shareholder-employees.

DRAFTING INFORMATION

The principal authors of this notice are Elizabeth Purcell of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) and Pietro E. Canestrelli of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding HSA issues in this notice, contact Ms. Purcell on (202) 622-6080. For information regarding partnership or S corporation issues, contact Mr. Canestrelli on (202) 622-3060 (not toll-free calls).

FROM THE OFFICE OF PUBLIC AFFAIRS

January 17, 2005
2005-2-10-16-26-6-17231

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $85,772 million as of the end of that week, compared to $85,289 million as of the end of the prior week.

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

	January 7, 2005			January 14, 2005		
TOTAL		85,289			85,772	
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	11,934	14,991	26,925	11,989	15,346	27,335
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	11,715	3,013	14,728	11,759	3,084	14,843
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]			19,203			19,177
3. Special Drawing Rights (SDRs) [2]			13,390			13,372
4. Gold Stock [3]			11,043			11,045
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	January 7, 2005			January 14, 2005		
	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

	January 7, 2005			January 14, 2005		
	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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January 18, 2005
js-2198

Treasury International Capital (TIC) Data for November

Treasury International Capital (TIC) data for October are released today and posted on the U.S. Treasury web site (w
which will report on data for December, is scheduled for February 15, 2005.

Long-Term Domestic Securities

Gross purchases of domestic securities by foreigners were $1,411.7 billion in November, exceeding gross sales of dc
$1,312.0 billion during the same month.

Foreign purchases of domestic securities reached $99.7 billion on a net basis in November, relative to $65.4 billion dı
flows reached $71.8 billion in November. Net private purchases of Treasury Bonds and Notes increased to $11.0 billi
Net private purchases of Government Agency Bonds were $24.4 billion, up from $22.9 billion the previous month. Ne
rose to $23.5 billion from $18.2 billion the previous month. Net private purchases of Equities rose to $13.0 billion from

Official net purchases of U.S. securities were $27.9 billion in November, relative to $14.9 billion in October. Official ne
of $21.0 billion accounted for the bulk of official inflows in November, up from $15.6 billion the previous month.

Long-Term Foreign Securities

Gross purchases of foreign securities owned by U.S. residents were $270.0 billion in November, relative to gross sale
$288.7 billion during the same month.

Gross sales of foreign securities to U.S. residents exceeded purchases by $18.7 billion, highlighting net foreign sales
$2.6 billion in Foreign Bonds to U.S. residents.

Net Long-Term Securities Flows

Net foreign purchases of both domestic and foreign long-term securities from U.S. residents were $81.0 billion in Nov
October. Net foreign purchases of long-term securities were $827.8 billion in the 12-months through November 2004
twelve months through November 2003.

The full data set, including adjustments for repayments of principal on asset-backed securities, as well as historical se
www.treas.gov/tic/.

Foreigners' Transactions in Long-Term Securities with U.S. Residents
(Billions of dollars, not seasonally adjusted)

Foreigners' Transactions in Long-Term Securities with U.S. R
(Billions of dollars, not seasonally adjusted)

		2002	2003	12 Months Through Nov-03	Nov-04
1	Gross Purchases of Domestic Securities	13,022.9	14,374.7	14,268.8	15,117.1
2	Gross Sales of Domestic Securities	12,475.4	13,628.8	13,555.4	14,206.3
3	**Domestic Securities Purchased, net** (line 1 less line	**547.6**	**745.9**	**713.5**	**910.9**

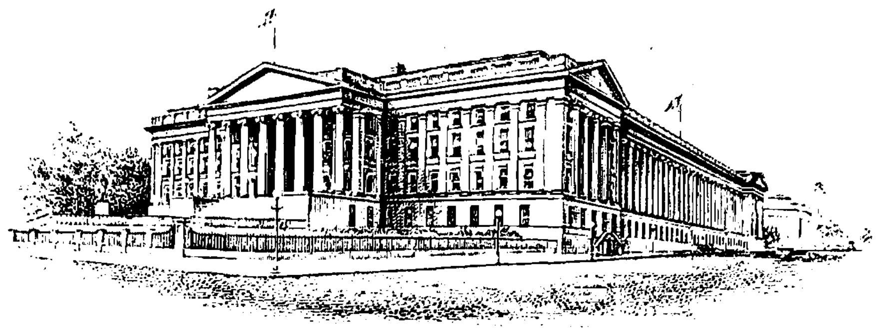
4	**Private, net /2**	**508.3**	**602.8**	**574.3**	**671.2**
5	Treasury Bonds & Notes, net	112.8	160.5	148.0	171.2
6	Gov't Agency Bonds, net	166.6	140.9	141.6	198.2
7	Corporate Bonds, net	176.7	263.3	256.7	269.9
8	Equities, net	52.2	38.2	27.9	32.0
9	**Official, net**	**39.3**	**143.1**	**139.2**	**239.6**
10	Treasury Bonds & Notes, net	7.1	113.5	111.1	204.8
11	Gov't Agency Bonds, net	28.6	24.3	23.4	23.7
12	Corporate Bonds, net	5.6	5.6	5.0	10.4
13	Equities, net	-2.0	-0.3	-0.2	0.7
14	Gross Purchases of Foreign Securities	2,640.0	2,891.0	2,869.9	3,146.9
15	Gross Sales of Foreign Securities	2,613.0	2,953.4	2,936.0	3,230.0
16	**Foreign Securities Purchased, net** (line 14 less line	**27.0**	**-62.3**	**-66.0**	**-83.1**
17	Foreign Bonds Purchased, net	28.5	20.1	12.2	7.5
18	Foreign Equities Purchased, net	-1.5	-82.4	-78.2	-90.6
19	**Net Long-Term Flows** (line 3 plus line 16)	**574.6**	**683.6**	**647.4**	**827.8**

/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

REPORTS

- (PDF) Foreigners' Transactions in Long-Term Securities with U.S. Residents (Billions of dollars, not s



DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

January 18, 2005
EMBARGOED UNTIL 9:00 AM

Contact: **Tony Fratto**
202-622-2910

TREASURY INTERNATIONAL CAPITAL DATA FOR NOVEMBER

Treasury International Capital (TIC) data for November 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 December, is scheduled for February 15, 2005.

Long-Term Domestic Securities

Gross purchases of domestic securities by foreigners were $1,411.7 billion in November, exceeding gross sales of domestic securities by foreigners of $1,312.0 billion during the same month.

Foreign purchases of domestic securities reached $99.7 billion on a net basis in November, relative to $65.4 billion during the previous month. Private net flows reached $71.8 billion in November. Net private purchases of Treasury Bonds and Notes increased to $11.0 billion from $5.2 billion the preceding month. Net private purchases of Government Agency Bonds were $24.4 billion, up from $22.9 billion the previous month. Net private purchases of Corporate Bonds rose to $23.5 billion from $18.2 billion the previous month. Net private purchases of Equities rose to $13.0 billion from $4.2 billion.

Official net purchases of U.S. securities were $27.9 billion in November, relative to $14.9 billion in October. Official net purchases of Treasury Bonds and Notes of $21.0 billion accounted for the bulk of official inflows in November, up from $15.6 billion the previous month.

Long-Term Foreign Securities

Gross purchases of foreign securities owned by U.S. residents were $270.0 billion in November, relative to gross sales of foreign securities to U.S. residents of $288.7 billion during the same month.

Gross sales of foreign securities to U.S. residents exceeded purchases by $18.7 billion, highlighting net foreign sales of $16.1 billion in Foreign Equities and $2.6 billion in Foreign Bonds to U.S. residents.

Net Long-Term Securities Flows

Net foreign purchases of both domestic and foreign long-term securities from U.S. residents were $81.0 billion in November compared with $48.3 billion in October. Net foreign purchases of long-term securities were $827.8 billion in the 12-months through November 2004 as compared to $647.4 billion during the twelve months through November 2003.

The full 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, http://www.treas.gov/tic/.

Foreigners' Transactions in Long-Term Securities with U.S. Residents
(Billions of dollars, not seasonally adjusted)

				12 Months Through					
		2002	2003	Nov-03	Nov-04	Aug-04	Sep-04	Oct-04	Nov-04
1	Gross Purchases of Domestic Securities	13,022.9	14,374.7	14,268.8	15,117.1	1,229.1	1,264.6	1,213.6	1,411.7
2	Gross Sales of Domestic Securities	12,475.4	13,628.8	13,555.4	14,206.3	1,174.3	1,198.9	1,148.2	1,312.0
3	**Domestic Securities Purchased, net** (line 1 less line 2) /1	**547.6**	**745.9**	**713.5**	**910.9**	**54.8**	**65.7**	**65.4**	**99.7**
4	**Private, net /2**	**508.3**	**602.8**	**574.3**	**671.2**	**35.6**	**51.4**	**50.5**	**71.8**
5	Treasury Bonds & Notes, net	112.8	160.5	148.0	171.2	-1.6	5.7	5.2	11.0
6	Gov't Agency Bonds, net	166.6	140.9	141.6	198.2	15.0	6.2	22.9	24.4
7	Corporate Bonds, net	176.7	263.3	256.7	269.9	23.4	42.3	18.2	23.5
8	Equities, net	52.2	38.2	27.9	32.0	-1.2	-2.9	4.2	13.0
9	**Official, net**	**39.3**	**143.1**	**139.2**	**239.6**	**19.2**	**14.3**	**14.9**	**27.9**
10	Treasury Bonds & Notes, net	7.1	113.5	111.1	204.8	15.5	10.9	15.6	21.0
11	Gov't Agency Bonds, net	28.6	24.3	23.4	23.7	2.5	2.2	-0.9	3.5
12	Corporate Bonds, net	5.6	5.6	5.0	10.4	1.1	1.2	0.9	1.9
13	Equities, net	-2.0	-0.3	-0.2	0.7	0.1	0.0	-0.7	1.5
14	Gross Purchases of Foreign Securities	2,640.0	2,891.0	2,869.9	3,146.9	241.2	243.2	254.2	270.0
15	Gross Sales of Foreign Securities	2,613.0	2,953.4	2,936.0	3,230.0	244.1	247.8	271.2	288.7
16	**Foreign Securities Purchased, net** (line 14 less line 15) /3	**27.0**	**-62.3**	**-66.0**	**-83.1**	**-3.0**	**-4.6**	**-17.1**	**-18.7**
17	Foreign Bonds Purchased, net	28.5	20.1	12.2	7.5	-3.2	-0.8	-4.5	-2.6
18	Foreign Equities Purchased, net	-1.5	-82.4	-78.2	-90.6	0.2	-3.8	-12.6	-16.1
19	**Net Long-Term Flows** (line 3 plus line 16)	**574.6**	**683.6**	**647.4**	**827.8**	**51.8**	**61.1**	**48.3**	**81.0**

/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

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 18, 2005
JS-2199

Anna Escobedo Cabral to be Sworn in as U.S. Treasurer Secretary Snow and Sen. Hatch to Deliver Remarks

Anna Escobedo Cabral will be sworn in by Treasury Secretary John W. Snow as the 42nd U.S. Treasurer today at 3:30 p.m. EST in the Treasury Department's Cash Room. U.S. Sen. Orrin G. Hatch will join Secretary Snow and Treasurer Cabral for the ceremony.

As Treasurer, Cabral will advise the Secretary, Deputy Secretary, Director of the United States Mint and the Director of the Bureau of Engraving and Printing on matters relating to coinage, currency and the production of other instruments by the United States. Cabral will also serve as a spokesperson for Treasury on a range of issues before the Department. President Bush nominated her to the post on July 22, 2004 and the U.S. Senate confirmed Cabral on November 20, 2004.

At today's swearing in, Secretary Snow will deliver remarks about the role of the U.S. Treasurer as it relates to financial education and financial literacy and he will place special emphasis on one of the great financial responsibilities of our nation: strengthening Social Security for our children and grandchildren.

WHAT
Swearing In Ceremony for 42nd U.S. Treasurer

WHO
Treasury Secretary John W. Snow
Treasurer Anna Escobedo Cabral
Sen. Orrin G. Hatch

WHEN
January 19, 2005
3:30 p.m. (EST)

WHERE
Treasury Department
Cash Room
1500 Pennsylvania Avenue
Washington, D.C.

News media without Treasury press credentials planning to attend should contact Frances Anderson in Treasury's Office of Public Affairs at (202) 528-9086 a.s.a.p. today with the following information: name, Social Security number and date of birth. This information may also be faxed to (202) 622-1999 or emailed to frances.anderson@do.treas.gov.

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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January 19, 2005
JS-2201

Treasury and IRS Issue Guidance on Manufacturing Deduction

WASHINGTON, DC - Today, the Treasury Department and IRS issued a Notice to help taxpayers calculate the newly enacted deduction relating to domestic production activities. The Notice provides interim guidance on which taxpayers may rely until regulations are issued.

The deduction relating to domestic production activities was enacted in October 2004 as part of the American Jobs Creation Act. The deduction generally equals three percent of income from domestic production activities for 2005 and, by 2010, nine percent of such income. The activities eligible for the deduction include not only the manufacture of personal property such as clothing, goods, and food, but also software development, film and music production, production of electricity, natural gas, or water, construction, and engineering and architectural services.

The domestic production activities deduction provides a tax savings on profits from production activities in the United States. The deduction is a portion of the taxpayer's profits from domestic production and increases proportionally as those profits increase.

"The Notice provides comprehensive rules and definitions to assist taxpayers in implementing this new provision," said Eric Solomon, Treasury's Acting Deputy Assistant Secretary for Tax Policy. "The Treasury Department and IRS anticipate that forthcoming proposed regulations will incorporate the rules set forth in the Notice. We request comments on the rules in the Notice and on any additional guidance that should be provided in the proposed regulations."

"This provision has widespread impact across our complex economy" said IRS Commissioner Mark W. Everson. "The guidance strikes a balance. It provides clear practical guidelines that are administrable both from the taxpayers' and the IRS' point of view."

A fact sheet providing further information on the Notice as well as a copy of the Notice are attached.

REPORTS

- 199 - Fact Sheet Guidance on Section 199
- Notice 2005 - 14

DEPARTMENT OF THE TREASURY
Office of Public Affairs

January 19, 2005

FACT SHEET:

Guidance on Section 199 – Income Attributable to Manufacturing Activities.

Overview:
On January 19, 2005, the Treasury Department and IRS issued a Notice under section 199 of the Internal Revenue Code regarding the deduction relating to income attributable to domestic production activities. The Notice provides interim guidance on which taxpayers may rely until proposed regulations are issued.

Background:
On October 22, 2004, President Bush signed into law the American Jobs Creation Act, which included a tax benefit for certain domestic production activities.

When is the provision effective?
The provision is effective for taxable years beginning after December 31, 2004.

How is the deduction computed?
For 2005, the deduction equals three percent of the lesser of: (a) taxable income derived from a qualified production activity; or (b) taxable income, for the taxable year. However, the deduction for a taxable year is limited to 50 percent of the W-2 wages paid by the taxpayer during the calendar year that ends in such taxable year. In 2010, when the deduction is fully phased-in, the three percent rate will have increased to nine percent.

What constitutes a "qualified production activity?"
The following activities are qualified production activities:

- The manufacture, production, growth, or extraction in whole or significant part in the United States of tangible personal property (e.g., clothing, goods, and food), software development, or music recordings;
- Film production (with exclusions provided in the statute), provided at least 50 percent of the total compensation relating to the production of the film is compensation for specified production services performed in the United States;
- Production of electricity, natural gas, or water in the United States;
- Construction or substantial renovation of real property in the United States including residential and commercial buildings and infrastructure such as roads, power lines, water systems, and communications facilities; or
- Engineering and architectural services performed in the United States and relating to construction of real property.

How is taxable income derived from the manufacture, production, growth, or extraction of tangible personal property determined?
Gross receipts derived from a lease, rental, license, sale, exchange, or other disposition of tangible personal property manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States are reduced by allocable costs and deductions.

What constitutes "in significant part"?
Property will be treated as manufactured by the taxpayer "in significant part" if:

- based on all of the taxpayer's facts and circumstances, the manufacturing, production, growth, or extraction activity performed by the taxpayer in the United States is substantial in nature; or
- the labor and overhead costs incurred by the taxpayer in the United States for the manufacture, production, growth, and extraction of the property are at least twenty percent of the taxpayer's total cost for the property.

For example, assume that a taxpayer purchases a small motor and various parts and materials for $75 and incurs $25 in labor costs at its factory in the United States to fabricate a plastic car body from the materials and to assemble a toy car. The taxpayer also incurs packaging, selling and other costs of $2 and sells the toy car in 2005 for $112. The toy car will be treated as manufactured by the taxpayer "in significant part" because the taxpayer's labor costs are more than twenty percent of the taxpayer's total cost for the toy car ($25 / ($25 + $75) = 25%). The taxpayer's domestic production activities deduction will be three percent of the taxpayer's $10 profit on the toy car or 30¢ (3% * ($112-$75-$25-$2). If the sale occurred in 2010, when the deduction is fully phased in, the deduction would be nine percent of the taxpayer's $10 profit on the car or 90¢ (9% * ($112-$75-$25-$2).

The domestic production activities deduction provides a tax savings on profits from production activities in the United States. If a taxpayer has satisfied the "significant part" test and the other requirements for the deduction, the deduction is a portion of the taxpayer's profits from domestic production and increases as those profits increase.

Are packaging, design, and development activities taken into account in applying the "significant part" test for tangible personal property?
Packaging, repackaging, labeling, and minor assembly operations are not taken into account for purposes of the "significant part" test. Thus, a taxpayer cannot qualify for the domestic production activities deduction if the taxpayer's only activities in the United States are packaging and labeling property produced outside the United States. Design and development activities also do not constitute manufacturing activities for purposes of the "significant part" test for tangible personal property because these activities produce an intangible asset (the design) rather than tangible personal property.

Is a contract manufacturer eligible for the deduction?
If one taxpayer performs manufacturing activities for another taxpayer, only the taxpayer with the benefits and burdens of ownership of the tangible personal property during the

manufacturing process will be treated as the manufacturer. As a result, only one taxpayer will be entitled to the deduction with respect to a manufacturing activity performed with respect to an item of tangible personal property.

Are there any safe harbor or de minimis rules?
Several safe harbor and de minimis rules will reduce computational and recordkeeping burdens, including:

- Simplified formulas to assist small taxpayers in determining taxable income from qualifying activities;
- De minimis rules to avoid the difficulty of making revenue and expense allocations as a result of small amounts of income from non-qualifying activities; and
- Simplified formulas for determining a taxpayer's W-2 wages.

What construction activities qualify for the deduction?
Qualifying activities include construction and substantial renovation of real property, including residential and commercial buildings and infrastructure such as roads, power lines, water systems, and communications facilities.

The statute does not provide that qualifying gross receipts for construction activities must be derived from a lease, rental, license, sale, exchange, or other disposition of the property. As a result, a taxpayer engaged in construction activities may qualify for the deduction even if the taxpayer does not have the benefits and burdens of ownership of the property being constructed. Therefore, more than one taxpayer may be regarded as constructing real property with respect to the same activity and the same construction project. For example, a general contractor and a subcontractor may both be engaged in construction activities with respect to the installation of a roof on a new building. Each taxpayer's benefit will be a percentage of its profit on its work with respect to the installation of the roof.

Gross receipts derived from the rental of real property that the taxpayer constructs are not derived from construction, but rather are income for the use or forbearance of the property. As a result, rental income for real property is not eligible for the qualified production activities deduction. Gain on the later sale of the property may qualify for the deduction if all other requirements are satisfied.

Does the preparation of food and beverages qualify for the deduction?
Food and beverages prepared at a retail establishment do not qualify for the deduction. A retail establishment is real property used in the trade or business of selling food or beverages to the public if retail sales occur at the facility. For example, a restaurant at which food and beverages are prepared, sold, and served to customers would be a retail establishment. However, the Treasury Department and IRS recognize that some retail establishments prepare food and beverages for both wholesale and retail sale. As a result, the Notice provides that even if a taxpayer's facility is a retail establishment, food or beverages prepared at the facility and sold at wholesale are not considered prepared at a

retail establishment and the taxable income related to the wholesale transactions is therefore eligible for the deduction.

How does a taxpayer compute W-2 wages for purposes of the wage limitation?
There are three alternative methods for computing W-2 wages. The first method permits a taxpayer to use the lesser of the W-2 wages reported in Box 1 or Box 5 of Forms W-2. Alternatively, there are two methods that, although more complex, provide a more precise determination of W-2 wages. The Notice provides that the W-2 wages are those wages of common law employees of the taxpayer.

What income derived from computer software is eligible for the deduction?
In general, income from a lease, rental, license, sale, exchange, or other disposition of software developed in the United States qualifies for the deduction, regardless of whether the customer purchases the software off the shelf or takes delivery of the software by downloading the software from the Internet. Computer software is not limited to software for computers and includes, for example, video game software. However, subject to certain de minimis rules, the following income does not qualify for the deduction because the income is attributable to the provision of a service and is not derived from a lease, rental, license, sale, exchange, or other disposition of the software:

- Fees for on-line use of software;
- Fees for customer support with respect to computer software;
- On-line services;
- Fees for telephone services provided in part through use of software;
- Fees for playing computer games on-line; and
- Provider-controlled online access services.

How does a partnership or S corporation compute the section 199 deduction?
The deduction attributable to the qualifying production activities of a partnership or S corporation (pass-through entity) is determined at the partner or shareholder (partner) level. As a result, each partner must compute its deduction separately. In general, each partner is allocated its share of items (including items of income, gain, loss, and deduction) allocable or attributable to qualifying production activities of the pass-through entity, along with any other items of income, gain, loss, deduction or credit of the pass-through entity. The partner must aggregate its share of the items allocable or attributable to the pass-through entity's qualified production activities, any expenses incurred by the partner directly that are allocable to the pass-through entity's qualified production activities, and items allocable or attributable to the partner's other qualified production activities to determine its qualified production activities deduction for the taxable year. Simplifying rules are provided for certain small partnerships.

How does a taxpayer allocate cost of goods sold and other deductions to qualifying production activities?
If a taxpayer cannot specifically identify the cost of goods sold, the taxpayer may use a reasonable method to determine the cost of goods sold related to the taxpayer's qualifying production activities. If the taxpayer uses a method to determine the allocable

portion of its gross receipts derived from qualifying production activities, the taxpayer must use the same method for purposes of determining the allocable cost of goods sold.

Two methods are provided for allocating deductions (other than cost of goods sold) to qualified production activities:

- Method 1, which is available to all taxpayers and generally follows existing rules applicable to taxpayers required to determine taxable income from within and outside the United States; and
- Method 2, which is available to taxpayers with average annual gross receipts (over the three prior years) of $25,000,000 or less, provides a simplified formula that allocates deductions based on the ratio of the taxpayer's receipts derived from qualifying production activities as compared to the taxpayer's receipts from all sources.

Lastly, the Notice provides a third method for small taxpayers that allocates both cost of goods sold and all other deductions based on the same ratio applicable to Method 2. This third method is available to taxpayers with average annual gross receipts of $5,000,000 or less and certain other small taxpayers permitted to use the cash method of accounting.

Will the Treasury Department and the IRS issue additional guidance regarding the deduction?

The Treasury Department and IRS anticipate that forthcoming proposed regulations will incorporate the rules set forth in the Notice. The Treasury Department and IRS request comments on the rules contained in the Notice and any additional guidance that should be provided in the regulations. Written comments must be received on or before March 31, 2005.

Part III - Administrative, Procedural, and Miscellaneous

Section 199.--Income Attributable to Domestic Production Activities

Notice 2005-14

CONTENTS

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 19, 2005
JS-2203

Anna Escobedo Cabral Sworn in as U.S. Treasurer

Anna Escobedo Cabral was sworn in today by Secretary John W. Snow as the 42nd U.S. Treasurer. President Bush nominated her to the post on July 22, 2004 and the U.S. Senate confirmed Cabral on November 20, 2004.

As Treasurer, Cabral will advise the Secretary, Deputy Secretary, Director of the United States Mint and the Director of the Bureau of Engraving and Printing on matters relating to coinage, currency and the production of other instruments by the United States. Cabral will also

serve as a spokesperson for Treasury on a range of issues before the Department.

Prior to joining the Administration, Cabral served as Director of the Smithsonian Institution's Center for Latino Initiatives, where she led a pan-institutional effort to improve Latino representation in exhibits, and public programming among the Institution's 19 museums, five research centers, and the National Zoo. From 1999 to 2003, Cabral served as President and CEO of the Hispanic Association on Corporate Responsibility, a non-profit organization which partners with Fortune 500 companies to increase Hispanic representation in employment, procurement, philanthropy and governance. Under her leadership, the organization published a best practices series, and instituted a partnership with Harvard Business School to provide executive training programs in Corporate Governance Best Practices to community leaders.

From 1993 to 1999, Cabral served as Deputy Staff Director for the United States Senate Judiciary Committee under Chairman Orrin G. Hatch. Additionally, beginning in 1991, she served as Executive Staff Director of the U.S. Senate Republican Conference Task Force on Hispanic Affairs, a caucus of 25 senators dedicated to ensuring that the concerns and needs of the Hispanic community are addressed by Congress through legislation.

A native of California, Cabral majored in political science at the University of California, Davis and earned a Master's degree in Public Administration with an emphasis in international trade and finance from the John F. Kennedy School of Government at Harvard University.

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 19, 2005
JS-2205

Statement of the Honorable John W. Snow on the swearing-in of U.S. Treasurer Anna Escobedo Cabral

Good afternoon. I want to extend a warm welcome to Anna's family and friends who have come here to be part of this very special day. This is a momentous occasion not just for Anna, but for everyone who holds her dear. It is a day to feel proud of her, proud to know her, and the first of many days ahead in which your support of her will be essential to the job she is embarking upon.

Family has been the strong foundation upon which Anna has built a full life and a brilliant career, and I suspect this new position will not change that fact. As the third generation of a family who immigrated to the United States from Mexico, Anna has been inspired by her family's vision - and fulfillment - of the American dream. Her grandparents were Americans-by-choice and their love for this country, for freedom and opportunity, engendered a love for the same in the generations that followed, including Anna.

Anna knows that she is the manifestation of her family's American dream; and I know that humbles her. It is also one of the many reasons why I know she will, as the oath says, faithfully discharge the duties of the office of which she is about to enter.

Like so many American families, Anna's passionately embraced their citizenship here while also holding dear their native culture and traditions. Anna has dedicated much of her career to representing Latinos and Latino culture in the corporate world, the non-profit community of art and learning, and in the Congress.

She believes that the United States offers great hope and opportunity to Latinos - and that Latinos make enormous contributions, every day, to this great country.

In her role as U.S. Treasurer, Anna will be reaching out to all citizens to talk about some of the most important financial issues of the day: from financial literacy to deficit reduction and reform of the Social Security system. Each of these issues is instrumental in keeping the American promise of economic opportunity and security.

The promises made by Social Security are of great concern at this particular time, as a passionate debate on the issue is already underway. The President is leading an effort to enact change this year, because it is clear that a lack of action would have serious implications for both the future performance of the American economy and as well as the retirement security of our children and grandchildren.

Social Security has served retirees well for 70 years. For millions of Americans, it is a critical element in their plans for a stable retirement. And for today's senior citizens and those nearing retirement, the system will fulfill all of its promises. But for younger workers, Social Security is on an unsustainable path. If we do not fix it now, the system will not be able to pay the benefits promised to our children and grandchildren.

The problem is one of arithmetic. Our demographics have changed in a way that is incompatible with the pay-as-you-go structure of the Social Security system. Current retirees are supported by the taxes paid by current workers. And while that ratio was strong for quite some time, today it is plummeting. In the 1950s, there were about 16 workers paying in for each person drawing out. Today, it's about three workers for every beneficiary. And by the time today's workers in their mid

20s begin to retire, there will be just over two.

The total projected shortfall is around $10 trillion, and with each year that we wait to act, to fix the system, that shortfall will increase by about $600 billion. If we do not act now, government will eventually be left with two choices: dramatically reduce benefits, or impose huge, economically harmful tax increases. Leaving our children with such a mess would be, as President Bush has called it, a generational betrayal.

A bi-partisan effort in the 109th Congress can achieve the goal of reform this year. Furthermore, we can and should achieve reform that: protects the benefits of those currently and near retirement age; does not increase payroll taxes; and includes a promising future for younger workers by allowing them to start a nest egg in the form of a personal retirement account.

I am looking forward, as I know Anna is, to the lively debate in the coming months, and most of all to working with both sides of the aisle in Congress on Social Security solutions. I am confident that out of the debate we will see a shared understanding that the problem is real and that acting today is the responsible thing to do.

Anna, you are joining this historic department at an historic time. On behalf of the Treasury, I welcome you.

I look forward to working with Anna and benefiting from her counsel. I know that the entire Department feels so fortunate to have her here, and it is my strong belief that her country will benefit greatly from her service.

Congratulations, Anna, and welcome to the Treasury.

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 25, 2005
JS-2206

Treasury Designates Individual Financially Fueling Iraqi Insurgency, al Qaida

The U.S. Department of the Treasury today took action against an individual to help stem cash flows to the Iraqi insurgency and al Qaida. Sulayman Khalid Darwish, who is located in Syria, was designated under Executive Order 13224 for providing financial and material support to the al-Zarqawi Network and al Qaida.

"This terrorist financier is helping support Zarqawi, who has launched violent acts against our troops, coalition partners and the Iraqi people," said Treasury Secretary John W. Snow. "Identifying financial operatives and choking off the flow of blood money moves us closer to our ultimate goal of fracturing the financial backbone of the Iraqi insurgency and al Qaida."

The U.S. is submitting Darwish to the United Nations 1267 Committee, which will consider adding him to the consolidated list of terrorists tied to al Qaida, Usama bin Laden and the Taliban.

The United States has now designated 397 individuals and entities as terrorists, their financiers or facilitators since September 2001. In addition, the global community has frozen over $147 million in terrorist-related assets.

Zarqawi was named a Specially Designated Global Terrorist (SDGT) on September 23, 2003. The Zarqawi Network, also know as Jama'at al Tawhid wal Jihad and Tanzim Qa'idat al-Jihad fi Bilad al-Rafidayn, was designated as a Foreign Terrorist Organization (FTO) and a SDGT on October 15, 2004.

According to information available to the U.S. Government, Darwish is a member of the Advisory (*Shura*) Council of the Zarqawi organization and served as one of Zarqawi's operatives. Moreover, Darwish, who was also involved in fundraising and recruiting for the organization, is a close associate of Zarqawi and one of the most prominent members of the Zarqawi Network in Syria.

While in Afghanistan, Darwish received training – on Zarqawi's orders – in the following areas: weapons, topography, artillery training, electronics training, explosives production and the use of explosives. Darwish also received training in Afghanistan, Iran, Turkey and Lebanon in document forging and is considered an expert in preparing forged documents for the Zarqawi Network.

Darwish handles mostly financial issues for Zarqawi, collecting, and distributing funds for him. Specifically, Darwish sent donations of $10,000-$12,000 to Zarqawi in Iraq every 20-25 days. Darwish sent the money into Iraq through suicide attack volunteers who were entering the country.

Darwish also was essential to recruiting and dispatching terrorist operatives, both for the planned attacks in Jordan and for operations elsewhere, particularly Iraq. For example, Darwish contacted jihadists who had been in Afghanistan and who were, by 2004, scattered in different countries; he recruited among these jihadists for fighters to join Zarqawi in Iraq.

In addition, Darwish was assigned by Zarqawi to train members of Asbat al-Ansar in preparing forged documents; Darwish also brought $10,000 for Abu Muhjin, the leader of Asbat al-Ansar, from Zarqawi. Asbat al-Ansar was designated a SDGT on September 24, 2001 and as a FTO on March 27, 2002.

Identifying Information
SULAYMAN KHALID DARWISH
AKA: Abu Al-Ghadiya
DOB: 1976
DOB: Circa 1974
POB: Outside Damascus, Syria
Nationality: Syrian
Passport No.: Syrian 3936712
Passport No.: Syrian 11012
Address: Syria

Sulayman Khalid Darwish was designated today pursuant to Executive Order 13224 chiefly pursuant to paragraphs (d)(i) and (d)(ii) based on a determination that he assists in, sponsors or provides financial, material, or technological support for, or financial or other services to or in support of, or is otherwise associated with, persons listed as subject to E.O. 13224. This individual also meets the standard for inclusion in the UN 1267 Sanctions Committee's consolidated list because of the support provided to UBL, al Qaida or the Taliban.

Inclusion on the 1267 Committee's list triggers international obligations on all member countries, requiring them to freeze the assets and prevent the travel of listed individuals and to block the sale of arms and military equipment. Publicly identifying these supporters of terrorism is a critical part of the international campaign to counter terrorism. Additionally, other organizations and individuals are put on notice that they are prohibited from doing business with them.

Blocking actions are critical to combating the financing of terrorism. When an action is put into place, any assets existing in the formal financial system at the time of the order are to be frozen. Blocking actions serve additional functions as well, acting as a deterrent for non-designated parties who might otherwise be willing to finance terrorist activity; exposing terrorist financing "money trails" that may generate leads to previously unknown terrorist cells and financiers, disrupting terrorist financing networks by encouraging designated terrorist supporters to disassociate themselves from terrorist activity and renounce their affiliation with terrorist groups; terminating terrorist cash flows by shutting down the pipelines used to move terrorist-related assets; forcing terrorists to use alternative, more costly and higher-risk means of financing their activities; and engendering international cooperation and compliance with obligations under UN Security Council Resolutions.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 25, 2005
2005-1-25-14-20-44-11923

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $85,436 million as of the end of that week, compared to $85,772 million as of the end of the prior week.

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

	January 14, 2005			January 21, 2005		
TOTAL	85,772			85,436		
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	11,989	15,346	27,335	11,940	15,294	27,234
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	11,759	3,084	14,843	11,712	3,074	14,786
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]			19,177			19,073
3. Special Drawing Rights (SDRs) [2]			13,372			13,299
4. Gold Stock [3]			11,045			11,045
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	January 14, 2005			January 21, 2005		
	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

	January 14, 200			January 21, 2005		
	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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January 25, 2005
JS-2207

Treasury and IRS Announce Final Regulations for Certain Defined Contribution Retirement Plans

WASHINGTON, DC -- The Treasury Department and IRS issued final regulations today to conform to changes made under section 411(d)(6)(E), as added by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), relating to defined contribution retirement plans that offer lump sum distributions. The regulations are substantially similar to proposed regulations that were issued in 2003.

The regulations are effective immediately.

REPORTS

- A copy of the regulations

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1

[TD 9176]

RIN 1545-BC35

Elimination of Forms of Distribution in Defined Contribution Plans

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that would modify the circumstances under which certain forms of distribution previously available are permitted to be eliminated from qualified defined contribution plans. These final regulations affect qualified retirement plan sponsors, administrators, and participants.

DATES: These regulations are effective January 25, 2005.

FOR FURTHER INFORMATION CONTACT: Vernon S. Carter, 202-622-6060 (not a toll free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains final amendments to 26 CFR part 1 under section 411(d)(6) of the Internal Revenue Code of 1986 (Code) as amended by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (115 Stat. 117).

Section 411(d)(6)(A) of the Code generally provides that a plan will not be treated as satisfying the requirements of section 411 if the accrued benefit of a participant is decreased by a plan amendment. Section 411(d)(6)(B) prior to amendment by EGTRRA provided that an amendment is treated as reducing an accrued benefit if, with respect to benefits accrued before the amendment is adopted, the amendment has the effect of either eliminating or reducing an early retirement benefit or a retirement-type subsidy, or, except as provided by regulations, eliminating an optional form of benefit.

The IRS published TD 8900 in the **Federal Register** on September 6, 2000 (65 FR 53901). TD 8900, which amended §1.411(d)-4 of the Income Tax Regulations, added paragraph (e) of Q&A-2 to provide for additional circumstances under which a defined contribution plan can be amended to eliminate or restrict a participant's right to receive payment of accrued benefits under certain optional forms of benefit.

Section 1.411(d)-4, Q&A-2(e)(1), provides that a defined contribution plan may be amended to eliminate or restrict a participant=s right to receive payment of accrued benefits under a particular optional form of benefit without violating the section 411(d)(6) anti-cutback rules if, once the plan amendment takes effect for a participant, the alternative forms of payment that remain available to the participant include payment in a single-sum distribution form that is otherwise identical to the eliminated or restricted optional form of benefit. The amendment cannot apply to a participant for any distribution with an annuity starting date before the earlier of the 90th day after the participant receives a summary that reflects the plan amendment and that satisfies Department of Labor=s requirements for a summary of material modifications under 29 CFR 2520.104b-3, or the first day of the second plan year following the plan year in which the amendment is adopted. Section 1.411(d)-4, Q&A-2(e)(2), provides that a single-sum distribution form is otherwise identical to the optional form of benefit that is being eliminated or restricted only if it is identical in all respects (or would be identical except that it provides greater rights to the participant), except for the timing of payments after commencement. A single-sum distribution form is not otherwise identical to a specified installment form of benefit if the single-sum form:

- is not available for distribution on any date on which the installment form could have commenced;
- is not available in the same medium as the installment form; or
- imposes any additional condition of eligibility.

Further, an otherwise identical distribution form need not retain any rights or features of the eliminated or restricted optional form of benefit to the extent those rights or features would not be protected from elimination under the anti-cutback rules. The single-sum distribution form would not, however, be disqualified from being an otherwise identical distribution form if the single-sum form provides greater rights to participants than did the eliminated or restricted optional form of benefit.

Section 645(a)(1) of EGTRRA added section 411(d)(6)(E), which provides that, except to the extent provided in regulations, a defined contribution plan is not treated as reducing a participant's accrued benefit where a plan amendment eliminates a form of distribution previously available under the plan if a single-sum distribution is available to the participant at the same time as the form of distribution eliminated by the amendment and the single-sum distribution is based on the same or greater portion of the participant's account as the form of distribution eliminated by the amendment. Thus, section 411(d)(6)(E) includes conditions that are similar to those in existing §1.411(d)-4, Q&A-2(e), but without the advance notice condition.

On July 8, 2003, a notice of proposed rulemaking (REG-112039-03) was published in the **Federal Register** (68 FR 40581) to reflect the addition of section 411(d)(6)(E) by EGTRRA. The proposed regulations amended §1.411(d)-4, Q&A-2(e) to eliminate the 90-day advance notice condition on plan amendments otherwise permitted under §1.411(d)-4, Q&A-2(e). Following publication of the proposed regulations, comments were received, but no public hearing was requested. After consideration of the comments received, the proposed regulations are adopted as revised by this Treasury decision.

Explanation of Provisions

These final regulations retain the general structure and much of the substance of the proposed regulations, including an example illustrating the provisions. Some changes have been made in connection with a specific recommendation for modification and clarification. The comments received in response to the proposed regulations are generally summarized below.

Two commentators were concerned that, following the elimination of the 90-day notice requirement, plan participants who counted on being able to retire with an annuity could discover that option is suddenly gone. The commentators argued that the participant may have made plans based on the expectation of receiving an annuity, and that, although participants can purchase annuities with their lump sums, they may find that annuities purchased outside the plan cost more or pay lower amounts than what they were expecting from the plan. The commentators recommended that, to the extent plan sponsors adopt amendments that terminate an annuity option, those plan sponsors should allow participants within 90 days of retiring at the time of the amendment to be permitted to elect that annuity.

The legislative history to section 645(a)(1) of EGTRRA shows that Congress was aware of the notice requirement in existing §1.411(d)-4, Q&A-2(e)(2), and adopted all of the same provisions in section 411(d)(6)(E) as are in existing §1.411(d)-4, Q&A-2(e)(2), except for the notice requirement. See Conference Report No 107-84, 107th Cong., 1st Session 253-254. Accordingly, these final regulations adopt the amendments in the proposed regulation. The regulations retain the rules under which a defined contribution plan may be amended to eliminate or restrict a participant=s right to receive payment of accrued benefits under a particular optional form of benefit without violating the section 411(d)(6) anti-cutback rules if, once the plan amendment takes effect for a participant, the alternative forms of payment that remain available to the participant include payment in a single-sum distribution. The regulations clarify that such an amendment can apply only to distributions with annuity starting dates after the amendment is adopted and, therefore, cannot apply to distributions that have already commenced. However, these final regulations remove the 90-day notice condition previously applicable to these plan amendments.[1]

One commentator commented on the example in §1.411(d)-4, Q&A-2(e), of the proposed regulations. The commentator stated it is not clear from the example why the amendment does not apply to P (the participant in the Plan) if P elects to have annuity payments begin before July 1, 2004. The commentator stated that the confusion may result because the example provided that the amendment is adopted on May 2, 2004,

[1] The Department of Labor has advised Treasury and the IRS that plans covered by Title I of ERISA are subject to the requirement under Title I that plan amendments be described in a timely summary of material modifications (SMM) or a revised summary plan description (SPD) to be distributed to plan participants and beneficiaries in accordance with applicable Department of Labor disclosure rules (see 29 CFR 2520.104b-3).

but does not provide when the amendment is effective. The example has been revised to reflect the comment.

Under section 101 of Reorganization Plan No. 4 of 1978 (43 FR 47713), the Secretary of the Treasury has interpretive jurisdiction over the subject matter addressed in these regulations for purposes of the Employee Retirement Income Security Act of 1974 (ERISA). Section 204(g)(2) of ERISA, as amended by EGTRRA, provides a parallel rule to section 411(d)(6)(E) of the Code that applies under Title I of ERISA, and authorizes the Secretary of the Treasury to provide exception to this parallel ERISA requirement. Therefore, regulations issued under section 411(d)(6)(E) of the Code apply for purposes of the parallel requirements of section 204(g)(2) of ERISA, as well as for section 411(d)(6)(E) of the Code.

Special Analyses

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

Drafting Information

The principal author of these regulations is Vernon S. Carter of the Office of the

Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in their development.

List of Subjects in 26 CFR Parts 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

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

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

Par. 2. Section 1.411(d)-4, Q&A-2(e) is revised to read as follows:

§1.411(d)-4 Section 411(d)(6) protected benefits.

* * * * *

A-2: * * *

(e) Permitted plan amendments affecting alternative forms of payment under defined contribution plans--(1) General rule. A defined contribution plan does not violate the requirements of section 411(d)(6) merely because the plan is amended to eliminate or restrict the ability of a participant to receive payment of accrued benefits under a particular optional form of benefit for distributions with annuity starting dates after the date the amendment is adopted if, after the plan amendment is effective with respect to the participant, the alternative forms of payment available to the participant include payment in a single-sum distribution form that is otherwise identical to the optional form of benefit that is being eliminated or restricted.

(2) Otherwise identical single-sum distribution. For purposes of this paragraph (e), a single-sum distribution form is otherwise identical to an optional form of benefit that is eliminated or restricted pursuant to paragraph (e)(1) of this Q&A-2 only if the single-sum distribution form is identical in all respects to the eliminated or restricted optional form of benefit (or would be identical except that it provides greater rights to the participant) except with respect to the timing of payments after commencement. For example, a single-sum distribution form is not otherwise identical to a specified installment form of benefit if the single-sum distribution form is not available for distribution on the date on which the installment form would have been available for commencement, is not available in the same medium of distribution as the installment form, or imposes any condition of eligibility that did not apply to the installment form. However, an otherwise identical distribution form need not retain rights or features of the optional form of benefit that is eliminated or restricted to the extent that those rights or features would not be protected from elimination or restriction under section 411(d)(6) or this section.

(3) Example. The following example illustrates the application of this paragraph (e):

Example. (i) P is a participant in Plan M, a qualified profit-sharing plan with a calendar plan year that is invested in mutual funds. The distribution forms available to P under Plan M include a distribution of P's vested account balance under Plan M in the form of distribution of various annuity contract forms (including a single life annuity and a joint and survivor annuity). The annuity payments under the annuity contract forms begin as of the first day of the month following P's severance from employment (or as of the first day of any subsequent month, subject to the requirements of section 401(a)(9)).

P has not previously elected payment of benefits in the form of a life annuity, and Plan M is not a direct or indirect transferee of any plan that is a defined benefit plan or a defined contribution plan that is subject to section 412. Distributions on the death of a participant are made in accordance with plan provisions that comply with section 401(a)(11)(B)(iii)(I). On September 2, 2004, Plan M is amended so that, effective for payments that begin on or after November 1, 2004, P is no longer entitled to any distribution in the form of the distribution of an annuity contract. However, after the amendment is effective, P is entitled to receive a single-sum cash distribution of P's vested account balance under Plan M payable as of the first day of the month following P's severance from employment (or as of the first day of any subsequent month, subject to the requirements of section 401(a)(9)).

(ii) Plan M does not violate the requirements of section 411(d)(6) (or section 401(a)(11)) merely because, as of November 1, 2004, the plan amendment has eliminated P's option to receive a distribution in any of the various annuity contract forms previously available.

(4) Effective date. This paragraph (e) is applicable on January 25, 2005.

* * * * *

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

Approved: January 10, 2005

Eric Solomon

Acting Deputy Assistant Secretary of the Treasury (Tax Policy)

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 25, 2005
JS-2208

Economic Policies in the Western Hemisphere:
Recent Accomplishments and Future Challenges
John B. Taylor
Under Secretary of Treasury for International Affairs
Remarks at a Luncheon for the
Ambassadors of the Latin American Group
Brazilian Embassy
Washington, D.C.
January 25, 2005

Thank you very much, Ambassador Abdenur, for inviting me to join you and your ambassadorial colleagues today. It is an honor to be here and to have the opportunity to speak before members of the diplomatic corps of the Latin American region. I have enjoyed working with many of you while I have served as Under Secretary at the U.S. Treasury. And I appreciate the warm hospitality I have received on visits to many of your countries during the last four years.

I would like to take this opportunity to talk to you about the remarkable economic accomplishments we have seen in many countries in the region over the past several years. I have heard some critics say that the United States has been too busy elsewhere to work with our neighbors in the region. I think the record and the results say otherwise. By working together in many different fora and by encouraging and implementing good economic policies, we have accomplished the best economic performance in the hemisphere in a quarter century.

To be sure, there are still challenges. Simply put, we need to work together to make the current economic recovery long-lasting, broader, and stronger so that people throughout the region can see significant increases in income and reductions in poverty. The Bush Administration in its second term plans to continue to work closely with the region to advance an ambitious agenda and meet these challenges.

Recent Accomplishments

The economic news from the region has been exceptional, exceeding even the most optimistic forecasts. Forecasters are now estimating that economic growth in Latin America was 5.8 percent in 2004, a significant acceleration from 1.9 percent in 2003 and the fastest growth rate since 1980. Private forecasters expect regional growth to be 4 percent in 2005, so the expansion is expected to continue.

There have also been dramatic improvements in economic stability. There are no countries in the region that are in a recession or financial crisis. Capital flows to Latin America are increasing. Market analysts estimate that governments in the region have already met about half of their financing needs for the entire year. The average risk spread for the region is near its lowest levels in seven years, even as the U.S. Federal Reserve has increased interest rates over the past several months. Mexico just placed a bond issue with its lowest-ever spread over U.S. Treasuries for the 10-year maturity.

I contrast this with the situation when I entered my current job four years ago, when I remember being briefed on the latest $14 billion IMF rescue package for Argentina approved in January 2001, hearing from Mexico's economic leadership about the sinking economy, and getting calls from my friends in Brazil about the fragile situation there.

It is also instructive to contrast the current situation with the wave of financial crises and contagion in the 1990s. Ten years ago Mexico plunged into crisis when the government nearly defaulted on its debt and was forced float the peso. Contrast this situation with today, where the Mexican economy is one of the most stable in emerging markets, enjoying an investment grade rating and some of the lowest risks spreads over U.S. Treasuries in emerging markets. There is also no sign or talk of financial market contagion anymore. The lack of contagion following Argentina's default in 2001--compared to the contagion seen after the Asian and Russian crises in 1997-8--exemplifies how far we have come.

What have been the causes of this improved growth and stability? Good economic policies, both in the region and the United States. The strong economic recovery in the United States, based on timely changes in monetary and fiscal policy such as President Bush's tax cuts in 2001 and 2003, have been a big factor in spurring Latin America's recovery through the close linkages we have through trade.

Within the region, governments have taken very significant steps during the last few years to improve fiscal policies aimed at reducing debt levels. Monetary policies have also improved, supported by a move to more flexible exchange rates and inflation-targeting regimes. Brazil, Chile, Colombia, and Peru all have well-established monetary policies based on inflation-targeting. Better monetary policies in Brazil and Argentina, for example, prevented the large depreciations in 2002 from translating into uncontrolled inflationary spirals. The United States has supported good policies in the region by strongly supporting IMF, World Bank, and Inter-American Development Bank assistance to countries that were pursuing good economic policies.

These good economic policies set the stage for the robust recovery in economic growth that we have observed in Latin America. They also underlie the improvements in economic stability in financial markets, as investors have taken note of better policies. Brazil, Mexico, Chile, Ecuador, Paraguay, and Uruguay--among others--received ratings upgrades from the credit rating agencies during the last two years.

Future Challenges

Despite these accomplishments, this is no time to be complacent. I see the current situation as a moment of historic opportunity for the region and emerging markets in general to put themselves on a robust growth path and act as stabilizing force in the world economy rather than being vulnerable to developments in the rest of the world. Emerging markets are accounting for an increasingly large share of global growth, inflation, and financing and as a consequence are playing an increasingly important role in determining their patterns.

Despite the political challenges in the region, I think there is the strong political leadership needed to take up this challenge. Just to name a few, we have been particularly impressed by what President Lula and Finance Minister Palocci have accomplished in Brazil, how President Gutierrez and Finance Minister Yepez in Ecuador have maintained disciplined fiscal policies in an unsettled political environment, how President Uribe in Colombia has simultaneously tackled economic reform and improved security, and how President Frutos has moved forward a broad-based reform agenda in Paraguay.

This is the time to be ambitious on economic policy and put in place what is needed for sustained growth by pursuing reforms aimed at, first, locking-in improvements in macroeconomic policy and, second, creating the microeconomic environment for higher productivity growth.

On the first of these, a lot of progress was made in 2004 in strengthening fiscal balances and lowering debt levels. However, debt levels in the region at 55 percent of GDP are still too high and a source of financial vulnerability. Further fiscal efforts will be needed to bring them down and to give the region greater financial flexibility as it encounters shocks in the future.

Part of this effort will involve advancing what we call structural fiscal reforms in order to ensure continued strong fiscal performance and lock-in the improvements we have seen over the past couple of years. Key among these include reforms to strengthen tax administration and broaden the tax base, pension reform to ensure the sustainability and solvency of pension systems, and fiscal responsibility regimes to institutionalize fiscal discipline at the provincial and regional levels. On the monetary side, additional work can be undertaken to bolster the operational and institutional underpinnings of inflation-targeting regimes. Chief among these is legislation to increase central bank autonomy and independence; Mexico, Chile, Peru, and Colombia have independent central banks.

The second challenge is to raise the region's growth rate so that we see the nearly 6% growth in 2004 not only in one year but every year. Growth of 4% as expected this year is simply not high enough to generate the large, sustained reductions in poverty that we all want to see. I think the region can do better.

The key to achieving higher per capita income growth is boosting productivity growth. Higher productivity growth translates into higher wages, and higher wages reduce poverty. Productivity growth in Latin America has been unacceptably low compared to other regions of the world. According to the IDB's "The Business of Growth" study, productivity growth was 0.7 percent per year in the region as a whole in the 1990s after being negative in the 1980s. The improvement is attributable to some significant economic reforms undertaken in the early 1990s. However, Latin America's performance compares poorly to that of other countries. During the 1990s, productivity growth was 1.7 percent in the developed countries and 2.7 percent in the East Asian countries. That 1 percent or 2 percent productivity difference could have made a huge difference in living standards in the region. Productivity growth in Latin America can and should be higher than 2 percent--or more than triple what it was in the 1990s.

The "Business of Growth" study also discusses the range of policy issues that need to be addressed in order to achieve higher rates of productivity growth. Improvements to the business climate, or microeconomic reforms as we call them, are central for creating the incentives to innovate and invest that are essential for boosting productivity. These are reforms that include trade liberalization, business deregulation, labor market reform, financial market reform, strengthening property rights, and fighting corruption. They also include investment in physical infrastructure and human capital or skills development.

The Bush Administration is firmly committed to working with countries in the region--both through our bilateral relationships and in multilateral fora--to help achieve higher rates of productivity growth and rising living standards.

We remain committed to further regional integration through advancing our ambitious trade agenda. We have concluded or are in the process of concluding a raft of FTA agreements throughout the region. These include the U.S.-Chile FTA, the Central American Free Trade Agreement (CAFTA), as well as our ongoing negotiations with Panama and the Andean region. All told, these FTAs will cover 90 percent of U.S. trade with Latin America.

The recent economic recovery in Latin America shows just how important trade is for economic growth. Exports have been a key driver of this growth throughout the region, rising an estimated 22 percent last year, up from 10 percent in 2003. More impressively, this is not just a commodity price phenomenon, with exports volumes rising an estimated 11 percent last year. Strong export performance has led to the second year in a row that Latin America has posted a current account surplus--at an estimated 1 percent of GDP in 2004, up from 0.5 percent of GDP in 2003 when the region ran its first current account surplus in 35 years.

We are committed to working with the countries of the region to seize the opportunity of the November 2005 Summit of the Americas to advance concrete initiatives for boosting economic growth and creating jobs. These initiatives aim to support the microeconomic conditions needed to boost productivity growth. At the Special Summit of the Americas held last January in Monterrey, Mexico, our leaders made important commitments to halve the cost of remittances, triple credit to small businesses catalyzed by IDB programs, and halve the time and cost of starting a new business.

At the upcoming Summit this November in Argentina, we are thinking of similar types of initiatives. I believe infrastructure will be an important focus of the Summit and we have a number of ideas on how we can promote more investment in infrastructure in an efficient and sustainable manner. I also think mortgage market development is an important potential initiative as it helps broaden capital markets and expands the opportunity of home and property ownership to the poor. The Summit also provides a chance for the region's leaders to support continued efforts by the multilateral development banks to show measurable results in their activities by increasing discipline over budget and project lending programs to achieve quantifiable results with strong controls over where the money goes. I look forward to working with the people in this room over the next few months to make the upcoming Summit a success.

Our bilateral dialogues continue to be a critical resource for sharing experiences and policy views about how to boost productivity growth. To take a couple of examples, we have made important progress in reducing the cost of sending remittances from the United States to Mexico in part through the work of the U.S.-Mexico Partnership for Prosperity launched in 2001. We have had valuable policy exchanges in the U.S.-Brazil Group for Growth that have helped refine approaches to reforms in areas like small business regulation.

A major way in which we are working with countries to meet the challenge of increasing productivity growth is through the Millennium Challenge Account (MCA). The MCA is an important bilateral initiative that the Bush Administration has developed to help the poorest countries in the region and around the world--countries that are putting in place the policies that encourage innovation and investment. I am particularly pleased to see that three countries in the region, Bolivia, Nicaragua and Honduras, have qualified for MCA assistance this year. It is also important to note that we are seeing countries develop very specific and well targeted programs to use their MCA assistance that have a greater chance of producing real, measurable results. Focusing on a few areas where a meaningful difference can be made, rather than undertaking a broad diffuse effort is much more likely to yield positive results.

Conclusion

In conclusion, let me say that I am pleased to have had the opportunity to work with you over the past few years--years in which we can be proud of a number of significant achievements. I look forward to carrying forward this work in our joint efforts to create better lives for all the peoples of our hemisphere.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 26, 2005
js-2209

Snow Applauds New States Offering Health Coverage Tax Credit Plans for 2005

Kentucky, Louisiana and New Jersey now offer plans

WASHINGTON, DC -- U.S. Treasury Secretary John W. Snow applauded Governor Fletcher of Kentucky, Governor Blanco of Louisiana and Acting Governor Codey of New Jersey for implementing a state qualified health plan option under the federal Health Coverage Tax Credit Program (HCTC) to help cover the cost of health insurance premiums for certain residents in those states. The plans went into effect January 1st, allowing citizens of these three states to take full advantage of the Health Coverage Tax Credit through approved health care plans.

"The HCTC will now bring affordable, quality health care to more hard working families in Kentucky, Louisiana and New Jersey," said Treasury Secretary John Snow. "The officials in these states have worked hard to ensure thousands of families will have the peace of mind that health care coverage brings. I applaud their leadership in establishing a qualified plan to provide coverage for eligible individuals and their families."

The Trade Adjustment Assistance Act President Bush signed into law in 2002 included the new Health Coverage Tax Credit (HCTC). Recipients can receive the HCTC either in advance, to help pay qualified health plan premiums as they come due, or in a lump sum when they file their federal tax returns. The HCTC advance payments program began nationally in August 2003. This program provides an advanced payment of 65 percent of the premium cost for a qualified health plan for individuals and their families who are eligible to receive Trade Adjustment Assistance (TAA) benefits or certain individuals who receive pension benefit payments from the Pension Benefit Guaranty Corporation (PBGC).

MORE

"The HCTC program is cutting edge tax policy. Bold ideas like the HCTC will lead the charge for innovative solutions to help real people obtain needed health care coverage in a flexible, reliable way," Snow continued. "We want to ensure that those who qualify for the credit get the help they need as quickly as possible."

To receive the credit, eligible individuals must enroll in qualified health insurance, such as a COBRA health plan or State Qualified Health Plan (SQHP). Forty states and the District of Columbia have SQHPs that will enable more than 200,000 of those potentially eligible for the HCTC to purchase health coverage. Nationwide, there are approximately 230,000 individuals potentially eligible for the HCTC.

For more information on a particular state and the health insurance programs that qualify, please visit the HCTC website at www.irs.gov and enter IRS Keyword: HCTC.

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 27, 2005
js-2210

The Honorable John W. Snow
Prepared Remarks: Real Estate Roundtable's State of the Industry Meeting
January 27, 2005

Thank you so much for having me here today. It's great to see all of you, and I'm looking forward to our conversation.

This is an exciting time for the real estate industry. Over the last few years, you've played an integral part in a remarkable, national economic recovery. Today, there is growth in your industry and the country's overall economy is very strong.

The housing market in particular has been vibrant in the past few years, and it truly dampened the effects of the recession as well as helped fuel the recovery. In 2004, housing starts climbed to a 26-year high. We expect that final data for 2004, which will be released soon, will show that sales of single-family homes set a new annual record. And boosted by new home building, jobs in the construction industry have increased by nearly 300,000 over the past 16 months, accounting for over 10 percent of the more than two and a half million jobs created since August of 2003.

This is exceptional news, and I deeply appreciate the economic contributions of the people represented in this room today. You are part of a vibrant national economy – the fastest-growing economy of any major industrialized nation in the world.

The American economy has posted steady job gains for each of the last fifteen months. The unemployment rate is down to 5.4 percent – lower than the average rate of the 1970s, 1980s and 1990s. After-tax income is up by over ten percent since the end of 2000 and household wealth – reflecting, among other things, rising home values – is at an all-time high. Inflation, interest rates, and mortgage rates remain at low levels. And, as you well know, homeownership rates are at record highs.

Is it enough? Can we do better? Yes – continued economic growth is important to every person in this room, and to every worker in America who is looking for a job.

We still face considerable economic challenges as a country, and this is a superb time to tackle those challenges. Our underlying economic fundamentals have been strengthened, thanks largely to well-timed tax cuts and sound monetary policy, and now we must address the next set of issues, each of which comes with significant short and long-term implications.

First up, it's budget time for the federal government, and I want you to know that the Bush administration is cognizant of both the short and the long-term implications when it comes to budgeting the taxpayers' money.

We're not happy with our deficit. It's unwelcome, although it is understandable, given what our economy and our country went through in recent history.

We're dealing with the deficit in two key ways: first, controlled spending and, second, implementation of policies that encourage continued economic growth.

Growth is important for so many reasons... and at this time most valued for creating jobs and reducing deficits. Four rounds of Bush tax cuts clearly stimulated growth; millions of jobs have been created and we are also seeing an increase in Treasury receipts – they are up 10.5% in the last three months versus the same three months last year.

The real key is spending discipline – we are not under-taxed – and the President's 2006 budget will control spending. We will remain on track to cut the deficit in half by 2009.

We're also focusing on the longer-term deficit situation including, importantly Social Security and other federal programs.

The current Social Security system is unsustainable; it's a matter of arithmetic. Demographic changes have brought us from circumstances where we had 16 workers paying into a system for every one beneficiary in the 1950s, to today where we have three workers for every beneficiary. That ratio will drop to two-to-one by the time today's young workers retire.

People are living longer and having fewer children. And that has made the pay-as-you-go Social Security system financially unsustainable. I've called for all sides of the reform debate to, first, agree on these simple facts.

Social Security is a sacred trust, and it has made a critical difference for millions of retirees. It has kept its promise to America's seniors since it was enacted in 1935. Social Security is secure for today's retirees and for those nearing retirement but it is offering empty promises to future generations.

It is the future of the program that President Bush is concerned about, and it is the future of the program that we must address, this year, in Congress.

We can, and should, do this without increasing payroll taxes. Many of you in this room are employers, and you know what a terrible impact massive payroll tax increases would have on our economy. It would negatively impact economic growth; jobs would be lost. We don't have to go that way.

We can, and should, reform the system in a way that encourages younger generations of workers to build a nest egg that they own and control and can pass on to their loved ones.

Those of you who are part of the housing industry likely appreciate how powerful this concept of ownership is. Owning your own house is the centerpiece of a free and independent way of life.

When you own your own home, you are proud of it, you look after it, you spend hours, days and years improving it and increasing its value. A retirement nest egg holds that same power, and that same promise. And that's why personal savings accounts should be part of Social Security reform.

The President is the nation's greatest advocate for owning your own home, owning your own retirement savings, and owning your own business. In a free country, we as individuals are uniquely positioned to achieve ownership, and the government should never impede us from doing so; it should encourage us.

Some of our laws, and a big part of our legal system, can make ownership frustrating. I'm thinking specifically of our civil justice system – an area that I know your group would like to see changed.

Abuse of the civil justice system is rampant. Trial attorneys make millions in cases where plaintiffs are paid pennies. Business owners are subject to what amounts to extortion – settling frivolous cases out of court rather than subject themselves to unknown legal costs at trial. And even if a suit is never filed, businesses and doctors pay the price of an out-of-control system through insurance fees, record-keeping and legal counsel.

There are few things that create a greater disincentive to job creation than an atmosphere where little stands between every business owner, ever manager, every doctor and professional of almost any kind... and the next frivolous lawsuit.

I want you all to know the priority that lawsuit abuse reform is to President Bush and his administration. We are deeply committed to ensuring that victims are compensated fairly when they are injured due to the fault of another person, but we also know that key job creators – the top ones being small-business owners – live in fear of frivolous suits that can damage or destroy their businesses and all the jobs they support.

We know that the current tort system is costing America well over $200 billion each year... that's a tort tax – paid in the form of lower wages, higher product prices, and reduced investments – of over $800 for every individual and more than $3200 for a family of four. And this is a regressive tax, imposed indiscriminately across our economy.

To make the situation even less fair, less than 50 cents of each dollar of those tort costs go to victims... and, of that, only 22 cents goes to compensate them for actual economic losses they have suffered... meanwhile the personal injury lawyers profit enormously.

At a time when our economy needs to continue expanding, at time when we need to reduce deficits and increase savings, this is unacceptable.

Because a frivolous lawsuit has never created a single job – except jobs for personal injury lawyers – but baseless and excessive suits have killed many. Every small-business owner knows this, as they are on the front lines of job creation.

Our economy is resilient. Our free market system is strong, and the envy of the world. Imagine if we freed it from frivolous suits.

Class action reform was re-introduced in the U.S. Senate on Monday. It has the unwavering support of the President, and I am optimistic this legislation will move us away from a system of jackpot justice and back to a more rational method for resolving genuine disputes. Predatory class action lawsuits have been the bane of innovation for many companies, and the time for ending this abuse of the system – and of the plaintiffs who are targeted to put their names on these suits – is long overdue.

Nothing, however, is longer overdue for reform than the U.S. tax code.

As you know, this is another top agenda item for President Bush's second term. The tax code is terribly long, mind-numbingly complicated, and ultimately leads to a lack of fairness and a disincentive for economic growth.

The President recently appointed an Advisory Panel on Tax Reform. It is made up of some of the sharpest minds in the tax policy community, chaired by two solid leaders: Senators Connie Mack and John Breaux. That panel will report recommendations to me later this year, and I will present them to the President by year's end. I am looking forward to reviewing proposals that increase the fairness of the code, reduce its length and complexity, and promote economic growth.

And, as the President has said, any proposal that goes forward will also retain our country's commitment to encouraging homeownership and charitable giving. These are elements of the current code that should be carried over into a new structure.

So much can be done to promote and protect the economic health of our country. A few issues of particular interest to your group include the regulation of government sponsored enterprises (GSEs) and the Terrorism Risk Insurance Act, and I'd like to touch briefly on each of those issues.

Promoting homeownership is a top priority of President Bush and thisdministration has enacted policies that have helped make owning a home a reality for millions of Americans. Our national system of housing finance plays a key role in promoting homeownership, and the housing GSEs, Fannie Mae, Freddie Mac and the Federal Home Loan Banks, have played a vital role in that system.

GSEs are among the world's largest financial institutions, and this administration has long noted that the GSEs' potential to create systemic risk warrants close examination.

Because of the important role the GSEs play in helping to fund our mortgage markets and in the financial markets as a whole, we need to be sure they are operating safely, prudently, and efficiently.

While GSEs have continued to grow in size, complexity, and importance, the regulatory structure governing their activities has not. Therefore, we need a strong, credible, and well-resourced regulator with a clear mandate and all the powers of other world class financial regulators. The new regulator should have at heart two guiding principles: promoting a sound and resilient housing financing system and increasing homeownership for less advantaged Americans.

The administration is committed to fully examining this complex issue and these critical questions, with the goal that the homebuyers and taxpayers are fully protected.

As for another issue that I know is on your mind... I want to talk a little bit about Terrorism Risk Insurance. First, by saying that we haven't forgotten how the horror of September 11th was particularly hard on your industry. I've heard from many of you and I know that the Terrorism Risk Insurance Act of 2002 – and the extension of the "make available" provision of the act – helped you through that difficult.

We made the decision to extend the "make available" provision because we wanted to ensure the continuation of the key elements of the re-insurance program. At the time we did so, I noted that the terrorism risk insurance program had been an important confidence builder as this country recovered from the attacks of September 11 and the recession.

The issue of reauthorization of TRIA is one that will involve a detailed analysis and more data than we have at this time. The Act requires that Treasury study its effectiveness and report to Congress by June 30, 2005. Through our study, ongoing at this time, we are seeking to answer the questions Congress posed in the Act, such as the financial capacity of the insurance industry, the pricing and take-up of terror risk insurance, whether risk can be priced and managed, the return of re-insurers to the market, and what is the most efficient mechanism to produce insurance for the risk.

We are looking forward to a prompt completion of our study, so that we and Congress can have a full and open discussion about these important questions.

It's an important issue, and Treasury is dedicated to the most thorough study and analysis possible so that Congress may make a fully informed decision about terrorism risk insurance in the future.

I know I've covered a lot of ground here today, and I'm looking forward to taking your questions.

Once again, I want to commend this group and your industry for your hard work and contributions to this great American economy... and of course to thank you so much for having me here today. I'll take your questions now.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 27, 2005
JS-2211

Treasury Deputy Assistant Secretary Iannicola to Teach Personal Finance Skills to Washington, D.C. High School Students

Treasury's Deputy Assistant Secretary for Financial Education, Dan Iannicola, Jr. will teach personal finance skills to 10th, 11th and 12th graders at three high schools in Washington, D.C. On Friday, Iannicola will teach a financial education lesson on budgeting and managing credit wisely to 12th graders at Margaret Murray Washington Career High School, and to 10th and 11th graders at Theodore Roosevelt Senior High School. On Monday, Iannicola will teach 12th graders at Howard D. Woodson Senior High School Academy of Finance.

Treasury's Office of Financial Education 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.

Friday, January 28, 2005

• Margaret Murray Washington Career High School
27 O Street, N.W.
Washington, D.C.
9 a.m. (EST)

• Theodore Roosevelt Senior High School
4301 13th Street, N.W.
Washington, D.C.
11:15 a.m. (EST)

Monday, January 31, 2005

• Howard D. Woodson Senior High School Academy of Finance
5500 Eads Street, N.E.
Washington, D.C.
10:45 a.m. (EST)

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 27, 2005
js-2212

Statement on Getting the Millennium Development Goals Back on Track
John B. Taylor, Under Secretary for International Affairs
United States Department of the Treasury
Davos, Switzerland
January 27, 2005

Thank you for inviting me to participate in this discussion. Since we are here to talk about "getting the millennium development goals (MDGs) back on track," the first question one must ask is why they are off track, particularly in Africa. In my view, a significant part of the answer has to do with the lack of measurable results. What gets measured gets done, and my experience has been that aid is increasingly being delivered in a way that is disconnected from the results we are trying to achieve. Donors and recipients share responsibility in this. For example, donors are engaging in budget support operations without demanding a serious effort to measure how those resources result in progress toward meeting the MDGs. On the recipient side, the Poverty Reduction Strategies -- which serve as the basis for budget support operations – are very weak when it comes to results measurement. I have traveled to developing countries throughout the world and visited many development projects, and I am still amazed, and frankly disappointed, at the unevenness of the results measurement efforts. Getting the MDGs on track will require all of us to aim development assistance squarely at the goals themselves, and to focus on tangible results that will allow us to chart our progress.

The report from the Millennium Project, *Investing in Development: A Practical Plan to Achieve the Millennium Development Goals*, takes a serious look at the steps the international community should take to deliver on time-bound development targets. The report's attention to an entrepreneurial private sector as an essential element for development is laudable. I am especially pleased by the forceful call for directing aid towards countries that have established a track record of governing both justly and wisely. Targeting such good performers has many merits. First, and as the report notes, quality of governance and a commitment to sound economic policies are necessary preconditions for any country that hopes to undertake and sustain the ambitious investment programs that are necessary to achieve the MDGs. In the absence of those preconditions, both donor resources as well as precious recipient country resources are likely to be wasted. A policy of targeting good performers can also provide other countries with strong incentives to govern more justly and wisely by further increasing the economic rewards to be gained through reform.

Indeed, the considerations that underpin the report's call for targeting "MDG fast-track countries" are precisely the same considerations that persuaded us in the U.S. to introduce the Millennium Challenge Account (MCA). The MCA is one of the only instruments in place that systematically directs aid to poor countries that, despite their economic condition, exhibit both quality of governance and a commitment to sound economic policies and investment in their people. The concessional windows of the multilateral development banks have a somewhat similar performance-based system in place; countries that rank higher on their Country Policy and Institutional Assessment (CPIA) indicators receive, all else being equal, a larger allocation of funds. We have been urging the World Bank to adopt the transparency standards of the MCA in its Country Policy and Institutional Assessment (CPIA) indicators so countries have clear incentives to improve and to hold the World Bank more accountable for its ratings. We have also worked to ensure that the weight of governance remains high in the calculation of those indicators. To reduce the weight of governance would reward countries like Zimbabwe at the expense of countries like Tanzania.

Regarding the relationship between aggregate aid flows and MDGs, the United

States has significantly increased ODA, but we think that it is simply impossible at this point in time to forecast how much will ultimately be required and disagree with the concept of specific ODA targets. Aid is just one of many important inputs to development, and the amount of aid that will be needed to meet the MDGs will depend critically on the quantity and quality of the supply of these other inputs. Indeed, the argument for targeting good performers grows out of the recognition that aid is most effective when coupled with good governance, and sound policy.

As we increase aid to poor but well-governed countries, it is particularly important that we do not cripple them with debt in the process. Through the increased use of grant funding to these very poor countries as they work to achieve sustainable development, we can help them to break free of recurrent "lend and forgive" cycles. Such cycles are signals of poor governance on the part of donors and recipients alike, and more importantly, can act to stifle the investments that are necessary to achieve growth. I am pleased to see that the report endorses the use of grants to the poorest countries.

The report mentions the need for countries to live up to the Monterrey Consensus commitments. In fact, the U.S. committed to increase our ODA by 50% from 2000 to 2006 and it was already up by 60% through 2003. In Sub-Saharan Africa, the U.S. has more than *quadrupled* its aid contributions in just three years alone, from $1.1 billion in 2000 to over $4.6 billion in 2003. As part of our concerted efforts to combat the specter of HIV/AIDS, the U.S. committed $1.2 billion in bilateral assistance for 2003, or $800 million more than the next largest donor. In FY 2004, the total U.S. budget for international HIV/AIDS programs was $2.4 billion and the U.S. is the largest investor in the Global Fund. With the help of our development partners, the U.S. is spearheading the global effort to eradicate Polio, having committed roughly $1 billion and now leading the way in mobilizing support for the World Health Organization's Polio Eradication Initiative.

None of these increases in assistance will be sustainable, and talk of even greater increases will be unrealistic, without measurable results. In my own experience, the best way to encourage more generosity from U.S. taxpayers is to provide them with clear evidence of results. Moving forward, we will need to present increased development assistance as a clear means towards an end rather than as an end in itself. This will require us (first) to define clear objectives for development funding and (then) to identify demonstrable results associated with those objectives. In addition to helping us persuade U.S. taxpayers, our efforts in this vein will teach us to use aid more effectively by providing the opportunity to evaluate and draw lessons from what works and what doesn't work.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 25, 2005
JS-2213

Remarks of
D. Scott Parsons
Deputy Assistant Secretary for Critical Infrastructure Protection
before the Outreach Meeting of the
Financial and Banking Information Infrastructure
Committee and the
Financial Services Sector Coordinating Council
New York, NY

I want to begin today by thanking the Federal Deposit Insurance Corporation for their work in putting together these conferences across our great country. The professionalism of the men and women of the FDIC has been exemplary, and we appreciate their dedication to this important outreach.

Winston Churchill's words more than a half-century ago are an appropriate description of our position today as we work together to protect our homeland. Churchill said, "This is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning."

Today is the culmination of an outreach program on critical infrastructure protection that took us to 29 cities across the country. In many ways, the idea for the outreach began here in New York City on September 11, 2001.

The spirit of America is one of steadfast resolve with an inclination toward action. And shortly after the cowardly attacks of September 11, we swung into action. The Administration put forward plans to protect our critical physical and cyber infrastructures. Even before the 9/11 commission was created, we began to break down old barriers that inhibited information sharing in the government.

At the Treasury, we have two important roles in protecting the homeland. The President designated Treasury as the lead agency for protecting the financial infrastructure that is the engine of our economy. The second role is to work to stop the flow of blood money to the terrorists. As Secretary Snow has said, "while hatred fuels the terrorist agenda, money makes it possible." To date, the global community has frozen over $147 million in terrorist-related assets.

But I want to return to the important role of leading the effort to protect our critical infrastructure. My office has the responsibility for discharging this obligation for the Department of the Treasury. I'm very pleased to note that the financial sector is strong and resilient. We know this because the sector has been tested, and we know this because of the significant attention the sector pays on a daily basis to business continuity and security. It was tested on 9/11, it was tested during the Northeast power outage in August of 2003, and it was tested again when the threat level for the financial sector in New York, New Jersey, and Washington, D.C. was elevated in August of 2004. It has survived tornadoes, hurricanes, and blizzards. Each incident proved the financial sector to be adaptable and resilient.

Today, we are engaged in a two-front war to protect our nation's critical infrastructure. One front is physical, with the focus on protecting people, property, plants, and equipment. The other front is cyber, and our efforts there center on protecting systems and data.

President Bush has stated that protection is "a shared responsibility...requiring close cooperation between government and the private sector at all levels." As we face a changing threat matrix, we must mount a powerful, coordinated defense: a partnership between the public and private sectors to minimize disruptions in the event of an attack and to quickly restore our way of life, which is the ultimate in defiance against terrorism.

We've organized our efforts to protect the critical infrastructure of the financial sector based on this perspective.

Our strategy is built on two pillars – a public sector pillar comprised of the federal and state financial regulators, and a private sector pillar that includes an organization of the leading financial industry trade associations and institutions. Communication between these government and business channels is the cornerstone of our strategy. Generating accurate and timely information about threats to our physical and cyber infrastructure and then sharing that information are essential outcomes of this communication.

The Treasury chairs an organization comprised of the federal and state financial regulators. This organization is the Financial and Banking Information Infrastructure Committee, or FBIIC. The FBIIC is chartered under the President's Working Group on Financial Markets, and is charged with improving coordination and communication among financial regulators, enhancing the resiliency of the financial sector, and promoting the public/private partnership.

You will hear shortly about two of our most important private sector organizations, the Financial Services Sector Coordinating Council and the Financial Services Information Sharing and Analysis Center. Each of these organizations works closely together to share information and collaborate on initiatives that advance the financial sector's preparedness.

Four principles guided our actions in the aftermath of September 11 and they continue to guide our actions today. These principles form the bedrock of our collaboration with the financial sector.

As I outline these principles, it is important to note that financial sector is highly resilient. The sector has been a target for criminals since its very beginnings. And while we have a strong regulatory regime in place that ensures the safety and soundness of financial institutions, I believe that protecting critical infrastructure is fundamentally a risk management issue, and that there is no "one size fits all solution" to be achieved through additional regulation. In fact, such regulation may actually harm our goal of ensuring a reliable and resilient financial services sector, by depriving the sector of the flexibility it needs to counter the threats that exist.

The first principle is the protection of people. People, not buildings or computers, produce financial services. And it is people who benefit from financial services.

We depend on people - tellers, technicians, loan officers, technologists - to operate the financial system and to see the system through during times of stress. Indeed, it was the commitment of these professionals to their institutions, customers, and colleagues that helped the financial system recover from the September 11 attacks.

Just as we depend on people to operate the financial system, people around the globe depend on the U.S. financial system to stay up and running. This leads to our second principle: maintaining confidence. We rely on financial services to process our paychecks, buy groceries, purchase a house, finance our children's education, or save for retirement. We must ensure that consumers trust in the financial system. And this in turn produces confidence. Rock-solid confidence in the ability of financial institutions to clear checks, execute transactions, and satisfy insurance obligations, despite disruptions, assures our citizens and the world that America is a good place in which to invest.

The third principle is to ensure that the financial system remains accessible and helps keep America "open for business." When a disaster occurs, investors rely on markets to price the impact of the disruption on assets. The longer markets are closed, the longer investors must go without knowing the effects of the disaster. This uncertainty can itself be harmful to the economy, compounding the impact of any disruption. An ability to re-open financial institutions quickly helps eliminate uncertainty, enabling us to dull the pain of an attack and speed recovery.

Fourth, we encourage decentralized decision-making and swift, responsible action by the private sector. In general, financial institutions should engage in problem-solving and make appropriate decisions without waiting for or depending on guidance from Washington. After all, it is the private sector that owns and operates the majority of the financial systems, and therefore the private sector knows best how to mend these systems after a disruption.

As government and private industry share more and better information, financial institutions become better prepared to estimate the risks they bear and better equipped to effectively reduce the probability of a disruption through strategic investments. Furthermore, as more institutions enhance security and reliability, the incentive increases for competitors to invest in innovative solutions as well. This cascading effect delivers an efficient and effective means of encouraging optimal investment in corporate resilience. In some firms, it may shift critical infrastructure protection from a corporate liability to an asset and competitive differentiator. Finally, an industry that responsibly protects itself reduces the need or desire for the government to impose costly, inflexible, and potentially ineffective regulation.

Thank you all both for your attendance here, and for all that you do to better secure America's vital financial services infrastructure.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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January 27, 2005
JS-2214

Treasury and IRS Announce Guidance On
Like-Kind Home Exchanges

-- Today the Treasury Department and the IRS published a revenue procedure providing guidance on a like-kind exchange of a home. The revenue procedure clarifies that a homeowner, who may exclude gain upon a sale or exchange of a home, also may benefit from a deferral of gain for a like-kind exchange with respect to the same property.

Generally, a homeowner may exclude up to $250,000 ($500,000 for certain joint returns) of gain upon the sale or exchange of a home. The homeowner must have owned and used the property as his or her principal residence, for periods aggregating two years or more, during the five-year period ending on the date of the sale or exchange, and must not have used the exclusion during the two-year period ending on that date. The home-sale exclusion may apply to a home office, or other business portion of a home, but not to depreciation from the business use.

In the case of business property, a property owner generally would not recognize gain upon the exchange of the business property for replacement property of a like kind. The property owner would recognize gain to the extent received in cash or property that is not of a like kind (commonly called boot). Property used solely as a home would not constitute business property.

The revenue procedure indicates that, in certain cases, a homeowner may benefit from both the home-sale exclusion and the like-kind deferral. In such cases, the property would have been used consecutively or concurrently as a home and a business (e.g. rental residence). The revenue procedure sets forth six examples, illustrating the treatment of depreciation and boot.

REPORTS

- A copy of the revenue procedure

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 1, §§ 121, 1031; 1.121-1, 1.1031(a)-1.)

Rev. Proc. 2005-14

SECTION 1. PURPOSE

This revenue procedure provides guidance on the application of §§ 121 and 1031 of the Internal Revenue Code to a single exchange of property.

SECTION 2. BACKGROUND

.01 Section 121(a) provides that a taxpayer may exclude gain realized on the sale or exchange of property if the property was owned and used as the taxpayer's principal residence for at least 2 years during the 5-year period ending on the date of the sale or exchange. Section 121(b) provides generally that the amount of the exclusion is limited to $250,000 ($500,000 for certain joint returns). Under § 121(d)(6), any gain attributable to depreciation adjustments (as defined in § 1250(b)(3)) for periods after May 6, 1997, is not eligible for the exclusion. This limitation applies only to depreciation allocable to the portion of the property to which the § 121 exclusion applies. See § 121-1(d)(1).

.02 Under § 1.121-1(e) of the Income Tax Regulations, a taxpayer who uses a portion of a property for residential purposes and a portion of the property for business purposes is treated as using the entire property as the taxpayer's principal residence for purposes of satisfying the 2-year use requirement if the residential and business portions of the property are within the same dwelling unit. The term "dwelling unit" has the same meaning as in § 280A(f)(1), but does not include appurtenant structures or other property. If, however, the business portion of the property is separate from the dwelling unit used for residential purposes, the gain allocable to the business portion of the property is not excludable unless the taxpayer has also met the 2-year use requirement for the business portion of the property.

.03 Section 1.121-1(e)(3) provides that, for purposes of determining the amount of gain allocable to the residential and business portions of the property, the taxpayer must allocate the basis and the amount realized using the same method of allocation the taxpayer used to determine depreciation adjustments (as defined in § 1250(b)(3)). Allocation based on the square footage of the residential and business portions of the property is an appropriate method of allocating the basis and the amount realized. Poague v. United States, 66 A.F.T.R.2d (RIA) 5825 (E.D. Va. 1990), aff'd, 947 F.2d 942 (4th Cir. 1991).

.04 Section 1031(a) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment (relinquished property) if the property is exchanged solely for property of like kind (replacement property) that is to be held either for productive use in a trade or business or for investment. Under § 1031(b), if a taxpayer also receives cash or property that is not like-kind property (boot) in an exchange that otherwise qualifies under § 1031(a), the taxpayer must recognize gain to the extent of the boot. Section 1031 does not apply to property that is used solely as a personal residence.

.05 Section 1012 provides that the basis of property is its cost. The basis of property acquired in an exchange is its fair market value, unless otherwise provided in the Code or regulations (for example, § 1031(d)). See Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954).

.06 Under § 1031(d), the basis of the replacement property is the same as the basis of the relinquished property, decreased by the amount of cash received and increased by the amount of gain recognized by the taxpayer in the exchange.

.07 Neither § 121 nor § 1031 addresses the application of both provisions to a single exchange of property. Section 121(d)(5)(B), however, provides rules for applying § 121 and another nonrecognition provision, § 1033, to a single replacement of property. Under § 1033, in general, gain is recognized only to the extent the amount realized from a compulsory or involuntary conversion of property exceeds the cost of qualifying replacement property, and the basis of the replacement property is its cost reduced by the amount of the gain not recognized.

.08 Section 121(d)(5)(B) provides that, in applying § 1033, the amount realized from the sale or exchange of property is treated as the amount determined without regard to § 121, reduced by the amount of gain excluded under § 121. Under § 121(d)(5)(B), the amount realized from an exchange of a taxpayer's principal residence for purposes of applying § 1033 is the fair market value of the relinquished property reduced by the amount of the gain excluded from gross income under § 121. Thus, Congress concluded that for exchanges meeting the requirements of both § 121 and § 1033, (1) the § 121 exclusion should be applied to gain from the exchange before the application of § 1033, (2) for purposes of determining gain that may be deferred under § 1033, the § 121 exclusion should be applied first against amounts received by the taxpayer that are not reinvested in the replacement property (amounts equivalent to boot that would result in gain recognition absent the application of § 121), and (3) the gain excluded under § 121 should be added in the calculation of the taxpayer's basis in the replacement property. See S. Rep. No. 830, 88th Cong., 2d Sess. 52-53, 1964-1 C.B. (Part 2) 505, 556-7 ("the basis of the taxpayer in the newly acquired residence will be his basis for the old residence increased by any exclusion of gain obtained by him under the provision which is reinvested in the new residence"); H.R. Rep. No. 749, 88th Cong., 1st Sess. 47, 1964-1 C.B. (Part 2) 125, 171.

SECTION 3. SCOPE

This revenue procedure applies to taxpayers who exchange property that satisfies the requirements for both the exclusion of gain from the exchange of a principal residence under § 121 and the nonrecognition of gain on the exchange of like-kind properties under § 1031. Thus, this revenue procedure applies only to taxpayers who satisfy the held for productive use in a trade or business or for investment requirement of § 1031(a)(1) with respect to the relinquished business property and the replacement business property (as defined below).

SECTION 4. APPLICATION

.01 In general. Taxpayers within the scope of this revenue procedure may apply both the exclusion of gain from the exchange of a principal residence under § 121 and the nonrecognition of gain from the exchange of like-kind properties under § 1031 to an exchange of property by applying the procedures set forth in this section 4.

.02 Computation of gain.

(1) Application of § 121 before § 1031. Section 121 must be applied to gain realized before applying § 1031.

(2) Application of § 1031 to gain attributable to depreciation. Under § 121(d)(6), the § 121 exclusion does not apply to gain attributable to depreciation deductions for periods after May 6, 1997, claimed with respect to the business or investment portion of a residence. However, § 1031 may apply to such gain.

(3) Treatment of boot. In applying § 1031, cash or other non-like kind property (boot) received in exchange for property used in the taxpayer's trade or business or held for investment (the relinquished business property), is taken into account only to the extent the boot exceeds the gain excluded under § 121 with respect to the relinquished business property.

.03 Computation of basis. In determining the basis of the property received in the exchange to be used in the taxpayer's trade or business or held for investment (the replacement business property), any gain excluded under § 121 is treated as gain recognized by the taxpayer. Thus, under § 1031(d), the basis of the replacement business property is increased by any gain attributable to the relinquished business property that is excluded under § 121.

SECTION 5. EXAMPLES

In each example below, the taxpayer is an unmarried individual and the property or a portion of the property has been used in the taxpayer's trade or business or held for investment within the meaning of § 1031(a) as well as used as a principal residence as required under § 121.

Example 1. (i) Taxpayer A buys a house for $210,000 that A uses as A's principal residence from 2000 to 2004. From 2004 until 2006, A rents the house to tenants and claims depreciation deductions of $20,000. In 2006, A exchanges the house for $10,000 of cash and a townhouse with a fair market value of $460,000 that A intends to rent to tenants. A realizes gain of $280,000 on the exchange.

(ii) A's exchange of a principal residence that A rents for less than 3 years for a townhouse intended for rental and cash satisfies the requirements of both §§ 121 and 1031. Section 121 does not require the property to be the taxpayer's principal residence on the sale or exchange date. Because A owns and uses the house as A's principal residence for at least 2 years during the 5-year period prior to the exchange, A may exclude gain under § 121. Because the house is investment property at the time of the exchange, A may defer gain under § 1031.

(iii) Under section 4.02(1) of this revenue procedure, A applies § 121 to exclude

$250,000 of the $280,000 gain before applying the nonrecognition rules of § 1031. A may defer the remaining gain of $30,000, including the $20,000 gain attributable to depreciation, under § 1031. See section 4.02(2) of this revenue procedure. Although A receives $10,000 of cash (boot) in the exchange, A is not required to recognize gain because the boot is taken into account for purposes of § 1031(b) only to the extent the boot exceeds the amount of excluded gain. See section 4.02(3) of this revenue procedure.

These results are illustrated as follows.

Amount realized		$470,000
Less:	Adjusted basis	$190,000
	Realized gain	$280,000
Less:	Gain excluded under § 121	$250,000
	Gain to be deferred	$ 30,000

(iv) A's basis in the replacement property is $430,000, which is equal to the basis of the relinquished property at the time of the exchange ($190,000) increased by the gain excluded under § 121 ($250,000), and reduced by the cash A receives ($10,000)). See section 4.03 of this revenue procedure.

Example 2. (i) Taxpayer B buys a property for $210,000. The property consists of two separate dwelling units (within the meaning of § 1.121-1(e)(2)), a house and a guesthouse. From 2001 until 2006, B uses the house as B's principal residence and uses the guesthouse as an office in B's trade or business. Based on the square footage of the respective parts of the property, B allocates 2/3 of the basis of the property to the house and 1/3 to the guesthouse. In 2006, B exchanges the entire property for a residence and a separate property that B intends to use as an office. The total fair market value of B's replacement properties is $360,000. The fair market value of the replacement residence is $240,000 and the fair market value of the replacement business property is $120,000, which is equal to the fair market value of the relinquished business property. From 2001 to 2006, B claims depreciation deductions of $30,000 for the business use. B realizes gain of $180,000 on the exchange.

(ii) Under § 121, B may exclude gain of $100,000 allocable to the residential portion of the house (2/3 of $360,000 amount realized, or $240,000, minus 2/3 of $210,000 basis, or $140,000) because B meets the ownership and use requirements for that portion of the property. Because the guesthouse is business property separate from the dwelling unit and B has not met the use requirements for the guesthouse, B may not exclude the gain allocable to the guesthouse under § 1.121-1(e). However, because the fair market value of the replacement business property is equal to the fair market value of the relinquished business property and B receives no boot, B may defer the remaining gain of $80,000 (1/3 of $360,000 amount realized, or $120,000, minus $40,000 adjusted basis, which is 1/3 of $210,000 basis, or $70,000, adjusted by $30,000 depreciation) under § 1031.

These results are illustrated as follows:

	Total property	2/3 residential property	1/3 business property
Amount realized	$360,000	$240,000	$120,000
Basis	$210,000	$140,000	$ 70,000
Depreciation adjustment	$ 30,000		$ 30,000
Adjusted basis	$180,000	$140,000	$ 40,000

Realized gain	$180,000	$100,000	$ 80,000
Gain excluded under § 121	$100,000	$100,000	
Gain deferred under § 1031	$ 80,000		$ 80,000

(iii) Because no portion of the gain attributable to the relinquished business property is excluded under § 121 and B receives no boot and recognizes no gain or loss in the exchange, B's basis in the replacement business property is equal to B's basis in the relinquished business property at the time of the exchange ($40,000). B's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($240,000).

Example 3. (i) Taxpayer C buys a property for $210,000. The property consists of a house that constitutes a single dwelling unit under § 1.121-1(e)(2). From 2001 until 2006, C uses 2/3 of the house (by square footage) as C's principal residence and uses 1/3 of the house as an office in C's trade or business. In 2006, C exchanges the entire property for a residence and a separate property that C intends to use as an office in C's trade or business. The total fair market value of C's replacement properties is $360,000. The fair market value of the replacement residence is $240,000 and the fair market value of the replacement business property is $120,000, which is equal to the fair market value of the business portion of the relinquished property. From 2001 to 2006, C claims depreciation deductions of $30,000 for the business use. C realizes gain of $180,000 on the exchange.

(ii) Under § 121, C may exclude the gain of $100,000 allocable to the residential portion of the house (2/3 of $360,000 amount realized, or $240,000, minus 2/3 of

$210,000 basis, or $140,000) because C meets the ownership and use requirements for that portion of the property.

(iii) The remaining gain of $80,000 (1/3 of $360,000 amount realized, or $120,000, minus $40,000 adjusted basis, which is 1/3 of $210,000 basis, or $70,000, adjusted by $30,000 depreciation) is allocable to the business portion of the house (the office). Under section 4.02(1) of this revenue procedure, C applies § 121 before applying the nonrecognition rules of § 1031. Under § 1.121-1(e), C may exclude $50,000 of the gain allocable to the office because the office and residence are part of a single dwelling unit. C may not exclude that portion of the gain ($30,000) attributable to depreciation deductions, but may defer the remaining gain of $30,000 under § 1031. These results ar

	Total property	2/3 residential property	1/3 business property
Amount realized	$360,000	$240,000	$120,000
Basis	$210,000	$140,000	$ 70,000
Depreciation adjustment	$ 30,000		$ 30,000
Adjusted basis	$180,000	$140,000	$ 40,000
Realized gain	$180,000	$100,000	$ 80,000
Gain excluded under § 121	$150,000	$100,000	$ 50,000
Gain deferred under § 1031	$ 30,000		$ 30,000

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($240,000). C's basis in the replacement business property is $90,000, which is equal to C's basis in the relinquished business property at the time of the exchange ($40,000), increased by the gain excluded under § 121 attributable to the relinquished business property ($50,000).

See section 4.03 of this revenue procedure.

Example 4. (i) The facts are the same as in Example 3 except that C also receives $10,000 of cash in the exchange and the fair market value of the replacement business property is $110,000, which is $10,000 less than the fair market value of the business portion of the relinquished property ($120,000).

(ii) Under § 121, C may exclude the gain of $100,000 allocable to the residential portion of the house (2/3 of $360,000 amount realized, or $240,000, minus 2/3 of $210,000 basis, or $140,000).

(iii) The remaining gain of $80,000 (1/3 of $360,000 amount realized, or $120,000, minus $40,000 adjusted basis) is allocable to the business portion of the house. Under section 4.02(1) of this revenue procedure, C applies § 121 to exclude gain before applying the nonrecognition rules of § 1031. Under § 1.121-1(e), C may exclude $50,000 of the gain allocable to the business portion of the house but may not exclude the $30,000 of gain attributable to depreciation deductions. Under section 4.02(2) of this revenue procedure, C may defer the $30,000 of gain under § 1031. Although C receives $10,000 of cash (boot) in the exchange, C is not required to recognize gain because the boot is taken into account for purposes of § 1031(b) only to the extent the boot exceeds the amount of excluded gain attributable to the relinquished business property. See 4.02(3) of this revenue procedure.

These results are illustrated as follows:

	Total property	2/3 residential property	1/3 business property
Amount realized	$360,000	$240,000	$110,000 + 10,000

Basis	$210,000	$140,000	$ 70,000
Depreciation adjustment	$ 30,000		$ 30,000
Adjusted basis	$180,000	$140,000	$ 40,000
Realized gain	$180,000	$100,000	$ 80,000
Gain excluded under § 121	$150,000	$100,000	$ 50,000
Gain deferred under § 1031	$ 30,000		$ 30,000

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($240,000). C's basis in the replacement business property is $80,000, which is equal to C's basis in the relinquished business property ($40,000), increased by the gain excluded under § 121 ($50,000), and reduced by the cash ($10,000) received. See section 4.03 of this revenue procedure.

Example 5. (i) The facts are the same as in Example 3 except that the total fair market value of the replacement properties is $540,000. The fair market value of the replacement residence is $360,000, the fair market value of the replacement business property is $180,000, and C realizes gain of $360,000 on the exchange.

(ii) Under § 121, C may exclude the gain of $220,000 allocable to the residential portion of the house (2/3 of $540,000 amount realized, or $360,000, minus 2/3 of $210,000 basis, or $140,000).

(iii) The remaining gain of $140,000 (1/3 of $540,000 amount realized, or $180,000, minus $40,000 adjusted basis) is allocable to the business portion of the house. Under section 4.02(1) of this revenue procedure, C excludes the gain before applying the nonrecognition rules of § 1031. Under § 1.121-1(e), C may exclude

$30,000 of the gain allocable to the business portion, at which point C will have excluded the maximum limitation amount of $250,000. C may defer the remaining gain of $110,000 ($140,000 realized gain minus the $30,000 gain excluded under § 121), including the $30,000 gain attributable to depreciation, under § 1031.

These results are illustrated as follows:

	Total property	2/3 residential property	1/3 business property
Amount realized	$540,000	$360,000	$180,000
Basis	$210,000	$140,000	$ 70,000
Depreciation adjustment	$ 30,000		$ 30,000
Adjusted basis	$180,000	$140,000	$ 40,000
Realized gain	$360,000	$220,000	$140,000
Gain excluded under § 121	$250,000	$220,000	$ 30,000
Gain deferred under § 1031	$110,000		$110,000

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($360,000). C's basis in the replacement business property is $70,000, which is equal to C's basis in the relinquished business property ($40,000), increased by the amount of the gain excluded under § 121 ($30,000). See section 4.03 of this revenue procedure.

Example 6. (i) The facts are the same as in Example 3 except that the total fair market value of the replacement properties is $750,000. The fair market value of the replacement residence is $500,000, the fair market value of the replacement business property is $250,000, and C realizes gain of $570,000 on the exchange.

(ii) The gain allocable to the residential portion is $360,000 (2/3 of $750,000 amount realized, or $500,000, minus 2/3 of $210,000 basis, or $140,000). C may exclude gain of $250,000 from gross income under § 121. C must include in income the gain of $110,000 allocable to the residential portion that exceeds the § 121(b) exclusion limitation amount.

(iii) The remaining gain of $210,000 (1/3 of $750,000 amount realized, or $250,000, minus $40,000 adjusted basis) is allocable to the business portion of the house. C may defer the $210,000 of gain, including the $30,000 gain attributable to depreciation, under § 1031.

These results are illustrated as follows:

	Total property	2/3 residential property	1/3 business property
Amount realized	$750,000	$500,000	$250,000
Basis	$210,000	$140,000	$ 70,000
Depreciation adjustment	$ 30,000		$ 30,000
Adjusted basis	$180,000	$140,000	$ 40,000
Realized gain	$570,000	$360,000	$210,000
Gain excluded under § 121	$250,000	$250,000	
Gain deferred under § 1031	$210,000		$210,000
Gain recognized	$110,000	$110,000	

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($500,000). C's basis in the replacement business property is $40,000, which is equal to C's basis in the relinquished business property at the time of the exchange.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective January 27, 2005. However, taxpayers may apply this revenue procedure in taxable years for which the period of limitation on refund or credit under § 6511 has not expired.

DRAFTING INFORMATION

The principal author of this revenue procedure is Sara Paige Shepherd of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Ms. Shepherd at (202) 622-4960 (not a toll free call).

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 28, 2005
JS-2215

Statement of Treasury Secretary John W. Snow on Fourth Quarter GDP Growth

Today's report on GDP wraps up a strong year of economic expansion and job creation. The addition of 2.3 million jobs and a solid year-over-year growth rate of 4.4 percent show the strength of our nation's economy. Real gross domestic purchases increased at a 4.7 percent rate in the fourth quarter, versus the GDP growth rate of 3.1 percent, underscoring the health of U.S. demand and the need for our trading partners to adopt policies that accelerate economic growth. With the President's economic leadership and the resolve of the American people, we will push forward with the important policies and reforms that will keep our economy on this upward path. This administration is focused on the fundamentals: cutting the deficit; establishing a fairer, simpler, pro-growth tax code; encouraging savings; reducing the burden of frivolous lawsuits on our economy and strengthening social security.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 28, 2005
JS-2216

The Private Sector's Role in
Promoting Economic Growth in the Broader Middle East and North Africa
John B. Taylor
Under Secretary for International Affairs
United States Treasury
Remarks at the World Economic Forum Business Dialogue:
The Arab Business Council and the G-8/BMENA Forum for the Future
Davos, Switzerland
January 28, 2005

I would like to thank the World Economic Forum for inviting me to participate in this distinguished panel. I would also like to thank Shafik Gabr, Chairman of the Arab Business Council, for moderating this discussion as well as for his able and energetic stewardship of the Council's activities.

Engagement with business leaders, through the Forum for the Future and other venues, underscores the deep link between economic and political reform. As Secretary Powell said in Rabat on the occasion of the first Forum for the Future, "Political freedom and economic freedom go hand in hand." And economic freedom, our subject for today's discussion, is not achievable without the active participation of independent business voices like that of the Arab Business Council.

Evidence has shown that increased incomes and poverty reduction can only be achieved via productivity growth. Productivity is simply the amount of goods and services that can be produced with by workers per unit of time. Productivity increases as the skills and tools that workers have to work with increase. Higher productivity growth means higher wages and thereby higher incomes.

Unfortunately, the recent trends in productivity growth in the Middle East are not good. Guido Tabellini, a colleague of mine when I was a Professor at Stanford University, has noted that productivity actually fell in the Middle East in the last 20 years, by 0.7 percent per year. In contrast, this is a period when productivity was increasing in the United States, Europe and East Asia. This contrast is particularly strong and worrisome. And the pressure on increasing productivity and creating jobs will only grow more intense in the years ahead, as the economic and demographic challenges confronting the Middle East and North Africa are significant. Regional unemployment levels are 15 percent and reach 30 percent among younger workers. The region will need to generate over 100 million jobs in the next 12 years just to maintain current levels of unemployment.

In his speech at the National Endowment for Democracy on the greater Middle East last November, President Bush stated, "As we watch and encourage reforms in the region, we are mindful that modernization is not the same as Westernization . . . There are, however, essential principles common to every successful society, in every culture."

The Council's Blueprint for Economic Reform, ratified in this forum one year ago, discusses precisely those universal principles to which President Bush referred - economic reform and liberalization, human resources development and governance reform. The regional business community is a natural partner and ally for reform minding governments because business people have strong incentives to counter backward looking isolationist tendencies that challenge both the economic and political stability of the region. They stand to benefit from reforms that can improve the lives of all the region's inhabitants. They also understand very well the need for reform.

I am very pleased that the Arab Business Council has turned from the elaboration of principle to the advancement of specific initiatives since the last meeting here at Davos. Two specific initiatives deserve strong support:

- First, I'd like to applaud the Arab Business Council for taking steps towards establishing a series of national competitiveness councils with the goal of benchmarking major business climate indicators and promoting competitiveness. It is important to continue to spread this work to more countries in the region. One aspect of this program that President Bush is firmly committed to is measuring results. What gets measured gets done. This is, in fact, a core component of the Administration's development strategy. We have pushed it in the Multilateral Development Banks, and have made it a centerpiece of the approach taken by the Millennium Challenge Account.
- I'd also like to applaud the Council for its work with the OECD to organize a Task Force on Investment. Productivity, as we know from economic theory and economic history, depends on the amount of capital each person has to work with and the level of technology. This region, unlike many others, has sufficient capital. It is reported that $ 1 trillion in local funds are invested abroad. Improvements in investment environment can help these funds come to rest closer to home, resulting in productivity improvements and, ultimately, jobs and economic growth.

There is a window of opportunity for reform in the broader Middle East today, and the members of the Arab Business Council are among the foremost of those who recognize the importance of acting now.

We in the United States recognize the importance of promoting the forces of economic advancement and integration. We are pleased that there are many voices in the Arab business community who share this vision.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 25, 2005
JS-2217

Remarks By United States Treasury Assistant Secretary Quarles at the Third Annual European Financial Services Conference Brussels, Belgium January 25, 2005

Introduction

I am delighted to participate in this Third Annual European Financial Services Conference on the "The New Policy Agenda for Financial Services." The agenda refers to the Commission's post-Financial Service Action Plan activities. But there are other reasons to discuss new agendas at this time. One is that it is the first 100 days of the new Commission. There is a relatively new European Parliament. Another is that it is the first week of the second term of the U.S. Administration and President Bush will soon be visiting Brussels. And even this late in January, it is never too late to make a New Year's resolution.

US-EU Economic and Financial Cooperation

US-European economic cooperation runs deep. The United States and the European Union have a special responsibility to promote economic growth and act as a model for global economic cooperation. Although it has been said many times, it is no less true: there is more that brings the US and EU together than pulls us apart. That doesn't sell newspapers; but it is a sound basis for working together. I think we have done well in recent years. I expect cooperation to intensify. Let me give you some examples.

One of the best contributions the US and EU can offer the world is to put in place sound policies for economic growth. The United States continues to grow solidly. We are working with EU members through the G-7 Agenda for Growth Initiative to help better understand the imperative of structural reforms to boost productivity and employment in our countries. European Commission President Barroso's pledge to place a premium on growth and jobs is extremely encouraging He has hit the mark by suggesting that a renewed Lisbon strategy should focus on a more dynamic market place and the improved functioning of labor markets with greater attention to skills and training.

Of course, we work with our European friends in the G-7 on other global issues as well – how to best promote development in the low-income countries; how to address the debt problems of the Heavily Indebted Poor Countries; how to respond to financial crises through the IMF.

Treasury has participated in recent months in each of the outreach sessions with US stakeholders in the transatlantic relationship as a follow-up to last year's US-EU summit. We have met with a wide range of business leaders spanning many sectors from clicks to bricks, and learned from them how important Europe's market is to their well-being.

We are working closely with our EU colleagues on combating terrorist financing. Last September, we created an informal dialogue on combating terrorist financing. We have had a good working relationship with the EU in this field, although we have pressed for improvements in the EU designation process. The informal, ad hoc dialogue will facilitate the sharing of information, experiences and best practices, support implementation of the Financial Action Task Force Special Recommendations, especially on cash couriers and non-profit organizations, and explore options for joint technical assistance in priority countries. We will continue to pursue counter terrorist financing issues with all European Member States and with them through other relevant organizations, such as the United Nations Security Council, the Financial Action Task Force, the Group of Seven and the International Financial Institutions.

We are also collaborating on financial services negotiations in the WTO as part of the larger talks called the Doha Development Agenda. Together we have called for a "floor" level of liberalization to be complemented by disciplines on regulatory transparency. WTO members are to table their offers by May. To date, few countries have done so and almost none have offered to cut significantly market access barriers on financial services.

Research by the World Bank has shown that countries with open financial markets experience higher economic growth. I am grateful that the private sector Financial Leaders Group -- that includes US and European participation -- will hold a seminar early next month to highlight successful experiences of countries that have liberalized their financial services sectors.

Last but not least, the informal US-EU Financial Markets Regulatory Dialogue that began three years ago is another testimonial to how our strong commonality of interests brings us together. The dialogue addresses issues of immediate importance and those we anticipate arising in the medium term; and it manages "spillover" effects that actions taken in one jurisdiction may have on another. The U.S. Treasury, the lead in the United States Administration for the dialogue, is joined by the SEC and the Federal Reserve Board in our meetings with the European Commission. The dialogue works informally, quietly and professionally. The stakes are too large to operate any other way.

The Securities Industry Association underscored the large stakes involved in its written submission for the stakeholder outreach. The two-way flow of trade, portfolio and direct investment between our two regions exceeds $1 trillion annually.

U.S. companies raised more than $171 billion in EU capital markets in 2003. 53% of US investors' foreign equity holdings are EU shares. And in 2003 EU investors acquired $225 billion of US stocks and bonds. These numbers are impressive.

US-EU Informal Financial Markets Regulatory Dialogue

The informal Financial Markets Regulatory Dialogue promotes economic growth as well as economic cooperation. The assessment of the Lisbon strategy by former Dutch Prime Minister Kok was that "dynamic and highly competitive financial markets are not only desirable in themselves – they are an essential driver of growth in all other sectors of the economy and must be a cornerstone of efforts to boost the EU's economic performance." Robust EU financial markets are good for economic growth not only in the EU, but also in the US and the world.

With the legislative phase of the Financial Services Action Plan completed, and with many of the initial transatlantic financial tensions having been addressed, it is only natural that the Dialogue will evolve. In my mind, the forthcoming agenda will be dominated by: problem solving; implementation of existing FASP measures; a forward looking agenda; and deepening cooperation.

Problem Solving

Admittedly, the dialogue has been at times reactive. In the first two plus years of the Dialogue, both sides needed to respond quickly to events as they arose. Hence, participants focused on ways to address "spillover effects" of complex issues. The Financial Conglomerates Directive and Sarbanes-Oxley are the two best examples. Participants recognized that each side shared similar objectives of promoting dynamic and sound global capital markets, even if we went about our business differently. Through frequent discussion and taking each other's views into account, we created a process and engendered mutual trust.

The Financial Conglomerates Directive was one of the first FSAP measures to take root. Despite our close tracking of this directive and on-going discussions, it required nurturing to stay on track. The US side needed to explain how it conducts comprehensive consolidated supervision of US financial institutions to the EU. The SEC formalized its structure of consolidated supervision of US investment houses. Results to date look good. The European Financial Conglomerates Committee has verified that US supervision is broadly equivalent with that in the directive, an assessment that national supervisors have respected.

From the EU side, US implementation of Sarbanes-Oxley legislation has reflected many of our discussions and accommodated many EU concerns. Most recently, the Public Company Accounting Oversight Board has indicated that it is prepared to rely on oversight of relevant firms by foreign supervisors in appropriate circumstances. The PCAOB has already begun to intensify its contacts with member state auditing authorities to explore details about implementation.

While we are striving to anticipate looming issues rather than react as they arise, it would be naïve to think we can be successful at every turn. A good example is our recent discussion of de-registration of securities in the United States. European companies argue that disclosure requirements for listings in the US, created decades ago before the evolution of global capital markets, prevent firms that now wish to leave the US capital market from doing so. Partly in light of US-EU discussions on this matter, SEC staff is now examining a number of possible solutions.

Implementation

I want to commend the Commission, Council and Parliament for completing the FSAP – basically retooling much of the EU's framework rules for securities and banking legislation. That is good news.

While FSAP measures have been promulgated, they also need to be implemented – that means transposition into national law and implementation by the supervisory structures in EU countries. But if 25 different supervisors implement the same measure 25 different ways, then obviously Europe will not reap the fruits of creating a single, dynamic, and integrated capital market, nor will the US and EU achieve a transatlantic capital market.

So the other news is that the practicalities of implementation will prove every bit as challenging as the work already completed. These practicalities will arise in many contexts. Let me give you a few examples.

Most obvious, the 25 supervisors need to implement, apply and enforce the FSAP measures in a consistent manner. How can this be achieved? In Europe these tasks will fall to three new committees. The Committee of European Securities Regulators (CESR) and the Committee of European Banking Supervisors (CEBS) have made a quick start. No doubt the Committee of European Insurance and Occupational Pension Supervisors (CIEOPS) will follow once new insurance legislation is adopted.

We believe that these three committees will play a vital role in determining whether the promise of the FSAP is achieved. It is natural that as they carry out their work on supervisory convergence within the EU that a dialogue commence between them and their US counterparts. The SEC and CESR have established a formal dialogue. The NAIC and CEIOPs are in the process of so doing. CEBs officials are in Washington for a round of consultations today.

We have all heard that the devil lies in the details. We are now watching implementation of the Market in Financial Instruments Directive (MiFID). The final legislation, however, reflected a general compromise, leaving important interpretations and details to be nailed down later. The delicate balance between and spirit of compromises reached on that legislation should be respected in the implementation process.

Moreover, firms need to be given adequate time to put in place new systems so that compliance with the legislation can be effective on day-one. This will help ensure robust competition among investment firms and exchanges that can benefit investors and enhance market efficiency.

Implementation also presents an unavoidable reality that can encourage improvements in our respective markets. As noted, the Financial Conglomerates Directive engendered measures taken by US supervisory authorities to make clear that financial entities are supervised on a consolidated basis. Enhanced auditing and corporate governance rules in the US have been paralleled by changes in the EU. As we share the objectives of sound, stable, and efficiently operating capital markets, we learn from each other, while respecting the uniqueness of each of our markets.

Forward Looking Agenda

The dialogue also continues to look ahead. Identifying issues today that are important for building a more vibrant transatlantic capital market tomorrow can enhance international cooperation and global growth.

Implementation of Basle II in the US and EU has been taken up at all Dialogue sessions. Through these discussions, each side has gained a much better appreciation for the other's approach and timing toward Basle implementation. While the Basle Accord Implementation Group has many details yet to resolve, it is important to bear in mind that the basic rationale for such an international agreement is to promote fair competition among major financial institutions. In this respect, the EU's capital adequacy directive – CAD III – should reflect the provisions emerging from Basle, including those being developed on trading books.

Clearing and settlement, mutual funds, and insurance – both reinsurance as well as the Solvency II project to strengthen capital adequacy standards -- are upcoming topics on which the dialogue already has exchanged views.

Convergence of international accounting standards and the implications for listings is a critical forward agenda issue. As you know, the FASB and IASB are now working on a process to converge accounting standards. At the end of the day, the objective is that the same accounting question yields a similar accounting answer, whether in the United States or Europe.

For years, US firms have listed in the Euromarkets on the basis of statements based on US GAAP. In contrast, foreign firms listing in US markets needed to submit financial statements using US GAAP or accounts reconciled to GAAP. As of 2005, all EU listed firms in Europe must use accounts prepared under International Financial Reporting Standards. Europe has already decided that until 2007, US firms listing on European exchanges may continue to use statements based on US GAAP.

Many Europeans have understandably expressed interest in their firms being able to list on US markets using accounts prepared in IFRS. To do so, it will be important for US authorities to have reviewed statements prepared on the basis of IFRS, thereby gaining a better understanding of them and whether they yield similar accounting answers. Also, it will be important for US authorities to see that Europe is applying, implementing and enforcing accounting standards in a consistent manner. SEC staff have indicated that they are ready to do their part as quickly as possible ensure that this standard is met.

Some in Europe have suggested that after 2007 Europe should no longer accept statements for foreign issuers that are prepared on the basis of US GAAP for meeting the requirements of the Prospectus and Transparency Directives. I think such an approach would be a mistake. A broad capital market is essential to promote economic growth. This means preserving the depth and liquidity of the Euromarkets.

In the meantime, CESR is advising the Commission whether US GAAP accounts should be considered equivalent for use in meeting the requirements of the Prospectus and Transparency Directives. In our view, the answer is a clear "yes." Closing off the existing market for US issuers with accounts prepared under US GAAP would be contrary to the EU's own economic interests. Individual member state supervisors have recognized that such accounts provide investors with adequate information. This has not changed, even as we all hope for the convergence of accounting standards I mentioned earlier.

Another area that we look forward to discussing with our colleagues is the potential for cross-border retail banking throughout the EU. Surely this is another area that holds significant promise for reducing transaction costs and bringing benefits to consumers.

Deepening Cooperation

Implementation, problem solving and discussing issues arising in the medium term will entail more work for the Dialogue. To understand the technical implications of implementation that can affect policy decisions or the ramifications of new issues arising in the medium term means that the dialogue will need to be more inclusive while retaining its informal nature.

We will be continuing to reach out to the academic community, private sector, member state governments and legislatures. As the EU supervisory committees develop the EU jurisprudence from their joint experiences in implementing the EU directives, their topics of discussion will expand with their US counterparts. The dialogue will need to be infused with the substance of such supervisory dialogues.

Conclusion

The informal Financial Markets Regulatory Dialogue thus far has been a success. But in dynamic markets, there must be constant re-assessment and retooling of the old to keep up with the new. What is "new" for the Dialogue is: 1) challenges arising on both sides of the Atlantic from implementation; 2) more opportunities for transatlantic and international cooperation; 3) fresh topics to be addressed; and 4) outreach to a wider array of views.

My New Year's resolution is to keep the dialogue fresh, to help it evolve with the changing times and issues. I invite you to work with me to keep it fresh.

Thank you for your attention.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 28, 2005
js-2218

Deputy Assistant Secretary Iannicola Teaches Personal Finance Skills to Students in Washington D.C. High Schools

Treasury's Deputy Assistant Secretary for Financial Education Dan Iannicola today taught personal finance skills, such as budgeting and managing credit wisely, to students at two Washington, D.C. high schools. Iannicola first taught a financial education lesson to 12th graders at Margaret Murray Washington Career High School, marking Treasury's 100th financial education event in the last twelve months. Iannicola later taught students in the 10th and 11th grades at Theodore Roosevelt Senior High School.

During both lessons, Iannicola emphasized the importance of budgeting and savings. He also explained how the credit reporting system works and how to avoid common credit pitfalls.

"Knowing how to responsibly use credit is an important skill for all Americans. But with high school students we have a unique opportunity to arm them with knowledge before they encounter credit cards, student loans, car loans and all the dangers and opportunities that go along with borrowing," said Iannicola. "Financial education in our schools is the ounce of prevention our young people need, precisely when they need it."

Iannicola praised both Margaret Murray Washington Career High School teacher Aloha Cobb and Theodore Roosevelt Senior High School teacher Gladys Pemperton, who are actively integrating financial education lessons into different subjects with the help and support of financial literacy partner organizations. "Educators like these are an essential link in delivering good financial education programs to our young people," he said.

Established in 1912, the Margaret Murray Washington Career High School vision is to create a curriculum that prepares students for undergraduate study, technical training, or for careers in health, education or food services. Theodore Roosevelt Senior High School provides students who complete the 9th grade a selected course of study in communications, travel and tourism or the 21st Century entrepreneurs academies. Today's financial education lesson at Theodore Roosevelt Senior High School was a collaborative effort with District of Columbia Public Schools and Junior Achievement.

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

January 31, 2005
2005-1-31-10-47-41-14326

PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM:
Tax Panel Announces First Meeting

WASHINGTON, DC – Senators Connie Mack and John Breaux, Chairman and Vice -Chairman of the President's Advisory Panel on Federal Tax Reform, today announced that the panel will hold its first meeting on Wednesday, February 16, 2005 at 10 am. The meeting will be held at the Ronald Reagan Building & International Trade Center Amphitheater, Concourse Level, 1300 Pennsylvania Avenue NW, Washington, DC.

The first meeting will provide an opportunity for the panel members to hear general background information about the federal tax code. This meeting is the first in a series of public meetings that the panel will hold before it submits its final report by July 31, 2005.

The President's Advisory Panel on Federal Tax Reform was established by President Bush on January 7, 2005. President Bush has charged the bipartisan panel with recommending reforms to the tax code that will make the U.S. tax system simpler, fairer and more growth oriented.

Further details, including the list of witnesses, will be provided in a later release.

The meeting notice, which will appear in the Federal Register, is attached.

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DEPARTMENT OF THE TREASURY 4810-25

Public Meeting of the
President's Advisory Panel on Federal Tax Reform

AGENCY: Department of the Treasury.

ACTION: Notice of Meeting.

SUMMARY: This notice advises all interested persons of the initial public meeting of the President's Advisory Panel on Federal Tax Reform.

Background: Executive Order 13369 (January 7, 2005) established the President's Advisory Panel on Federal Tax Reform. The Order provides that the purpose of the Advisory Panel shall be to submit to the Secretary of the Treasury a report with revenue neutral policy options for reforming the Federal Internal Revenue Code. The options should (a) simplify Federal tax laws to reduce the costs and administrative burdens of compliance with such laws; (b) share the burdens and benefits of the Federal tax structure in an appropriately progressive manner while recognizing the importance of homeownership and charity in American society; and (c) promote long-run economic growth and job creation, and better encourage work effort, saving, and investment, so as to strengthen the competitiveness of the United States in the global marketplace. At least one option submitted by the Advisory Panel should use the Federal income tax as the base for its recommended reforms.

Purpose: This is the first meeting of the Advisory Panel. The meeting will include background information presentations concerning the Federal tax system.

Comments: Interested parties are invited to attend the meeting; however, no public comments will be heard at this meeting. The public will be provided additional opportunities to submit comments regarding issues of tax reform at later dates. Any written comments with respect to this meeting must be submitted by mail to The President's Advisory Panel on Federal Tax Reform, 1440 New York Avenue NW, Suite 2100, Washington, DC 20220. An electronic address will be provided as soon as it is available. All written comments will be made available to the public.

Records: Records are being kept of Advisory Panel proceedings and will be available at the Internal Revenue Service's FOIA Reading Room at 1111 Constitution Avenue, N.W., Room 1621, Washington, DC 20024. The Reading Room is open to the public from 9 a.m. to 4 p.m., Monday through Friday except holidays. The public entrance to the reading room is on Pennsylvania Avenue between 10th and 12th streets. The phone number is (202) 622-5164 (not a toll-free number). Advisory Panel documents, including meeting announcements, agendas, and minutes, will also be available on the Advisory Panel's web site, which is currently under construction.

DATES: The meeting will be held on Wednesday, February 16, 2005, at 10 a.m.

ADDRESSES: The meeting will be held at the Ronald Reagan Building & International Trade Center Amphitheater, Concourse Level, 1300 Pennsylvania Avenue NW, Washington, DC 20004. Seating will be available to the public on a first-come, first-served basis.

FOR FURTHER INFORMATION CONTACT: Mark S. Kaizen, Designated Federal Officer, (202) 283-7900 (not a toll-free call).

Dated: January 28, 2005

Mark S. Kaizen
Designated Federal Officer

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 31, 2005
JS-2219

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

The economy continued to grow at a solid pace over the final three months of 2004, bringing real GDP growth on an average annual basis to 4.4 percent last year, up from 3.0 percent in 2003. Last week's advance report on fourth-quarter Gross Domestic Product showed that real GDP grew at a 3.1 percent annual rate following a 4.0 percent gain in the third quarter. Virtually all of the slowdown in the fourth quarter reflected a wider trade deficit. Excluding net exports, gross domestic purchases grew by a strong 4.7 percent annualized rate in the quarter.

Consumers maintained a healthy spending pace. After increasing at a 5.1 percent rate in the third quarter, the largest quarterly gain in almost three years, real personal consumption expenditures were up at a 4.6 percent annual rate in the fourth quarter. Real disposable personal income grew by an outsized 8.4 percent annual rate in the fourth quarter, boosted by a $32 billion special dividend payout by Microsoft, most of which went into personal income. Loan delinquencies on consumer loans and residential real estate loans are very low, suggesting consumers are not over-extended.

Business fixed investment rose at a 10.3 percent rate in the fourth quarter, down a bit from 13.0 percent in the prior quarter. Investment in equipment and software continued to post rapid growth of 14.9 percent on top of the 17.5 percent gain in the third quarter. Equipment and software investment was up 13.4 percent in 2004 on an average annual basis, and followed an annual increase of 6.4 percent in 2003 and a decline of 5.5 percent in 2002. Investment in structures, typically one of the slowest sectors to recover after an economic downturn, has shown only a few quarters of sporadic growth since the recession, and declined at a 4.1 percent rate in the fourth quarter.

Business investment has been boosted over the past several years by bonus expensing, initiated with the Job Creation and Worker Assistance Act of 2002 and expanded by the Jobs and Growth Act of 2003. That incentive expired at the end of last year, but corporate profits from current production (adjusted to measure inventories and depreciation at replacement cost) are providing strong support to investment going forward. The profit share of gross domestic income rose to a recent peak of 10.2 percent in the first quarter of 2004, the highest since 1997, due to rapid gains in productivity and benign labor costs. In the third quarter (latest available), the profit margin held close to that 10.2 percent share (excluding the effects on profits from the recent hurricanes). Rising profits have led to large gains in cash flow – the internal funds that are available to corporations for investment. Not all of those funds have been tapped for capital expenditures, and the "financing gap" (capital expenditures less cash flow and inventory profits) has been negative on average for the past two years. With the business sector running a financial surplus, corporations have been able to improve their balance sheets.

The trade deficit continued to widen in the fourth quarter and has been a drag on growth for five straight quarters. The deficit increased by $48.7 billion in real terms in the fourth quarter, reaching a record $631.9 billion, and subtracted 1.73 percentage points from GDP growth. Over all of 2004, the deficit took about 1 percentage point from real GDP growth. The increase in the deficit in the latest quarter reflected a 9.1 percent annual rate rise in total imports. In contrast, real exports decreased 3.9 percent. The relatively stronger performance of the U.S. economy compared to its major trading partners, such as the eurozone countries and Japan, continues to be a factor in the widening trade gap. This trade profile underscores the need for our trading partners to adopt policies that accelerate economic activity, so that the United States is not the only engine of world growth. Greater currency flexibility in those economies that lack flexibility would also help to improve trade imbalances.

The U.S. labor market continued its upward trend during the fourth quarter as 606,000 jobs were added to nonfarm payrolls after 402,000 new jobs were created in the third quarter. Those gains brought the increase in the number of new payroll jobs in 2004 to 2.23 million, an average of 186,000 per month and the best year for job creation since 1999. Those figures do not even include the expected upward revision to payroll employment due to the annual benchmarking, the results of which will be reported this Friday by the Bureau of Labor Statistics along with the release of January labor market data. The unemployment rate has come down from 5.7 percent at the beginning of 2004 to an average of 5.4 percent in the final three months of the year, almost a full percentage point below the June 2003 peak.

Prospects for the first quarter of 2005 and throughout the year are highly favorable. The economy's basic fundamentals – high productivity, low inflation, and expanding employment – are sound and point to continued expansion economic activity at a healthy pace this year.

The U.S. economy now appears to be on solid footing after the challenges of the past few years. Return to a healthy economy allows us to turn our attention to some of the issues that will affect the longer-term well-being of our citizens, specifically retirement income security.

The Administration recently released the outlines of our proposal to reform the single-employer defined benefit pension system; the Treasury Department played an active role in the design of this proposal. The retirement security of the 34 million Americans participating in single employer defined benefit pension plans depends on employers keeping the promises they make; however, the current system does not ensure that pension plans are adequately funded. Underfunded plan terminations are also placing an increasing financial strain on the pension insurance system and, through that system, impose an increasing burden on healthy employers who sponsor well-funded pension plans.

To protect participating workers and retirees, to improve the financial status of the Pension Benefit Guaranty Corporation, and to encourage continued voluntary sponsorship of defined benefit pension plans by companies, the President's proposal focuses on three areas:

- Ensuring pension promises are kept by improving opportunities, incentives and requirements for funding plans adequately;
- Improving disclosure to workers, investors and regulators about pension plan status; and
- Adjusting the pension insurance premiums to better reflect each plan's risk and ensure the pension insurance system's financial solvency.

The Social Security system is an even larger and more essential part of Americans' retirement income security. The current system is secure for today's seniors but is not financially stable for future generations and must be fixed. Because of demographic changes and benefit growth, the current system will not be able to afford to pay the benefits scheduled for our children and grandchildren without enormous payroll tax increases or huge benefit cuts. Fortunately, this untenable situation is fixable. President Bush has said that "Social Security is one of the greatest achievements of the American government, and one of the deepest commitments to the American people." The President supports Social Security reform that increases the power of the individual, does not increase the tax burden, and provides economic opportunity for more Americans.

The President wants to see Social Security permanently strengthened for our children and grandchildren, without raising payroll taxes. The President's focus on a permanent strengthening of the system reflects a principled decision not to leave problems to future generations. Delaying permanent reform implicitly places additional burdens on future generations - our children and grandchildren - to foot the bill. By contrast, the permanent and timely reform the President has called for will allow us the most options for strengthening Social Security for future generations.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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January 31, 2005
js-2220

Treasury Announces Market Financing Estimates

The Treasury Department announced today that it expects net borrowing of marketable debt to total $147 billion in the January – March 2005 quarter. The estimated cash balance on March 31 is $10 billion. Today's estimate is unchanged from Treasury's announcement on November 1, 2004.

Treasury also announced that it expects net borrowing of marketable debt to total $12 billion in the April – June 2005 quarter. The estimated cash balance on June 30 is $15 billion.

During the October – December 2004 quarter, Treasury's net borrowing of marketable debt totaled $98 billion and the cash balance on December 31 was $25 billion. On November 1, Treasury announced that it expected net borrowing of marketable debt to total $100 billion with an estimated end-of-quarter cash balance of $25 billion.

Additional financing details relating to Treasury's Quarterly Refunding will be released at 9:00 A.M. on Wednesday, February 2.

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REPORTS

- Report

TREASURY ANNOUNCES MARKET FINANCING ESTIMATES

Today, the Treasury Department announced net borrowing of marketable debt for the January – March 2005 and April – June 2005 quarters.

Quarter	Estimated Borrowing ($ billion)	Estimated End-of-Quarter Cash Balance ($ billion)
Jan-Mar 2005	$147	$10
Apr-Jun 2005	$12	$15

Since 1997, the average absolute forecast error in net borrowing of marketable debt for the current quarter is $9 billion and the average absolute forecast error for the end-of-quarter cash balance is $9 billion. Similarly, the average absolute forecast error for the following quarter is $30 billion and the average absolute forecast error for the end-of-quarter cash balance is $11 billion.

The following tables reconcile the variation between forecasted and actual net borrowing of marketable debt in the October - December 2004 quarter.

Quarter	Estimated Borrowing ($ billions)	Actual Borrowing ($ billions)	Estimated End-of-Quarter Cash Balance ($ billions)	Actual End-of-Quarter Cash Balance ($ billions)
Oct - Dec 2004	$100	$98	$25	$25

Categories	Chg from Nov Estimate
Receipts	+$7
Outlays	(1)
Other	(4)

Additional financing details relating to Treasury's Quarterly Refunding will be released at 9:00 A.M. on Wednesday, February 2.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 31, 2005
2005-2-10-15-38-16-12857

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $85,425 million as of the end of that week, compared to $85,436 million as of the end of the prior week.

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

	January 21, 2005			January 28, 2005		
TOTAL		**85,436**			**85,425**	
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	11,940	15,294	27,234	11,932	15,205	27,137
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	11,712	3,074	14,786	11,702	3,056	14,758
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]			19,073			19,139
3. Special Drawing Rights (SDRs) [2]			13,299			13,345
4. Gold Stock [3]			11,045			11,045
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	January 21, 2005			January 28, 2005		
	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

	January 21, 2005			January 28, 2005		
	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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February 2, 2005
JS-2221

**Report to The Secretary of The Treasury
from the
Treasury Borrowing Advisory Committee Of The Bond Market Association**

Dear Mr. Secretary:

Since the Committee's last meeting in November, the expansion has remained on track with real GDP in Q4 growing at an annualized pace of 3.1%. Q3 GDP growth has been revised higher to 4.0% from the originally reported 3.4%. During the second half of 2004, domestic demand rose at an exceptionally strong 4.6% pace. The latest economic readings point to a continuation of above trend growth in Q1, as a likely strengthening in exports offsets a slight moderation in domestic demand. The latest data also indicate that home sales are near record high levels and are likely to remain firm given mortgage applications for purchasing new homes.

Notwithstanding an expected January slowdown due to unseasonably cold weather, economic conditions seem supportive of another year of good economic performance in 2005. Consumer spending grew 4.6% in Q4, following an impressive 5.1% growth rate during Q3. Strong consumer spending is being fueled by a powerful secular trend of wealth creation. The trend is evident in not only the highest income quintile, where it has traditionally been focused, but also in the second and middle income quintiles. According to Federal Reserve Flow of Funds data, household wealth has nearly doubled over the last decade to over $46 trillion.

These positive outcomes are being reinforced by ongoing improvements in the labor market outlook and prospects for strong household income gains. The trend in payroll employment has remained solid, with job gains averaging over 200,000 per month in Q4. While this was softer than payroll growth in Q2, it does represent a pickup over Q3's moderate job growth. Payroll growth looks to remain strong in 2005. The 4-week moving average of jobless claims has remained fairly low and surveys of hiring intentions among firms are at recovery highs. While oil prices are below their October peak, they remain elevated. The impact of higher oil prices over the past year has moderated real output from what would have been spectacular levels to above trend growth.

Following core inflation's rise in the first half of 2004, its upward trajectory slowed in the second half of the year. The core CPI rose an annualized 2.3% in Q4, higher than the 1.5% annualized pace of Q3 but below the 3.0% annualized pace of Q2. The core PCE deflator increased at only a 1.6% annualized pace in Q4, holding the year-over-year change in December to 1.6%, while the year-over-year change in the core CPI rose to 2.3%. Despite a renewed fall in airline fares, the decline in the value of the dollar and the pick-up in unit labor costs suggest a risk of increases in core inflation ahead. Similarly, a risk of future inflation is emerging in higher rates of utilization and the declining pool of available labor. The persistence of higher energy and other raw material prices may be prompting numerous industries to try to pass through higher costs in order to support earnings. The trade-weighted dollar has depreciated nearly 15% from its highs two years ago. The decline in the value of the dollar has resulted in a pick-up in import prices excluding food and energy. In particular, prices of imported consumer goods rose in 2004 for the first time since 1995. In addition, capital goods import prices were nearly unchanged in 2004 after being a drag on inflation for the prior 9 years.

After rising before the first FOMC tightening in June, long-term treasury yields have declined by roughly 50 basis points since this tightening cycle began. As the FOMC has since increased its short-term target by 125 basis points, this has led to a substantial flattening of the yield curve, even compared to previous tightening cycles of 1994 and 1999. However, the spread between long and short interest rates remains near mean historical levels in the 2- to 10-year portion of the curve. Over Q4, while the 10-year yields rose by 25bp, the 2s/10s curve has flattened by almost 25 basis points. Two-year yields are currently 170bp higher than the lows observed in mid-March and the yield curve is almost 70bp flatter than its steepest levels during Q4. The market is currently pricing in nearly a 100% probability that the Fed will raise rates by 25bp at the February FOMC meeting and is pricing in a funds rate of roughly 3% by mid-2005.

Fourth quarter reported earnings appear to be pointing toward signs of moderation in early 2005. After a strong acceleration over the past year and a half, and with half of the S&P 500 reporting, approximately two-thirds have exceeded expectations while 17% have failed to meet expectations. Slower growth of earnings in financials, specifically among insurance and brokerage concerns, and a moderation of earnings in software, old-line industrial and consumer discretionary sectors, are largely behind the slowdown in earnings growth. The peak in earnings growth for this cycle appears to be behind us. Equity markets have risen approximately 5% over the past three months ending January 28 th

The Federal budget performance on a twelve-month rolling basis was better than expected, mainly reflecting the effects of solid income and profit growth on tax receipts. However, ongoing military operations in the Middle East present upside risks to overall budget outlays. That said, cyclical forces suggest that the peak in the twelve-month rolling budget deficit has passed.

Against this economic and financial backdrop, the members of the Committee responded to Treasury's charge. The charge was composed of four questions. In the initial section, Treasury asked the Committee to comment on its issuance pattern given the recent growth in its expected borrowing needs.

In general the Committee felt there was no need to change issuance patterns as sufficient flexibility exists within the current framework. One member noted that the average maturity of the debt has shortened and advised consideration of lengthening the issuance maturity profile. Others pointed out that Treasury has increased issuance of 3-, 5- and 10-year maturities as well as longer-dated TIPS to account for this, as it has reduced net borrowing in bills and the 2-year note. Another member pointed out that the average maturity of issuance was shorter than the average maturity of debt outstanding and this would lead to a continued shortening of the maturity profile. Other members were more comfortable with this trend, but advised further consideration of this issue over time with portfolio optimization analytics and techniques. The Committee concluded that retaining a focus on new issuance of longer-duration instruments is appropriate and that further examination is warranted.

In the second part of the charge the Treasury asked to comment on the following topic:

While the stock of Treasury debt is well within historical and international norms as a percentage of GDP, questions have been raised about whether the large proportion of total debt held by foreigners creates risk for the Treasury. We would like the Committee's views on whether the high percentage of foreign ownership of Treasuries outstanding creates risks for future Treasury financing, broader risks to the U.S. economy or, instead, reflects the efficient use of Treasury securities as a financing and investment vehicle.

As a means of framing the discussion, one member presented the Committee with a presentation comprised of a series of charts and comments that summarized the degree of foreign participation in the Treasury market. These included portrayals of the stock of Treasury debt currently held by foreigners, just over 50%, a depiction of the split of this stock between private and official foreign sectors and a comparison of the amount of Treasuries held as a percentage of the gross foreign holding of fixed income assets, amongst others. The entire presentation is appended to the TBAC discussion charts.

The presenting Committee member concluded that the large portion of debt held by foreigners does not create a substantial risk for the Treasury. A broader, global investor base should be more stable than a narrow, concentrated, solely domestic one. Moreover, if foreign buying slowed or stopped, there is ample scope for domestic investors to fill the void given broad based observance of portfolio underweighting in fixed income portfolios. US market liquidity is deep and domestic holdings of Treasuries are at historic lows. For all of these reasons, the high proportion of foreign ownership of Treasuries should pose no risk to future financing. Similarly, high foreign ownership of US Treasuries - and of US financial assets in general -- should pose little risk to the economy. It is a reflection of the globalization of financial markets as well as the particular attraction of US assets, that foreign ownership of virtually all US financial assets has risen sharply. US financial markets are the most liquid by most measures. The majority of international transactions, revenues and contracts, are denominated in US dollars, and the dollar remains by far the largest reserve currency. It is true that the growth in foreign ownership of US assets is a reflection of the rise in the current account deficit. That said, financial market adjustments to this imbalance, which could include a lower dollar and higher interest rates, would represent a natural corrective process, and currently there is no reason to expect it to become destabilizing. The presenting member's conclusion was that the increase in foreign ownership of US assets reflects more efficient financial markets, and any efforts to reduce foreign ownership would be counterproductive.

Committee members in general agreed with the conclusions of the presenting member. Several members urged Treasury to continue to encourage the growth of foreign participation in financing markets. Members felt that with higher short rates would come greater risks of chronic or intractable fails if foreign participation in repo markets was not assured. Other members encouraged Treasury to examine stress scenarios which would be observed in the tails of the probable distribution of outcomes. Members also encouraged Treasury to consider extending the maturity of its newly issued debt to meet the strong external demand for its offerings. In general, most members felt that Treasury enjoys an enviable position with foreign investors, one which should be vigilantly maintained.

In the next section of the charge, the Committee considered the composition of marketable financing for the January-March quarter to refund $11.3 billion of privately held notes and bonds maturing on 2/15/05. The Committee recommended a $22 billion three-year note due 2/15/08, a $15 billion five-year note due 2/15/10 and a $14 billion 10-year note due 2/15/15. For the remainder of the quarter, the Committee recommended a $24 billion 2-year note issued in February and a $24 billion 2-year note issued in March, a $15 billion five-year note issued in March and a $9 billion reopening of the 10-year note in March. For the April-June quarter, the Committee recommended financing as contained in the attached tables. Relevant features include three $24 billion 2-year notes, a $22 billion 3-year note, three $15 billion 5-year notes, a $14 billion 10-year note in May followed by a $9 billion reopening of that 10-year in June. The Committee further recommended a $10 billion 10-year TIPS for issuance in April as well as a $9 billion re-opening of the same in June, and a $12 billion 5-year TIPS in April.

In the last section of the charge, Treasury asked the Committee to bring to its attention any other issues the group felt important with regard to the Treasury market. Members commented upon the need for market participants to comprehend in full the administration's upcoming proposal for Social Security reform. As financing requirements are likely to be impacted, a greater understanding of the proposal would allow market participants to better judge what, if any, impact those changes might bring in total debt outstanding and its composition.

Respectfully submitted,
Mark B. Werner

Chairman

Ian Banwell
Vice Chairman

Attachments (2)

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REPORTS

- Tables: Q1
- Tables: Q2

US TREASURY FINANCING SCHEDULE FOR 1st QUARTER 2005
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	12/30	1/3	1/6	*10.00*	*19.00*	*17.00*	*54.01*	*-8.01*
	1/6	1/10	1/13	*8.00*	*19.00*	*16.00*	*44.84*	*-1.84*
	1/13	1/18	1/20	*8.00*	*19.00*	*16.00*	*45.64*	*-2.64*
	1/20	1/24	1/27	*8.00*	*19.00*	*16.00*	*46.93*	*-3.93*
	1/27	1/31	2/3	*12.00*	*20.00*	*17.00*	*46.95*	*2.06*
	2/3	2/7	2/10	15.00	20.00	17.00	46.00	6.00
	2/10	2/14	2/17	18.00	20.00	17.00	44.00	11.00
	2/17	2/22	2/24	21.00	20.00	17.00	44.00	14.00
	2/24	2/28	3/3	24.00	20.00	17.00	48.00	13.00
	3/3	3/7	3/10	27.00	20.00	17.00	51.00	13.00
	3/10	3/14	3/17	27.00	19.00	17.00	53.00	10.00
	3/17	3/21	3/24	27.00	19.00	16.00	56.00	6.00
	3/24	3/28	3/31	24.00	19.00	16.00	60.00	-1.00
					698.00		640.37	57.63
CASH MANAGEMENT BILLS								
15-DAY BILL	12/28	12/30	1/3		*15.00*		15.00	0.00
	Matures 1/18							
5-DAY BILL	1/7	1/11	1/12		*4.00*		*4.00*	0.00
	Matures 1/18							
11-DAY BILL	2/2	2/3	2/4		8.00		8.00	0.00
	Matures 2/15							
11-DAY BILL	3/2	3/3	3/4		15.00		15.00	0.00
	Matures 3/15							
								0.00
COUPONS						CHANGE IN SIZE		
5-Year Note	1/10	1/12	1/18		*15.00*			*15.00*
10-Year TIPS	1/10	1/13	1/18		*10.00*	*1.00*		*10.00*
20-Year TIPS (R)	1/20	1/25	1/31		*8.00*	*-3.00**		*8.00*
2-Year Note	1/24	1/26	1/31		*24.00*		25.84	-1.84
3-Year Note	2/2	2/8	2/15		22.00			22.00
5-Year Note	2/2	2/9	2/15		15.00			15.00
10-Year Note	2/2	2/10	2/15		14.00		11.30	2.70
2-Year Note	2/22	2/24	2/28		24.00		27.00	-3.00
5-year Note	3/7	3/9	3/15		15.00			15.00
10-Year Note (R)	3/7	3/10	3/15		9.00			9.00
2-Year Note	3/28	3/30	3/31		24.00		27.00	-3.00
					180.00		91.13	88.87

*First Reopening

R = Reopening
A = Announced
Actual Amounts in Italics

Treasury announced a Q1 borrowing need of $147 billion on Jan 31st

NET CASH RAISED THIS QUARTER: 146.50

US TREASURY FINANCING SCHEDULE FOR 2nd QUARTER 2005
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	3/31	4/4	4/7	20.00	18.00	15.00	63.00	-10.00
	4/7	4/11	4/14	16.00	18.00	15.00	63.00	-14.00
	4/14	4/18	4/21	12.00	18.00	15.00	64.00	-19.00
	4/21	4/25	4/28	14.00	19.00	16.00	62.00	-13.00
	4/28	5/2	5/5	16.00	20.00	16.00	59.00	-7.00
	5/5	5/9	5/12	18.00	20.00	17.00	55.00	0.00
	5/12	5/16	5/19	18.00	20.00	17.00	49.00	6.00
	5/19	5/23	5/26	18.00	20.00	18.00	51.00	5.00
	5/26	5/31	6/2	18.00	20.00	18.00	53.00	3.00
	6/2	6/6	6/9	16.00	20.00	18.00	55.00	-1.00
	6/9	6/13	6/16	14.00	20.00	18.00	54.00	-2.00
	6/16	6/20	6/23	14.00	20.00	17.00	54.00	-3.00
	6/23	6/27	6/30	14.00	20.00	17.00	54.00	-3.00
					678.00		736.00	-58.00
CASH MANAGEMENT BILLS								
9-DAY BILL	4/5	4/5	4/6		20.00		20.00	0.00
	Matures 4/15							
12-DAY BILL	6/1	6/2	6/3		25.00		25.00	0.00
	Matures 6/15							
								0.00
COUPONS								
						CHANGE IN SIZE		
5-Year Note	4/11	4/13	4/15		15.00			15.00
10-Year TIPS (R)	4/11	4/14	4/15		10.00			10.00
5-Year TIPS ®	4/21	4/26	4/29		12.00			12.00
2-Year Note	4/25	4/27	4/29		24.00		26.30	-2.30
3-Year Note	5/4	5/10	5/16		22.00			22.00
5-Year Note	5/4	5/11	5/16		15.00		22.00	-7.00
10-Year Note	5/4	5/12	5/16		14.00		17.63	-3.63
2-Year Note	5/23	5/25	5/31		24.00		23.91	0.09
5-year Note	6/6	6/8	6/15		15.00			15.00
10-Year Note (R)	6/6	6/9	6/15		9.00			9.00
2-Year Note	6/27	6/29	6/30		24.00		23.73	0.27
					184.00		113.56	70.43

R = Reopening
A = Announced

Treasury announced a Q2 borrowing need of $12 billion on Jan 31st

NET CASH RAISED THIS QUARTER: 12.43

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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February 2, 2005
JS-2222

Assistant Secretary for Financial Markets Timothy S. Bitsberger February 2005 Quarterly Refunding Statement

We are offering $51.0 billion of notes to refund approximately $11.4 billion of privately held securities and Government account holdings maturing or called on February 15, raising approximately $39.6 billion. The securities are:

- A new 3-year note in the amount of $22 billion, maturing February 15, 2008;
- A new 5-year note in the amount of $15 billion, maturing February 15, 2010;
- A new 10-year note in the amount of $14 billion, maturing February 15, 2015.

These securities will be auctioned on a yield basis at 1:00 PM Eastern time on Tuesday, February 8, Wednesday, February 9, and Thursday, February 10, respectively. All of these auctions will settle on Tuesday, February 15. The balance of our financing requirements will be met with weekly bills, monthly 2-year and 5-year notes, the March 10-year note reopening, and the April 5-year and 10-year TIPS reopenings. Treasury is also likely to issue cash management bills in early March and April.

Data Review

Following the November 2004 refunding, Treasury received many comments and suggestions on data we currently publish on Treasury auctions and holdings. We are continuing to assess the data in terms of what additional data we should make public and the relevance of existing data that we publish. We expect to implement changes soon. A list of the data under review can be found in the primary dealer meeting agenda released on October 22, at the following link: http://www.treas.gov/offices/domestic-finance/debt-management/dealer-agenda/2004-q4.pdf

Policies under Consideration

Setting of Coupons in Decimal Increments

Treasury is considering a coupon format change for Treasury notes and bonds. Currently coupons are set in 1/8 percent increments. Under consideration is a proposal to set coupons in decimal increments (with the increment yet to be decided) rather than the current 1/8 percent increments. This change, if implemented, would apply to all nominal Treasury and TIPS coupon securities and would lower the probability of unintended reopenings of outstanding securities.

"Stepping Down" Coupons to Prevent Unintended Reopenings

Treasury is also considering implementing a policy of "stepping down" the coupon on newly auctioned securities by one increment to avoid unintended reopenings of existing securities that occasionally occur when a new security has the same maturity and same coupon as an existing security. Under the proposal, when an auction results in a coupon that creates an unintended reopening, Treasury would set the coupon 1/8 percent increment lower than normal on the newly-auctioned security and adjust the price of the new security downward (bigger price discount). The yield established at the auction would be identical to the yield set under the current practice. This proposed process would avoid unintended reopenings.

Please send comments and suggestions on these subjects or others relating to debt management to debt.management@do.treas.gov.

The next quarterly refunding announcement will take place on Wednesday, May 4, 2005.

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

January 26, 2005
js-2223

Remarks of Wayne A. Abernathy
Assistant Secretary for Financial Institutions
at the Secretary's Honor Awards Ceremony

Mr. Secretary, thank you for the kind award and recognition, and to my friends and colleagues, for the remembrances of this office. Thank you for your kind and generous attendance at this ceremony.

In addition to my kind friends who have made presentations today, I am grateful for the presence of NCUA Chairman JoAnn Johnson, OFHEO Director Armando Falcon, Fed Governor Mark Olson, SEC Commissioner Cynthia Glassman, CFTC Commissioner Walt Lukken, Federal Housing Finance Board Members Alicia Castañeda and Allan Mendelowitz and each you who has taken the time and trouble to be here with me today in this historic room.

You honor me with your presence.

I would like to indulge in a liberal paraphrasing of Bilbo Baggins: two years is far too short a time to serve among such excellent and admirable gnomes and gremlins of the Treasury. Soon to be a gnome alumnus, this ceremony is mostly a pleasant opportunity for me to say thank you to so many with whom I have worked so closely, inside and outside of the Treasury, over the last 26 months.

But not 26 months alone. Since this is also my departure from over 20 years of government service, I have taken the liberty to gather, as much as could be done, friends with whom I have worked during all of that time. And to all of you, I say thank you for the kindness, the mentoring, the friendship and the fellowship that have helped to make that service worthwhile.

President Reagan is reported to have said that there is no limit to the amount of good you can do in Washington if you are not worried about who gets the credit.

That is very appropriate for our work here at Treasury (as much as it was in the Congress). It is certainly true for the work that I have been involved in, because I cannot recall anything that I have been involved in that has not been the product and effort of many people.

When I worked at my last job, for Senator Phil Gramm on the Senate Banking Committee, Senator Gramm liked to say that all the work was done by others, that he was just the front guy. Well, he knew better then, but I even more so now know better his feelings as I have so often played the roll of front guy for the great work done by my team here at Treasury.

There is a little town in western New York, where I grew up as a teenager. It has I think an unusual distinction for towns of its size anywhere in America. That little town, of not more than 10,000 people, has had two of its children serve as Assistant Secretaries of the Treasury. What is more unusual, we both graduated in the same high school class and in fact we both were two-thirds of three young fellows who were inseparable in high school and all three of which came to school here in Washington.

I remember as a young college student walking with my friend, John Rogers (who later served with Secretary Baker as Assistant Secretary for Management), I remember he and I walking on a street close by this building, speculating on what jobs we would some day have here in Washington. We both knew that we would work for the federal government--that's why we were here, why we were studying here, those were our plans, and we as typical youngsters thought big.

Neither of us thought big enough. I did not think at that time that I would be privileged enough to work for the Treasury Department. I am glad that America is a place where young people can think big and where big thoughts can become reality.

I hope that my non-Treasury friends will pardon me if I say that Treasury is the best place to work in the Executive Branch. It is the best Department, a place where a wonderful combination of things that really matter to hundreds of millions of people every day are worked on by a team close enough for us all to know one another by name and face and work together without stultifying layers of bureaucracy.

As I have been packing my things this past week, I have been stunned by the number and variety of important matters that we at Treasury have been involved in. Just in the two years that I have personally witnessed we've worked on:

- reinforcing our national credit information system;
- fighting identity theft;
- strengthening the resilience of our financial infrastructure;
- implementing a model community development program;
- designing an effective supervisory structure for our GSEs;
- taking the Terrorism Risk Insurance Program from nothing to fully operational in no time at all;
- completing the privatization of Sallie Mae; and
- spreading financial education standards and promoting efforts all over the nation.

And all the while fighting regulatory burden, promoting the idea that the role of government is service to the governed, that regulation should add value, and if it doesn't, then its value should be questioned.

Those are just some highlights. And the plate is full with more to do.

I am grateful to have been able to serve in the government. It has been an honor to serve in the Administration of President George W. Bush. But I must admit that I am also excited to join my friends in the private sector in the cause of building prosperity and opportunity in America, and to keep thinking big.

My friend and colleague, Matt Shimkus, gave me a rugged sign that I have kept in my office. It says, "Who Is John Galt?" I am ready to go and find out.

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

February 1, 2005
js-2224

President Bush's 2006 Budget to Request Boost for IRS Enforcement

WASHINGTON, DC - President Bush's 2006 budget will request an additional $500 million for IRS enforcement activities. This represents a 7.8% increase in funding over FY 2005.

"Americans who play by the rules and pay their taxes deserve confidence that others pay their fair share as well," stated Secretary of the Treasury John Snow. "Increasing enforcement not only catches tax cheats, but discourages others from avoiding paying their taxes. The vast majority of Americans pay their taxes. The IRS is committed to striking a balance between catching those who would avoid paying and providing excellent service to all taxpayers."

"Enforcement more than pays for itself," IRS Commissioner Mark W. Everson said. "Particularly in a period of deficit reduction, funding IRS enforcement is a wise investment."

Congress enacted $6.392 billion for IRS enforcement in FY 2005, the President's FY 2006 budget requests $6.893 billion. The increase will provide additional resources to examine more tax returns, collect past due taxes and investigate cases of tax avoidance.

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federal financing bank NEWS
WASHINGTON, D.C. 20220
Press 202-622-2960
FFB 202-622-2450

FEDERAL FINANCING BANK **January 2005**

Brian D. Jackson, Chief Financial Officer, Federal Financing Bank (FFB) announced the following activity for the month of December 2004.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $27.9 billion on December 31, 2004, posting an increase of $391.4 million from the level on November 30, 2004. This net change was the result of an increase in net holdings of government-guaranteed loans of $391.4 million, representing primarily an increase in Rural Utilities Service ("RUS") loans. The FFB made 61 disbursements and received 12 prepayments during the month of December.

Attached to this release are tables presenting FFB December loan activity and FFB holdings as of December 31, 2004.

JS-2225

FEDERAL FINANCING BANK
DECEMBER 2004 ACTIVITY

Borrower	Date	Amount of Advance	Final Maturity	Interest Rate	
GOVERNMENT-GUARANTEED LOANS					
GENERAL SERVICES ADMINISTRATION					
San Francisco OB	12/02	$162,967.93	8/01/05	2.593%	S/A
Foley Services Contract	12/07	$23,540.41	7/31/25	4.665%	S/A
Foley Square Office Bldg.	12/07	$839,523.00	7/31/25	4.665%	S/A
DEPARTMENT OF EDUCATION					
Tuskegee Univ.	12/22	$209,505.25	11/02/26	4.508%	S/A
RURAL UTILITIES SERVICE					
Arizona Electric #2128	12/03	$2,975,000.00	12/31/24	4.635%	Qtr.
Pointe Coupee Electric #2042	12/06	$700,000.00	12/31/37	4.717%	Qtr.
Citizens Tel (VA) #680	12/07	$704,411.00	3/31/05	2.314%	Qtr.
North Georgia Elec. #2135	12/07	$4,550,000.00	12/31/37	4.799%	Qtr.
Prince George Elec. #2111	12/07	$2,500,000.00	12/31/37	4.799%	Qtr.
Twin Valley-Ulen Tel. #2177	12/07	$8,312,678.31	3/31/05	2.307%	Qtr.
Ravalli #641	12/10	$1,000,000.00	12/31/29	4.593%	Qtr.
Wood County Electric #826	12/10	$2,000,000.00	12/31/36	4.712%	Qtr.
Cental Virginia Elec. #2126	12/13	$2,000,000.00	1/03/39	4.722%	Qtr.
East River Power #793	12/13	$2,500,000.00	1/02/35	4.674%	Qtr.
Red River Valley #484A	12/13	$630,000.00	1/03/33	4.768%	Qtr.
Orange County Elec. #2179	12/14	$850,000.00	3/31/08	3.219%	Qtr.
Burt County Public #669	12/15	$398,000.00	1/02/35	4.640%	Qtr.
Consolidated Elec. #2072	12/15	$300,000.00	1/03/06	2.659%	Qtr.
Sho-Me Power #2160	12/15	$2,500,000.00	12/31/37	4.678%	Qtr.
East Kentucky Power #2171	12/16	$50,000,000.00	1/03/39	4.619%	Qtr.
Farmer's Rural Elec. #2046	12/16	$2,000,000.00	3/31/05	2.257%	Qtr.
Harrison County #799	12/16	$741,000.00	12/31/35	4.587%	Qtr.
Missoula Elec. #688	12/16	$406,000.00	12/31/29	4.483%	Qtr.
Southeastern Indiana #2062	12/16	$2,000,000.00	3/31/05	2.257%	Qtr.
Medina Electric #2050	12/17	$2,000,000.00	12/31/37	4.725%	Qtr.
Petit Jean Electric #887	12/17	$4,500,000.00	12/31/31	4.641%	Qtr.
Rutherford Electric #2091	12/17	$2,000,000.00	12/31/37	4.726%	Qtr.
Clark Energy Coop. #2087	12/20	$1,845,000.00	3/31/05	2.250%	Qtr.
Kankakee Valley Elec. #857	12/20	$1,000,000.00	12/31/36	4.726%	Qtr.
Arkansas Valley Elec. #895	12/21	$5,000,000.00	12/31/36	4.717%	Qtr.
Dunn Electric Coop. #861	12/21	$400,000.00	12/31/36	4.717%	Qtr.
Hart Elec. #885	12/21	$4,598,000.00	12/31/36	4.717%	Qtr.
Tri-State #757	12/21	$4,963,000.00	12/31/25	4.472%	Qtr.
Tri-State #2052	12/21	$31,379,000.00	1/03/34	4.679%	Qtr.
East Kentucky Power #2171	12/22	$50,000,000.00	1/03/39	4.700%	Qtr.
Jefferson Davis Elec. #2076	12/22	$1,694,000.00	12/31/37	4.691%	Qtr.
Pataula Electric #2121	12/22	$175,000.00	1/03/06	2.720%	Qtr.
Brazos Electric #2181	12/23	$20,000,000.00	3/31/05	2.221%	Qtr.
Brazos Electric #2181	12/23	$20,000,000.00	3/31/08	3.242%	Qtr.

FEDERAL FINANCING BANK
DECEMBER 2004 ACTIVITY

Borrower	Date	Amount of Advance	Final Maturity	Interest Rate
Brazos Electric #2181	12/23	$20,000,000.00	3/31/10	3.581% Qtr.
Brazos Electric #2181	12/23	$20,000,000.00	4/02/12	3.883% Qtr.
Brazos Electric #2181	12/23	$20,000,000.00	3/31/15	4.120% Qtr.
Brazos Electric #2181	12/23	$8,186,000.00	3/31/05	2.221% Qtr.
Brazos Electric #2181	12/23	$16,500,000.00	3/31/15	4.120% Qtr.
Brazos Electric #2182	12/23	$5,000,000.00	3/31/05	2.221% Qtr.
Brazos Electric #2182	12/23	$2,180,000.00	3/31/05	2.221% Qtr.
E. Iowa Coop. #807	12/23	$1,000.00	3/31/06	2.785% Qtr.
GOLDEN VALLEY ASSOC. #639A	12/27	$35,000,000.00	12/31/24	4.445% Qtr.
Hancock-Wood Elec. #842	12/27	$1,200,000.00	12/31/36	4.736% Qtr.
KEM Electric #537	12/27	$849,000.00	1/03/34	4.696% Qtr.
Lamar Electric #716	12/27	$55,000.00	12/31/35	4.724% Qtr.
Chariton Valley #524	12/28	$615,000.00	12/31/29	4.695% Qtr.
Arizona Electric #2128	12/29	$5,068,000.00	12/31/24	4.523% Qtr.
Dunbarton Telephone #2183	12/29	$712,000.00	1/02/24	5.405% Qtr.
East Kentucky Power #2171	12/29	$50,000,000.00	1/03/39	4.821% Qtr.
McLennan County Elec. #784	12/29	$1,787,000.00	12/31/35	4.690% Qtr.
Tri-County EMC #814	12/29	$1,600,000.00	12/31/36	4.802% Qtr.
Dairyland Power #588	12/30	$2,326,691.00	1/03/28	4.787% Qtr.
Dairyland Power #589	12/30	$1,003,310.00	1/03/28	4.662% Qtr.
Logan County Coop. #749	12/30	$909,000.00	12/31/35	4.813% Qtr.
North Western Elec Coop #880	12/30	$2,000,000.00	12/31/36	4.823% Qtr.

S/A is a Semiannual rate.
Qtr. is a Quarterly rate.

FEDERAL FINANCING BANK HOLDINGS
(in millions of dollars)

Program	December 31, 2004	November 30, 2004	Monthly Net Change 12/1/04-12/31/04	Fiscal Year Net Change 10/1/04-12/31/04
SOT				
Agency Debt:				
U.S. Postal Service	$0.0	$0.0	$0.0	-$1,800.0
Subtotal*	$0.0	$0.0	$0.0	-$1,800.0
Agency Assets:				
FmHA-RDIF	$200.0	$200.0	$0.0	$0.0
FmHA-RHIF	$680.0	$680.0	$0.0	$0.0
Rural Utilities Service-CBO	$4,270.2	$4,270.2	$0.0	$0.0
Subtotal*	$5,150.2	$5,150.2	$0.0	$0.0
Government-Guaranteed Lending:				
DOD-Foreign Military Sales	$1,429.7	$1,449.3	-$19.6	-$35.2
DoEd-HBCU+	$120.9	$120.7	$0.2	$2.9
DHUD-Community Dev. Block Grant	$0.2	$0.2	$0.0	-$0.2
DHUD-Public Housing Notes	$971.9	$971.9	$0.0	-$82.9
General Services Administration+	$2,140.0	$2,140.7	-$0.7	-$1.4
DOI-Virgin Islands	$7.6	$7.6	$0.0	$0.0
DON-Ship Lease Financing	$498.6	$498.6	$0.0	$0.0
Rural Utilities Service	$17,574.6	$17,161.7	$413.0	$613.6
SBA-State/Local Development Cos.	$51.5	$52.9	-$1.4	-$5.0
DOT-Section 511	$2.8	$2.9	$0.0	$0.0
Subtotal*	$22,797.9	$22,406.6	$391.4	$491.7
Grand total*	$27,948.1	$27,556.8	$391.4	-$1,308.3

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