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FROM THE OFFICE OF PUBLIC AFFAIRS

May 2, 2005
js-2413

Treasury Secretary John Snow Marks Anniversary of Social Security Commission

In a speech to the Association for Advanced Life Underwriting this morning, Treasury Secretary John Snow recognized the fourth anniversary of the Social Security Commission that President Bush convened four years ago on May 2nd, 2001.

"The bipartisan commission made recommendations to the President, who listened carefully to their recommendations in establishing his priorities for reform," Snow noted during his remarks, which focused primarily on reforming the financial unsustainable system.

"This anniversary reminds us that the President has been courageously leading the discussion on this issue for years... and that the time for action, for moving forward on saving and strengthening the system for future generations, is now."

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FROM THE OFFICE OF PUBLIC AFFAIRS

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May 2, 2005
JS-2414

Treasury Announces Market Financing Estimates

The Treasury Department announced today that it expects to pay down $42 billion in net marketable debt during the April – June 2005 quarter. The estimated cash balance on June 30 is $20 billion. On January 31, Treasury announced a net market borrowing of $12 billion with an end-of-quarter cash balance of $15 billion. The decrease in borrowing is primarily the result of higher individual tax receipts and State and Local Government Series security issuances.

Treasury also announced that it expects net borrowing of marketable debt to total $103 billion in the July – September 2005 quarter. The estimated cash balance on September 30 is $30 billion.

During the January – March 2005 quarter, Treasury's net borrowing of marketable debt totaled $144 billion and the cash balance on March 31 was $22 billion. On January 31, Treasury announced that it expected net borrowing of marketable debt to total $147 billion with an estimated end-of-quarter cash balance of $10 billion. The higher cash balance is primarily the result of larger-than-projected issuances of State and Local Government Series securities.

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

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REPORTS

- Market Financing Estimates Table

TREASURY ANNOUNCES MARKET FINANCING ESTIMATES

Today, the Treasury Department announced net borrowing of marketable debt for the April - June 2005 and July - September 2005 quarters.

Quarter	Estimated Borrowing ($ billion)	Estimated End-of-Quarter Cash Balance ($ billion)
Apr-Jun 2005	($42)	$20
Jul-Sep 2005	$103	$30

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 $29 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 January – March 2005 quarter.

Quarter	Estimated Borrowing ($ billions)	Actual Borrowing ($ billions)	Estimated End-of-Quarter Cash Balance ($ billions)	Actual End-of-Quarter Cash Balance ($ billions)
Jan – Mar 2005	$147	$144	$10	$22

Categories	Chg from Nov Estimate
Receipts	+$4
Outlays	(1)
Other	+12
Larger End-of-Quarter Cash Balance	(12)

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

FROM THE OFFICE OF PUBLIC AFFAIRS

May 2, 2005
JS-2415

Assistant Secretary of the Office of Economic Policy
Mark J. Warshawsky
Statement for the Treasury Borrowing Advisory Committee
of the Bond Market Association
May 2, 2005

The U.S. economy remains on a solid growth track. Real GDP rose at a 3.1 percent annual rate in the first quarter, about in line with our estimate of trend growth, following a gain of 3.8 percent in the fourth quarter. The deceleration largely reflected a slower pace of business investment after double-digit rates of growth last year.

Investment in equipment and software rose by 6.9 percent at an annual rate in the first quarter, following an increase of 14.5 percent during all of 2004. Although data are not yet available by which to evaluate the impact of the bonus expensing provision of the Jobs and Growth Tax Relief Reconciliation Act, the expiration of the provision at the end of last year may have contributed to the pullback. Investment in structures, which has been slower to recover from the 2001 downturn, declined at a 2.6 percent annual rate. Overall, business fixed investment increased by 4.7 percent in the first quarter after rising by 11.0 percent over the four quarters of last year. Inventory investment made a substantial positive contribution to first-quarter growth, adding 1.2 percentage points to the increase in real GDP on top of a 0.5 point addition in the previous three-month period.

Personal consumption expenditures moderated in the first quarter to a 3.5 percent annual rate from a brisk 4.7 percent pace during the second half of 2004. A drop in purchases of motor vehicles and parts accounted for most of the slowdown. The fundamentals of the household sector nonetheless remain sound. Nearly half a million jobs were added to nonfarm payrolls during the first quarter, bringing the increase since the May 2003 employment trough to 3.1 million. The unemployment rate continued to recede and in March stood at 5.2 percent, 1.1 percentage points below the June 2003 peak.

There has been some concern of late about recent declines in real wages. However, these declines followed unusual strength of real wages during the recession and early recovery period. Measured from the March 2001 business cycle peak, the performance of real average hourly earnings of production and other nonsupervisory workers in the current cycle is the second strongest on record. Rising benefit costs have been an important factor constraining wage growth recently. The Employment Cost Index showed that hourly compensation costs in private industry rose by a moderate 3.4 percent in nominal terms over the year ending in March – a small gain in real terms. Because of a rapid 5.8 percent increase in benefit costs, however, growth of wages and salaries was held to only 2.4 percent. We nonetheless are encouraged by the deceleration in benefit costs over the past year from growth in the 7 percent range a year ago. As the labor market continues to firm, real wages are expected to strengthen. In the meantime, consumer balance sheets appear to be on solid ground. Debt service payments do not appear to be problematic, consumer loan performance has improved notably in the past few years, and household net worth relative to disposable income is higher than at any time prior to the late 1990s, when the runup in equity markets boosted the wealth ratio to record levels.

Real residential investment picked up to a 5.7 percent pace in the first quarter from the fourth quarter's 3.4 percent annual rate increase. The housing market has been exceptionally vibrant the past few years. A number of records were broken in 2004 and in March new home sales shattered previous highs. On the other hand, housing starts fell sharply in March and building permits have tilted lower in recent months, possibly signaling the sector's return to a more normal and sustainable pace.

The trade deficit widened further in the first quarter, acting as a brake on growth for the sixth consecutive quarter. Imports climbed by 14.7 percent, more than offsetting a 7.0 percent increase in exports. This boosted the trade gap by $42.1 billion in real terms to $663.2 billion and shaved 1.5 percentage points off the first-quarter advance in real GDP. The strong performance of the U.S. economy compared to its major trading partners is partly responsible for the growing deficit.

Inflation has shaded higher over the past year, boosted in part by rising oil prices. The consumer price index rose by 3.1 percent over the year ending in March, up from a 1.7 percent increase in the year-earlier period. Core inflation has also accelerated modestly but remains contained at 2.3 percent.

The rise in energy prices has affected the U.S. economy in other dimensions as well. The one-month futures price of West Texas Intermediate crude oil spiked to a new monthly high of $54.63 per barrel in March, up more than $6.50 from the prior month's average, and on the first day of April soared to a record $57.27 per barrel. Retail gasoline prices averaged close to $2.25 per gallon in April, an all-time high that exceeded year-ago levels by about 45 cents. By cutting into real wages, weighing on consumer confidence, and heightening business uncertainty, energy prices have exerted a drag on economic activity that became visible at the end of the first quarter. So far, the economy has shown considerable resilience in the face of an approximate doubling of oil prices over the past 2-1/2 years but some tempering of growth is consistent with both modeling results and past experience.

Persistently high fuel prices highlight the need to implement the Administration's proposals to bolster domestic energy supplies and adopt technologies to use energy more efficiently, particularly in light of the rise in energy demand from the developing world. Strong growth in consumption among emerging economies is one of the factors that is putting considerable upward pressure on energy prices. It is therefore imperative that we assist rapidly growing countries like China and India in developing cleaner, more efficient technologies to reduce their own demand. By sharing our knowledge, we will contribute to the conservation of energy resources, helping to restrain prices and preserve the environment.

Unless oil prices surge sharply higher, the economy appears well-equipped to weather any loss in momentum we may be experiencing currently. The unemployment rate is low, inflation remains contained, and productivity continues to rise. The strength of these underlying fundamentals suggests that the economy is poised to grow at a healthy rate for the remainder of the year.

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May 3, 2005

The President
The White House
Washington, DC 20500

Dear Mr. President:

It is with enormous appreciation and gratitude that I respectfully submit my resignation as Assistant Secretary of the Treasury effective May 31, 2005. It has been a singular privilege to serve you at the Treasury Department and to help implement your agenda for economic growth over the last four years.

Under your leadership, the Treasury Department has advanced policies that have strengthened the U.S. economy, created jobs, and spread prosperity around the world. Your emphasis on free trade and free market capital flows is critical to growing emerging economies as well as keeping our economy and our financial markets the most dynamic, resilient and robust in the world.

I will always cherish the experience of working at the Treasury Department with an extremely dedicated group of appointees and career civil servants; they have become family to me. Thank you again for the privilege and the honor of serving under your great leadership at such a critical time in our nation's history.

Sincerely,

Rob Nichols

JS-2416

FROM THE OFFICE OF PUBLIC AFFAIRS

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May 3, 2005
JS-2417

**Statement of Treasury Secretary John W. Snow
On the Departure of Treasury Assistant Secretary Rob Nichols
May 3, 2005**

"The Treasury Department is preparing to bid a very fond farewell to Rob Nichols, who will be departing from a distinguished career in public service at the end of this month. He has served his country honorably as a public official and we wish him the very best in his new life in the private sector.

"As the Assistant Secretary of Public Affairs, and before that as Deputy Assistant Secretary, Rob has been involved with every issue that the Treasury Department handles. His communications and management skills, combined with his understanding of financial markets, the financial services industry and a wide breadth of economic matters, made him a uniquely valuable advisor to me, to the Treasury Department leadership, and to officials throughout the Administration. His leadership and counsel on public relations, strategy and relationships with the news media have been second-to-none, and his office is widely know as one of the most well-managed and efficient in the Treasury organization.

"On a more personal note, Rob has been a steady source of wisdom as well as camaraderie since I became Treasury Secretary over two years ago. He has been an infinitely valuable member of the Treasury team and of the larger Bush Administration team; he will be deeply missed."

REPORTS

- "Assistant Secretary Nichols' Resignation Letter"

May 3, 2005

The President
The White House
Washington, DC 20500

Dear Mr. President:

It is with enormous appreciation and gratitude that I respectfully submit my resignation as Assistant Secretary of the Treasury effective May 31, 2005. It has been a singular privilege to serve you at the Treasury Department and to help implement your agenda for economic growth over the last four years.

Under your leadership, the Treasury Department has advanced policies that have strengthened the U.S. economy, created jobs, and spread prosperity around the world. Your emphasis on free trade and free market capital flows is critical to growing emerging economies as well as keeping our economy and our financial markets the most dynamic, resilient and robust in the world.

I will always cherish the experience of working at the Treasury Department with an extremely dedicated group of appointees and career civil servants; they have become family to me. Thank you again for the privilege and the honor of serving under your great leadership at such a critical time in our nation's history.

Sincerely,

Rob Nichols

FROM THE OFFICE OF PUBLIC AFFAIRS

May 3, 2005
JS-2418

The Honorable John W. Snow
Prepared Remarks: The American Academy of Actuaries' Spring Meeting
Washington, DC

Good afternoon. I'm thrilled to be here, to spend some time with all of you. I have an awful lot of respect for your profession, and for your perspective on the fiscal and retirement policies of our great country.

Above all else, you are a fair and ethical profession. Unbiased. Motivated by what is accurate, not by the opinions of the day. That is a difficult standard for mortals to achieve, and you do it as well as any group I've been familiar with.

You may have noticed that I talk a lot about actuaries when I talk about Social Security reform. I point to your work because I know that it stands solid, without the tint or tarnish of politics.

I have been aggravated, as I'm sure you have been, by the partisan politics that have sullied the issue of saving and strengthening Social Security.

The national dialogue that the President has engendered has really been terrific, and we're very proud of the fact that Social Security is being discussed all over the country, from lunch counters to college dining halls, from family dinner tables to the halls of Congress.

The national conversation has definitely changed from "should it be fixed?" to "how can we fix it," and that is great progress.

But not everyone has the President's courage. The political temptation has been to deny the problem or delay the solution, and that's a shame.

Those of you in this room today know better than anyone that to deny that the system is in financial trouble is to deny the facts, period. And delaying action is fiscal foolishness.

So I imagine that we are preoccupied with some common concerns: the long-range fiscal health of the nation's Social Security system, and the implications of both reform and of inaction.

You know the scenario of inaction: A compounding problem, growing worse by $600 to $700 billion each year.

The President doesn't believe in ignoring that reality. He doesn't think it would be wise to turn a blind eye to the reports of your non-partisan colleagues, which tell us that the program, in its current form, is unsustainable.

The President is too honest to ignore the irrefutable facts, the undeniable truth that

the Social Security system is on an unsustainable path. As you well know, the demographics, the arithmetic, cannot be denied: Cash flows peak in 2008 and turn negative in 2017, and the trust fund itself will be exhausted in 2041. People are living longer and having fewer children, so there are fewer workers to support retirees. We had 16 workers paying into a system for every one beneficiary in 1950, and today we only have about three workers for every beneficiary. That ratio will drop to two-to-one by the time today's young workers retire.

When those young workers retire, in 2041, the system will be exhausted, bankrupt. Today's 30-year-old can expect a nearly 30 percent benefit cut from the current system when he/she reaches retirement age. Without action, our children and grandchildren will be faced with huge benefit cuts or massive tax increases.

That's the scenario of inaction. And it's one the President won't accept. He understands that the government must plan for the future and deal with looming financial threats when we see them.

We also need to talk about the financial consequences of taking the wrong action. We have to do it right because of the enormous impact Social Security can have on our economy overall. The American economy is the most dynamic and resilient in the world, but we cannot take that for granted.

Your association's website has a clever feature, "the Social Security game." I think it's a great way to show what some of the options are that we have to address solvency, and it's a helpful tool that inspires healthy debate.

Now I wish someone would come up with a game that shows the economic consequences of taking the wrong action on Social Security reform.

For example, the deeply negative consequences a tax increase would have on American's take-home income and the ability of businesses to create new jobs.

The Social Security Trustees' report showed that we would have to raise the payroll tax immediately by 3.5 percentage points to make the system whole on a permanent basis. In other words, the payroll tax would have to be increased by nearly 30 percent.

Both workers and employers would bear a significant cost. For very small employers – who employ more than half of America's private-sector employees – I fear that much of a tax increase would force them to make terrible choices, from lay-offs to health benefit cuts. And it would make hiring new people even more difficult… which is worrisome since small business creates most of our nation's new jobs.

Increasing payroll taxes hurts the economy and it hurts job creation, period. That's why the President is against it.

Tax increases aren't the answer, so the President has put a number of ideas on the table that might be. He has encouraged the Congress to propose a variety of ideas that might be the answer as well, and we appreciate very much that those ideas are coming forward.

One of the President's core beliefs on this issue is that we ought to move toward a system that is pre-funded, that we should gradually move away from a pay-as-you-go model and give Americans the chance to save their own money. He wants to move away from the filing cabinet of IOUs and toward something that people actually own and that represents real capital.

Voluntary personal accounts are a step toward pre-funding the system, and that's going to put it on a more stable, guaranteed basis down the road.

Additionally, the power of compound interest is a mighty one – I don't need to tell

you that – and including personal retirement accounts in Social Security reform will mean opening a door to that power for people who would not have had the opportunity otherwise. This is an exciting and empowering proposition, and best of all we know that it can be done without disrupting the system of benefits for their parents and other generations of retired beneficiaries.

Former Democratic Congressmen Tim Penny and Charlie Stenholm have said recently that "if Social Security were being created from scratch today, Americans would want to include a way to help everyone build up a nest egg."

Now is our chance to make the system work in today's – and tomorrow's – demographic reality. You are key players in this national dialogue; we seek and welcome your input and ideas, and I suspect Congress does as well.

When talking about retirement, it is of course important to include pension reform, another issue that the President is dedicated to, and the administration is working on.

As you all know, the single employer defined benefit pension system is in serious financial trouble. Many plans are badly underfunded, jeopardizing the pensions of millions of American workers. The insurance system protecting these workers in the event that their own pension plans fail has a substantial deficit. Such a deficit means that although the PBGC has sufficient cash to make payments in the near-term, without corrective action, ultimately the insurance system will simply not have adequate resources to pay all the benefits that it owes to the one million workers and retirees currently owed benefits who were participants of failed plans and to the beneficiaries of plans that fail in the future.

The Administration believes that current problems in the system are not transitory nor can they be dismissed as simply the result of restructuring in a few industries. The cause of the financial problems is the regulatory structure of the defined benefit system itself. Correcting these problems and securing the retirement benefits of workers and retirees requires that the system be restructured. Minor tinkering with existing rules will not be sufficient. If we want to retain defined benefit plans as a viable option for employers and employees, fundamental changes must be made to the system to make it financially sound.

The President's solution to these issues is to fundamentally reform the rules governing pension plan funding, disclosure and PBGC premiums, based on the following three simple principles:

- Funding rules should ensure pension promises are kept by improving incentives to fund plans adequately.
- Workers, investors and pension regulators should be fully aware of pension plan funding status.
- Premiums should reflect a plan's funding status and the plan sponsor's risk and ensure the pension insurance system's financial solvency.

Such changes will increase the likelihood that workers and retirees actually receive the benefits that they have earned and as a result will moderate future insurance costs that will be borne by sound plan sponsors. Today I am going to discuss how the Administration's initiative improves incentives for adequate plan funding. We have proposed a fundamental reform of the treatment of defined benefit pension plans, one that we believe will change plan sponsor behavior, ultimately result in better funded and better managed defined benefit pension plans, and secure benefits for workers and retirees.

The Administration proposal is designed both to simplify funding rules and to enhance pension plan participants' retirement security. The federal government has an interest in defining and enforcing minimum prudent funding levels, but many other funding, investment, and plan design decisions are best left to plan sponsors. Under this proposal, pension plans would be required to fund towards an economically meaningful funding target – a measure of the currently accrued pension obligations. Plans that fall below the minimum funding target would be

required to fund-up to the target within a reasonable period of time. Plans that fall significantly below the minimum acceptable funding level would also be subject to benefit restrictions.

Some key features of the proposed funding rules:

- *Funding based on meaningful and accurate measures of liabilities and assets.* The proposal provides funding targets that are based on meaningful, timely, and accurate (using the yield curve for discounting is a central component of this proposal) measures of liabilities that reflect the financial health of the employer.
- *Accrued benefits funded.* Sponsors that fall below minimum funding levels will be required to fund up within a reasonable period of time. The proposal requires a 7-year amortization period for annual increases in funding shortfalls. There will be restrictions on the extension of new benefit promises by employers whose plans' funded status falls below acceptable levels. Benefit restrictions will limit liability growth as a plan becomes progressively underfunded relative to its funding target.
- *Plan sponsors able to fund plans during good times.* Many believe that the inability of plan sponsors to build sufficiently large funding surpluses during good financial times under current rules has contributed to the current underfunding in the pension system. The proposal addresses this problem directly by creating two funding cushions that, when added to the appropriate funding target, would determine the upper funding limit for tax deductible contributions. And every plan will be allowed to fund to a level of funding corresponding to the total cost of closing out the plan.

Under our proposal, allowing plan sponsors the opportunity to prefund and therefore limit contribution volatility is a critical element.

Defined benefit plans are a vital source of retirement income for millions of Americans. The Administration is committed to ensuring that these plans remain a viable retirement option for those firms that wish to offer them to their employees. The long run viability of the system, however, depends on ensuring that it is financially sound. The Administration's proposal is designed to put the system on secure financial footing in order to safeguard the benefits that plan participants have earned and will earn in the future. We are committed to working with Congress to ensure that effective defined benefit pension reforms that protect worker's pensions are enacted into law.

A final issue that I think will be of interest to all of you is the status of the Treasury Department's study on Terrorism Risk Insurance Act.

The terrorism risk insurance program was 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. As you know, the Act required 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.

Thanks again for having me here today; I look forward to taking your questions.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 3, 2005
JS-2419

U.S. Economic & Financial Engagement with Latin America
Randal K. Quarles
Assistant Secretary of Treasury for International Affairs
Council of the Americas 35th Washington Conference
Washington, DC
May 3, 2005

It is a pleasure to be here today to discuss U.S. economic and financial engagement with Latin America.

As those in this room know, recent economic performance in the region has been outstanding. Growth is strong, inflation has fallen, and capital is flowing back to the region. Underlying these improvements are good economic policies by Latin American countries themselves, supported by extensive and effective U.S. economic engagement.

I would like to take my time today to review where the region's economies stand, how we got here, and our priorities for the future. The Bush Administration is committed to working with the countries of the region to transform the current economic recovery into sustained economic growth that will produce significant increases in income and reductions in poverty. Our agenda for achieving this is a comprehensive one, involving a range of bilateral and multilateral, financial and non-financial tools.

Regional Economic Performance

Economic developments in Latin America have exceeded even the most optimistic forecasts in recent months. Real GDP growth for the region as a whole was almost 6 percent in 2004. That is the highest growth rate since 1980. With the exceptions of Haiti and Grenada--countries that experienced political unrest and natural disasters--every country in the region registered positive growth last year. This robust growth has created millions of new jobs and raised incomes for workers and their families.

Economic stability in the region has also improved dramatically following the turbulence of 2001-2002. No countries are currently experiencing recession or financial crisis. Capital flows to Latin America have increased, with many countries already completing large portions of their financing needs for the entire year. Some governments have even prefinanced themselves through most of 2006. Risk spreads for countries in the region remain near record lows, even as the Federal Reserve has continued its tightening cycle in the United States.

When the Bush Administration entered office four years ago, the situation was not so positive. Growth was slowing across the region. Major financial crises were unfolding in Argentina, and then in Uruguay and Brazil. These came in the wake of the serial financial crises of the 1990s, starting with Mexico in 1994-95, during which financial difficulties leapt across borders even to countries that lacked direct linkages to those that were originally affected.

The contrast to the present time couldn't be greater. There was no contagion following Argentina's default in 2001, versus the contagion seen after the Asian and

Russian crises in 1997-8. Mexico--the country the typified the new generation of financial crises--now has an investment grade rating and among the lowest risk spreads over U.S. Treasuries among the emerging markets.

The reason for these improvements is clear: better economic policies. Governments across the region have strengthened their fiscal balances with the objective of reducing debt levels. Countries from Mexico to Colombia to Brazil have moved aggressively to reduce the proportion of their public debt denominated in or linked to foreign currencies. Better monetary policies--supported by flexible exchange rates (or in some instances dollarization)--have successfully brought inflation down and prevented large depreciations in 2002 from becoming hyperinflations. Countries have also taken advantage of the favorable environment to build international reserves to help cushion them against unexpected shocks in the future.

The Bush Administration has played a vital role in supporting better policies in the region. First, we have pursued sound economic policies at home. Timely changes in monetary and fiscal policy--such as President Bush's tax cuts in 2001 and 2003--helped make the U.S. slowdown mild and the recovery rapid. This has enabled the United States to continue to serve as an engine for the global economy.

Second, we have strongly supported countries following good policies in the region through assistance from the International Monetary Fund (IMF), World Bank, and Inter-American Development Bank. In 2002, Brazil, Colombia, and Uruguay faced intense financial difficulties that threatened to push these countries into default and deep crisis. In each case, the governments articulated strong strategies to restore economic stability and address sources of vulnerability.

Though success was not assured, we at the Treasury believed that these good policies--backed by financial support from the IMF and multilateral development banks--could underpin a return to strong growth. These assessments proven accurate: in 2004, Brazil, Colombia, and Uruguay posted growth rates of 5.2 percent, 4.0 percent, and 12.0 percent respectively.

U.S. engagement with the region has been critical to ending this period of financial instability and putting the region back on the path of economic growth. We now look to working with our regional partners to translate this renewed growth into sustained improvements in standards of living for all the people of the region, a subject I would like to turn to now.

Challenges Ahead

We think about the agenda ahead in terms of two main challenges: first, institutionalizing the important improvements in macroeconomic policy that have been achieved recently; and second, addressing the business climate problems needed to spur higher levels of productivity growth and reduce poverty.

With respect to the first challenge, better fiscal policies in many countries have succeeded in bringing down high levels of debt. But debt levels remain too high and are a continuing source of vulnerability. So far most Latin American governments have shown good leadership by maintaining fiscal discipline during the recent economic recovery, reversing a pattern that was all-too-frequent in the past of expanding spending during economic booms. There is a strong appreciation in the region today of how running better fiscal balances during the boom years can provide more flexibility to a country during the lean years.

But good intentions in this regard are sometimes complicated by institutional features of tax and spending systems that act as obstacles to more effective fiscal policies. Addressing these impediments requires what we call structural fiscal reforms. These include policies to strengthen tax administration and broaden the tax base; reform pension systems to ensure sustainability and solvency; reduce widespread revenue earmarking that creates "automatic" spending during periods of tax revenue growth and inhibits adjustment during downturns; and adopt fiscal responsibility regimes to institutionalize fiscal discipline at the provincial and

regional levels.

There are also actions on the monetary side that Latin American governments can take to institutionalize better macroeconomic policies. These include steps to bolster the operational and institutional underpinnings of inflation-targeting regimes. Chief among these is legislation to increase central bank autonomy and independence.

With respect to the second challenge, it is well-known that Latin America has lagged behind other regions of the world like East Asia in generating sustained growth in per capita income. The objective of economic policy in the region should be to achieve growth rates like the 6 percent attained last year over the long term. Robust growth of this magnitude is needed to generate large reductions in poverty and gains in living standards. Chile, which achieved per capita income growth of nearly 5 percent during the 1990s, cut poverty in half during the same period.

Achieving higher rates of economic growth requires countries to improve the environment for business and innovation. This means strengthening financial sectors and expanding access to financing for the private sector, especially for small businesses. It means eliminating distortions in the labor market that lead to high levels of informal employment. It means investing in education and productive infrastructure so that society has the basic building blocks for raising productivity growth. It means opening markets and lowering trade barriers to take full advantage of the opportunities for export-led growth. It means encouraging entrepreneurship, improving the investment climate, deregulating, and fighting corruption so that there are the right incentives for starting and expanding businesses. The average time it takes to start a business in Latin America (70 days) is higher than in any other region of the world. Finally, it means harnessing the full potential of remittance transfers by reducing the cost of sending remittances and bringing these funds into the formal banking sector to expand the options for savings and investment.

U.S. Economic and Financial Engagement

The Bush Administration is committed to building upon the achievements to date and advancing a comprehensive agenda aimed for raising economic growth and living standards in the region.

The Bush Administration is committed to an ambitious trade agenda in the region. The United States has concluded or is in the process of concluding numerous free trade agreements (FTAs) with Latin American countries. These include the U.S.-Chile FTA, the Dominican Republic-Central American Free Trade Agreement (DR-CAFTA), as well as our ongoing negotiations with Panama and the Andean region. These FTAs and NAFTA will cover 90 percent of U.S. trade in this hemisphere. In addition to promoting trade, these FTAs promote the rule of law, regulatory transparency, and regional integration. The United States is continuing efforts to conclude a Free Trade Area of the Americas (FTAA) that would encompass all countries in the hemisphere in an integrated market.

Increased trade is critical to long-run economic growth in the region. The importance is evident in the role that trade has played as a driver of economic growth during the current economic recovery. Exports grew 24 percent last year. The growth is not merely a price phenomenon-- export volumes rose 11 percent last year. It is also not confined to commodity exports; to take one example, Brazil's exports of manufactured and semi-manufactured products have grown nearly 30% over the last year. This export growth has lead to the second straight year in which Latin America has run a current account surplus; in 2003, the region ran its first current account surplus in 35 years.

We have actively used multilateral fora to advance creative initiatives for increasing economic growth and creating jobs. At last year's Special Summit of the Americas, President Bush reached agreement with other leaders in the hemisphere on actions to halve the cost of sending remittances in the region, triple the amount of credit to small businesses generated by the programs of the Inter-American Development

Bank, and significantly reduce the time and cost of starting new businesses. At this year's Summit, we are working to develop additional initiatives to advance economic opportunity for the people of the region. One area of particular importance is encouraging more productive public and private investment in infrastructure.

The Bush Administration has made improving the effectiveness of the multilateral development banks a global priority. We will continue our efforts to work with the 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. Success in this effort is certainly important for promoting development in Latin America.

We have also ramped up our bilateral dialogues with key economies and sub-regional groupings of countries within Latin America. Through the U.S.-Mexico Partnership for Prosperity launched in 2001, we worked with our Mexican counterparts to develop a secondary mortgage market in Mexico and create the conditions for the halving of remittance transfer costs that we have seen over the past several years. In the U.S.-Brazil Group for Growth, we have shared experiences on policies like small business regulation, which has influenced the Lula Administration's approach to reforms in this area. We have reached out to smaller countries through sub-regional meetings by Secretary Snow with finance ministers of the Central American countries and the Andean countries. Most recently, we launched the Security and Prosperity Partnership of North America with Mexico and Canada, aimed at boosting productivity growth through regulatory cooperation and improving the legitimate flow of people and goods across our common borders.

Finally, we are working with the poorest countries in our hemisphere to create jobs and fight poverty through the new Millennium Challenge Account (MCA). The idea behind the MCA is to assist countries that are pursuing the right policies for promoting economic growth through good governance, promotion of economic freedom, and investments in human capital like health and education. To make sure that MCA assistance makes a difference in raising living standards, proposals for its use must be specific, measurable, and well-targeted. Three countries in Latin America--Bolivia, Honduras, and Nicaragua--are in the process of developing proposals for the use of MCA funds.

Conclusion

To be sure, this is an ambitious agenda. And the challenges for policymakers in the region are large. But I think that Latin America's leaders are ready to rise to this challenge. We have already seen what strong leadership can accomplish--from those like President Lula in Brazil, to President Uribe in Colombia, to President Maduro in Honduras. Good economic policies embraced by these leaders and others helped take the region from crisis to stability. Good policies in the future can translate improved stability into sustained economic growth and poverty reduction.

The countries of the region can count on the Bush Administration to support them in this effort.

Thank you again.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 3, 2005
2005-5-3-17-33-1-15445

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 $79,483 million as of the end of that week, compared to $79,577 million as of the end of the prior week.

I. Official U.S. Reserve Assets *(in US millions)*						
	April 22, 2005			April 29, 2005		
TOTAL	79,577			79,483		
1. Foreign Currency Reserves [1]	Euro	Yen	TOTAL	Euro	Yen	TOTAL
a. Securities	12,056	14,861	26,917	11,941	15,032	26,973
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	11,788	2,987	14,775	11,652	3,022	14,674
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]			15,212			15,184
3. Special Drawing Rights (SDRs) [2]			11,632			11,610
4. Gold Stock [3]			11,041			11,041
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets						
	April 22, 2005			April 29, 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		
	April 22, 2005	April 29, 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.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 4, 2005
JS-2420

Assistant Secretary for Financial Markets Timothy S. Bitsberger May 2005 Quarterly Refunding Statement

We are offering $51.0 billion of notes to refund approximately $39.6 billion of privately held securities and government account holdings maturing or called on May 15, raising approximately $11.4 billion. The securities are:

- A new 3-year note in the amount of $22 billion, maturing May 15, 2008;

- A new 5-year note in the amount of $15 billion, maturing May 15, 2010;

- A new 10-year note in the amount of $14 billion, maturing May 15, 2015.

These securities will be auctioned on a yield basis at 1:00 PM EDT on Tuesday, May 10, Wednesday, May 11, and Thursday, May 12, respectively. All of these auctions will settle on Monday, May 16. The balance of our financing requirements will be met with weekly bills, monthly 2-year and 5-year notes, the June 10-year note reopening, and the July 10-year TIPS and 20-year TIPS reopening. Treasury also is likely to issue cash management bills in early June and July.

Thirty-Year Nominal Issuance

Treasury is considering whether or not to reintroduce regular issuance of a 30-year nominal Treasury bond. A decision on 30-year nominal issuance will be announced at the August 2005 refunding on August 3, 2005.

We will examine if we have the flexibility to issue 30-year bonds while maintaining deep and liquid markets in our other securities and determine if nominal bond issuance is cost effective.

There are two possible outcomes:

- No change in current policy; or
- Semi-annual auctions of a 30-year nominal security beginning in February 2006.

We welcome comments from all market participants on this issue and will respect the confidentiality of any proprietary information received.

New and Revised Data Releases

In November 2004, Treasury announced that we were assessing the data we publish on Treasury auctions and holdings. We received many comments and suggestions on this topic. We have made the following changes to the data listed below:

- ***Investor Class Auction Allotments***

Beginning on May 10, 2005, Treasury will release investor class auction allotment data for the previous month. We anticipate releasing future data at 3:00 PM EST on the 7th business of each month.

Data for both Treasury bill and coupon auctions will be released on the Office of Debt Management's website at the following link:

Treasury previously released only the coupon allotment data in the quarterly Treasury Bulletin table PDO-4.

- ***State and Local Government Series (SLGS)***

By August 2005, Treasury will begin releasing daily SLGS activity and balances, with historical data back to 1999. Data for SLGS new subscriptions, cancelled subscriptions, new issues, summary of redemptions by type, and SLGS balances by maturity range will be released on Bureau of the Public Debt's website at the following link:

- ***Savings Bonds***

Beginning on June 10, 2005, Treasury will release monthly savings bond data for the previous month. We anticipate releasing savings bond data on the 10th calendar day of each month. Data for savings bond sales, redemptions, amounts outstanding, interest payments, and average maturities will be released on Bureau of the Public Debt's website at the following link:

- ***Monthly Statement of the Public Debt***

We have made several formatting changes to the MSPD to make it more user friendly and easier to download. The MSPD can be found on Bureau of the Public Debt's website at the following link:

State and Local Government Series (SLGS) Regulatory Changes

Treasury expects to issue new final rules on State and Local Government Securities by June 30, 2005. On September 30, 2004 Treasury issued a Notice of Proposed Rulemaking (NPRM) regarding the SLGS security program. The proposed rule is designed to curb arbitrage activity that exists largely because of exploitable pricing lags between SLGS and marketable securities. Treasury believes that such trading activity is against the spirit of the SLGS program. This arbitrage activity creates excessive volatility in Treasury cash balances, adversely impacting marketable borrowing in a manner that is costly to federal taxpayers.

Over a 45-day comment period following publication of the NPRM, Treasury received comment letters from market participants concerning the proposed rule. Treasury is carefully considering these comments in crafting the final rule. Treasury believes the final rule will make SLGS securities better resemble other investment opportunities that are available in the market. Treasury believes that the final rule will maintain the simplicity, flexibility, and ease of use of the SLGS program in a fashion that meets its intended purpose of assisting tax-exempt borrowers in complying with IRS arbitrage rebate rules, while eliminating opportunities to arbitrage and exploit the current program.

Please send comments and suggestions on these subjects or others relating to Treasury debt management to

The next quarterly refunding announcement will take place on Wednesday, August 3, 2005.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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May 4, 2005
JS-2421

Report to The Secretary Of The Treasury From The Treasury Borrowing Advisory Committee Of The Bond Market Association
May 3, 2005

Dear Mr. Secretary:

Since the Committee's last meeting in February, the economic expansion has continued at a moderate pace. Real GDP grew at an annualized rate of 3.1% in the first quarter, reflecting continued growth in consumer spending, strong gains in housing, and moderating strength in business investment in equipment and software. The latest economic readings show that domestic demand has softened in the wake of higher energy costs and rising interest rates, although home buying ended Q1 at a near record pace. Notwithstanding the threat from renewed increases in energy prices, financial conditions remain supportive and along with solid profits and income gains, likely will sustain growth this year modestly above trend, on average.

Consumer spending grew by 3.5% in Q1, following an impressive 3.8% growth during 2004. Spending on durable goods stalled due in part to higher energy costs and higher interest rates. The moderation can be seen in recent downbeat earnings reports from large auto manufacturers. Higher energy costs have crimped real income gains and are limiting final demand growth temporarily. While energy costs are likely to remain elevated, gasoline prices have stopped rising for now and oil prices have retreated somewhat.

Record corporate profits have buoyed business confidence after a prolonged period of unusual caution and the effects are evident generally in more entrenched economic expansion and specifically in continued healthy growth in employment. The trend in payroll employment has remained solid, with private sector job gains averaging 160,000 per month over the past half year. While recent monthly gains have been uneven, on balance the pace of hiring has been supportive of a gradual but steady decline in the unemployment rate from 5.4% in December to 5.2% in March. Non-farm payroll growth looks to remain firm in 2005. While jobless claims rose in March, they have receded again and their four-week moving average is well below year ago levels.

Record high oil prices have heightened concern about the potential for an unfavorable mix of slower growth and higher inflation. While underlying economic growth is strong enough to overcome these higher oil prices, the Fed's Beige Book found that, "firms were able to pass at least a portion of cost increases along to their customers," highlighting the upside risks to inflation. Nonetheless, the spillover to underlying inflation has been relatively tame, the core CPI rose at a 2.6% annualized pace in Q1, slightly faster than the 2.3% rate in Q4. The core PCE deflator increased at a 2.2% annualized pace in Q1, bringing the year-over-year change to 1.6%, up from an earlier cyclical low near 1%.

The pass-through of higher energy prices, the decline in the dollar, and gradually

diminishing slack in both labor and product markets hint at a further modest pick up in core inflation. There are increased reports that businesses are successfully passing along higher energy and other raw material prices. And, the decline in the dollar already has resulted in a pick up in import prices excluding food and energy Nonetheless, overall labor costs pressures are rising only slowly and longer-term inflation expectations have been well contained to this point and should remain so as the Fed continues to unwind accommodation.

After rising sharply ahead of the first FOMC tightening in June, 2004, long-term Treasury yields have declined by roughly 25 basis points since this tightening cycle began. As the FOMC has increased its short-term target by 200 basis points, this has led to a substantial flattening of the yield curve. The market is currently pricing in a 100% probability that the FOMC will raise rates by 25 basis points at its June meeting and is pricing in a funds rate of 3.75 % by year end.

First quarter reported operating earnings moderated from Q4 as is typical but have increased nearly 12% from a year ago. With over 80% of the S&P 500 companies having reported Q1 earnings: 80% had met or beaten expectations, while 20% had failed to meet expectations. Operating earnings have thus far surprised to the upside by 4.6% and reflect a quarter of strong earnings results. The original EPS estimate for the S&P 500 in Q1 was for 8.2% year-over-year growth vs. current expected growth of greater than 12% year-over-year. The two main contributing factors were continued strength in the oil market leading to higher Energy Sector earnings and better than expected results from the Financial Sector. After accelerating in Q4, the equity markets have declined year-to-date: the S&P 500 Index has declined approximately 4% and the NASDAQ composite has declined 11%.

The Federal budget performance on a twelve-month rolling basis has been on an improving trend, mainly reflecting both the dissipation of last year's tax cuts and solid income growth. However, ongoing military operations in the Middle East and Afghanistan caused both the CBO and the Bush administration to revise their budget numbers upwards. Still, it seems that a peak in the twelve-month rolling budget deficit is behind us, largely due to expectations of stronger employment and income growth and hence stronger tax receipts. Strong tax receipts in April make it likely that funding needs in Q2 will be less that the issues maturing during the quarter.

Against this economic and financial backdrop, the members of the Committee responded to Treasury's charge. The charge was comprised of four questions. In the initial section, a member presented charts depicting Treasury's public debt portfolio and its characteristics including average maturity of debt, steady state issuance patterns, and rollover risk. This member concluded that the Treasury liability portfolio appears to be well balanced and designed to meet Treasury's objectives while providing for flexibility for most fiscal scenarios. A concern was raised that upside surprises in budgetary deficits might force Treasury action. Treasury asked if there are other metrics that should be used to develop debt management policies. One member suggested developing other metrics of the demand function for Treasury securities. Broker/dealer technology advances could support data collection that might be useful to Treasury for better understanding trends on the demand side. Another member pointed out that increased partial duration hedging of mortgage securities has driven greater activity and demand in intermediate maturities. The Committee felt that Treasury would be well served to further study the changing long-term demand function resulting from shifts in pension investing, growth in mortgage and credit markets, as well as foreign participation trends.

In the second part of the charge, Treasury asked the Committee to describe any trends in the Treasury market that it felt are significant to Treasury as an issuer. The presenting member showed a number of slides depicting the strong demand for long duration fixed-income assets from pension funds, another showing the shortening of mortgage durations due to a higher percentage of ARM originations. The member also discussed the maturation of the TIPS market and changes to agency issuance patterns. The member discussed at length the buying patterns of both Chinese and Japanese official institutions and how their behavior had been

modified. The member also discussed the explosive growth of credit derivatives markets noting that derivative contracts in some instances exceeded reference credits. Members discussed the TIPS market and most felt that it was likely to continue to improve in liquidity but concurred with the presenting member that it lacked the liquidity characteristics of nominals. Members also commented on the buying patterns of foreign central banks noting that while their preference for higher yielding fixed-income assets and equities may increase over time, they were unlikely to abruptly shift their preference for Treasuries. A member also discussed the continued strong demand for Treasuries from dealers to affect other fixed income and derivative transactions. In general, members felt that there were not apparent threatening trends afoot which might undermine demand for Treasuries.

In the third part of the charge, Treasury asked whether or not the Committee felt it should consider reintroducing 30-year bond issuance. Treasury presented a number of slides enunciating its belief that achieving the lowest cost of borrowing over time requires issuance diversification. Treasury stated a number of considerations it makes when deciding upon the maturity and amount of public borrowings, among them: optimal levels of diversification, the balance between liquid bond and short-dated issuance, effects on portfolio characteristics, issuance sizes, borrowing costs and refunding needs. Slides followed that showed the percentage of debt maturing in the next thirty-six months, distribution of marketable debt outstanding by security, and average maturities . Further, Treasury depicted several paths for the average maturity of outstandings with and without the reintroduction of 30-year bonds. Most Committee members felt that Treasury should reconsider 30-year bond issuance given a number of factors. Most members felt that given the decline in the average maturity of debt and the likelihood that it will decline further in coming years, a reintroduction would give the Treasury greater flexibility with a modest associated cost. Additionally, reintroducing 30-year bonds would serve to mitigate rollover risk given large maturities in coming years. Other members stated that given the market's familiarity with 30-year bonds, there would be little, if any, disruption and that the supply would be easily absorbed given current global and local demand dynamics. However, most members felt it important that Treasury clearly communicate its reasoning for issuance pattern changes in the context of its stated long-term objectives of achieving lowest-cost borrowing over time. Members also advised against limiting discussions of issuance changes to the 30-year bond in isolation, but rather urged Treasury to consider the full myriad of longer duration financing alternatives.

In the next section of the charge, the Committee considered the composition of marketable financing for the April-June quarter to refund $39.6 billion of privately held notes and bonds maturing May 16, 2005 as well as the composition of Treasury marketable financing for the remainder of the April-June quarter and the July-September quarter. To refund $39.6 billion of privately held notes and bonds maturing May 16, 2005, the Committee recommended a $22 billion 3-year note maturing May 15, 2008, a $15 billion 5-year note due May 15, 2010 and a $14 billion 10-year note due May 15, 2015. For the remainder of the quarter, the Committee recommended a $24 billion 2-year note issued in May, and $24 billion 2-year issued in June, a $15 billion 5-year note issued in June and $9 billion reopening of the 10-year note in June. The Committee also recommended a $20 billion 12-day cash management bill issued June 3, 2005 and maturing June 15, 2005. For the July-September quarter, the Committee recommended financing as contained in the attached table. 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 August followed by a $9 billion reopening of that 10-year note in September. The Committee further recommended a $10 billion 10-year TIPS for issuance in July as well as an $8 billion second re-opening of the 20-year TIPS in July.

http://www.treas.gov/press/releases/js

Respectfully submitted,

Ian G. Banwell
Chairman

Thomas G. Maheras
Vice Chairman

Attachments (2)

\- 30 -

REPORTS

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	24.00	18.00	16.00	59.52	-1.52
	4/7	4/11	4/14	10.00	17.00	15.00	59.39	-17.39
	4/14	4/18	4/21	8.00	16.00	14.00	60.90	-22.90
	4/21	4/25	4/28	8.00	16.00	14.00	55.02	-17.02
	4/28	5/2	5/5	8.00	15.00	13.00	63.00	-27.00
	5/5	5/9	5/12	*16.00*	*15.00*	*13.00*	*49.00*	*-5.00*
	5/12	5/16	5/19	*16.00*	*17.00*	*15.00*	*45.00*	*3.00*
	5/19	5/23	5/26	*16.00*	*17.00*	*15.00*	*46.00*	*2.00*
	5/26	5/31	6/2	*16.00*	*19.00*	*17.00*	*46.00*	*6.00*
	6/2	6/6	6/9	*16.00*	*19.00*	*17.00*	*54.00*	*-2.00*
	6/9	6/13	6/16	*14.00*	*19.00*	*17.00*	*53.00*	*-3.00*
	6/16	6/20	6/23	*14.00*	*16.00*	*16.00*	*53.00*	*-7.00*
	6/23	6/27	6/30	*14.00*	*16.00*	*16.00*	*52.00*	*-6.00*
					598.00		695.82	-97.82
CASH MANAGEMENT BILLS								
14-DAY BILL	3/28 Matures 4/15	3/30	4/1		25.00		25.00	0.00
8-DAY BILL	4/4 Matures 4/15	4/6	4/7		15.00		15.00	0.00
4-DAY BILL	4/11 Matures 4/18	4/13	4/14		7.00		7.00	0.00
12-DAY BILL	6/1 Matures 6/15	6/2	6/3		*20.00*		*20.00*	*0.00*
								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		9.00	-1.00		9.00
5-Year TIPS (R)	4/21	4/26	4/29		9.00	-3.00		9.00
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*			
5-Year Note	5/4	5/11	5/16		*15.00*			
10-Year Note	5/4	5/12	5/16		*14.00*		*39.60*	*11.40*
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*
					180.00		113.53	66.46

Estimates are italicized

NET CASH RAISED THIS QUARTER: -31.36

R = Reopening

US TREASURY FINANCING SCHEDULE FOR 3rd 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	6/30	7/5	7/7	*16.00*	*16.00*	*16.00*	*51.00*	*-3.00*
	7/7	7/11	7/14	*20.00*	*16.00*	*16.00*	*47.00*	*5.00*
	7/14	7/18	7/21	*20.00*	*16.00*	*16.00*	*46.00*	*6.00*
	7/7	7/25	7/28	*20.00*	*16.00*	*16.00*	*46.00*	*6.00*
	7/28	8/1	8/4	*20.00*	*16.00*	*16.00*	*46.00*	*6.00*
	7/7	8/8	8/11	*22.00*	*17.00*	*16.00*	*50.00*	*5.00*
	8/11	8/15	8/18	*22.00*	*17.00*	*16.00*	*52.00*	*3.00*
	7/7	8/22	8/25	*22.00*	*17.00*	*16.00*	*53.00*	*2.00*
	8/25	8/29	9/1	*18.00*	*17.00*	*16.00*	*55.00*	*-4.00*
	7/7	9/5	9/8	*18.00*	*17.00*	*16.00*	*57.00*	*-6.00*
	9/8	9/12	9/15	*10.00*	*16.00*	*15.00*	*57.00*	*-16.00*
	7/7	9/19	9/22	*10.00*	*16.00*	*15.00*	*56.00*	*-15.00*
	9/22	9/26	9/29	*16.00*	*16.00*	*15.00*	*51.00*	*-4.00*
					652.00		667.00	-15.00
CASH MANAGEMENT BILLS								
9-DAY BILL	7/1 Matures 7/15	7/5	7/6		*25.00*		*25.00*	*0.00*
14-DAY BILL	8/26 Matures 9/15	8/31	9/1		*30.00*		*30.00*	*0.00*
8-DAY BILL	9/2 Matures 9/15	9/7	9/15		*12.00*		*12.00*	*0.00*
								0.00
COUPONS						CHANGE IN SIZE		
5-Year Note	7/11	7/13	7/15		*15.00*			*15.00*
10-Year TIPS (R)	7/11	7/14	7/15		*10.00*			*10.00*
20-Year TIPS (R)	7/21	7/26	7/29		*8.00*			*8.00*
2-Year Note	7/25	7/27	8/1		*24.00*		*24.13*	*-0.13*
3-Year Note	8/3	8/9	8/15		*22.00*			
5-Year Note	8/3	8/10	8/15		*15.00*			
10-Year Note	8/3	8/11	8/15		*14.00*		*18.55*	*32.45*
2-Year Note	8/22	8/24	8/29		*24.00*		*23.17*	*0.83*
5-year Note	9/1	9/7	9/15		*15.00*			*15.00*
10-Year Note (R)	9/1	9/8	9/15		*9.00*			*9.00*
2-Year Note	9/26	9/28	9/30		*24.00*		*24.95*	*-0.95*
					180.00		90.79	89.20

Estimates are italicized

NET CASH RAISED THIS QUARTER: 74.20

R = Reopening

FROM THE OFFICE OF PUBLIC AFFAIRS

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May 4, 2005
JS-2422

Minutes Of The Meeting Of The Treasury Borrowing Advisory Committee Of The Bond Market Association May 3, 2005

May 3, 2005

The Committee convened in closed session at the Hay-Adams Hotel at 3 p.m. All members of the Committee were present. Assistant Secretary for Financial Markets Timothy Bitsberger welcomed the Committee and gave them the charge.

The Committee addressed the first question in the Committee charge (attached) on what characteristics of Treasury's liability portfolio are most salient, including the average maturity of debt, steady state issuance, and rollover. A Committee member presented a series of charts on this topic (attached) showing that current issuance patterns lead to a growing proportion of TIPS and 5-year notes in the portfolio and that the percentage of debt maturing in 3 years or less was expected to remain stable at around 60 percent.

The Committee member noted that rollover risk did not appear high compared to the last 25 years but, absent changes in coupon sizes, bill issuance would need to increase markedly in 2008. The member observed that Treasury may need to decide if more long-term issuance was warranted. The Committee member indicated that under the central forecast, there was no need for strategic changes until bills begin to become a sizable portion of issuance in 2008. However, noting that the market's consensus forecast was biased toward a pessimistic scenario, the member observed that there may be a need to make a decision to change financing sooner, perhaps in 2007 or even 2006. The member suggested that the nature of Treasury's rollover risk was related to refinancing at less attractive terms, as opposed to not having market access.

The Committee member briefly reviewed Treasury's debt management efforts to meet its objective of lowest cost borrowing over time by issuing debt in a regular and predictable pattern, engaging with the market in transparent fashion, and not attempting to time markets. The Committee member concluded that Treasury's portfolio appears to be well balanced, meeting Treasury's objectives and providing flexibility for most possible financing outcomes. The Committee member did note that there was an asymmetric risk profile, noting that higher unexpected borrowing needs would force a change in issuance before lower borrowing needs would.

Continuing the discussion on overall demand for Treasuries, the Committee member noted that the yield curve has flattened recently, largely driven by anecdotal stories of pension fund demand and speculative accounts trading on those anecdotes. The Committee member questioned whether the demand for long-term issuance was temporal or persistent, and cautioned about reacting to short-term changes in the market. Noting that the liquidity for 30-year futures contracts was still low relative to the intermediate sector, the member suggested that sustainable long term demand was not there yet.

The Committee member also noted that demand for Treasuries is being driven by

developments in other sectors of the fixed income universe, including the mortgage market. One member stated that adjustable rate mortgages (ARM) are currently 36 percent of new origination, creating significantly more hedging demand in the intermediate sector of the Treasury curve.

Turning to foreign demand, one Committee member noted that foreign participation in primary and secondary markets can be unpredictable and that Treasury should take a longer-term view towards foreign demand -- not a one or two year perspective but a decade long view. The member noted that foreign participation will change over time but that Treasury should not change its policy based on high concentrations of its largest three or four foreign buyers.

One Committee member recommended efforts to improve collection of data on foreign participation in the primary and secondary markets and analysis of long-term trends in foreign demand. The Committee member also noted that traditional metrics of auction performance, the bid/cover ratio and market tail, are not very helpful in explaining auction outcomes relative to issue size. In response to the observation on the quality of metrics, one member suggested that the Treasury should consider conducting annual surveys to ascertain the holders of Treasuries. The member thought this would provide a better measure of sources of demand for Treasuries.

Next the Committee turned to the second question of whether there are any market trends of significance to Treasury as an issuer. A Committee member presented a series of charts on this topic (attached). The Committee member noted several trends – an imbalance between long duration supply and demand, foreign demand for Treasury debt, and growth of the credit derivatives market.

Regarding long-duration supply and demand, the Committee member noted that pension fund dynamics in the face of pending reform argue for a potential shift in asset-liability management which could increase demand for long-term securities. Demand for long-term assets has out-paced demand for intermediate term assets but that much of this demand has been speculative in nature as hedge funds and speculative accounts have tried to get ahead of the curve on pension reform.

The Committee member noted that some recent figures suggest that pension plans are currently under-funded by $450 billion and that if pension reforms pass there will likely be greater demand for long-term assets. However, another member noted that the process for introduction of pension reforms is expected to be a seven-year process and that there is significant time for Treasury to assess the market before bringing a long-term instrument.

The presenting Committee member noted a flattening of the 10s-30s curve since the Labor Department released a proposal for reform of defined benefit pension funding rules. The Committee member also noted that the increase in ARM origination has shortened the duration of mortgage assets and agency outstanding securities, further decreasing longer-duration supply. While increased issuance of long-dated TIPS was noted, the Committee member observed that the TIPS market remains illiquid relative to the nominal Treasury market and was not seen as a viable alternative for long-dated nominal securities until the TIPS market matured further. The member stated that high levels of investor concentration in the TIPS market posed risks of substantial dislocations should changes in investment strategy occur.

The Committee member then presented a chart assessing the possible borrowing costs of using a duration weighted combination of 2- and 30-year bonds in place of 5-year issuance. On a historical basis, it was noted that such a strategy would have reduced interest costs in recent years, but the current attractiveness of such a strategy is small.

Turning to foreign participation in Treasury auctions, the Committee member noted that changes in China's exchange rate management could reduce China and other Asian official purchases of Treasuries. The Committee member suggested that reduced official purchases would exert upward pressure on Treasury rates which

could be magnified by dollar weakness, increasing Treasury's borrowing costs. Despite these potential concerns, the Committee member noted that overall foreign purchases remain robust.

Finally, the Committee member noted that trading volume and notional outstanding in credit derivative markets had doubled over the last two years. The Committee member noted that in the context of a slowing economy and rising interest rates it was possible that credit quality could deteriorate in the coming quarters. The Committee member noted it was difficult to assess whether credit derivative markets would function well if faced with a major credit event.

Next, Assistant Secretary Bitsberger turned to the third question of the charge: whether Treasury should consider the reintroduction of a 30-year nominal bond. Assistant Secretary Bitsberger presented a series of charts on this topic. Assistant Secretary Bitsberger stated that Treasury's primary objective of lowest cost financing over time requires issuance diversification. Such diversification widens Treasury's investor base, provides flexibility in financing, lowers operational and event risk and facilitates efficient cash management.

Next Assistant Secretary Bitsberger discussed questions that Treasury would consider regarding possible long-dated issuance. The questions were what is the optimal level of diversification, can bond issuance be undertaken within Treasury's commitment to a short-dated bias and do future financing needs and market conditions provide a rationale for bond reintroduction.

Assistant Secretary Bitsberger then presented a chart showing the impact of bond issuance on the percentage of debt maturing in upcoming years, the consequences of bond issuance on the distribution of debt outstanding by security, an average maturity chart with and without hypothetical bond issuance, an illustration of the implications of bond issuance on average changes in auction sizes, and an interest cost comparison between a portfolio with and without bonds.

One Committee member led off the discussion noting that based on the presentation he felt better about the average maturity of Treasury's portfolio including bonds. He noted that Treasury had issued bonds before and that Treasury presently is one of the few in the G-7 that does not issue a 30-year instrument. The member also expressed the view that additional Treasury supply in the sector could facilitate the work of the Federal Reserve.

Another Committee member noted the flattening of the yield curve suggested long-dated issuance made sense. However, a third Committee member observed that the chart in the Committee's presentation on assessing the possible borrowing costs of using a duration weighted combination of 2- and 30-year bonds in place of 5-year issuance suggested that the time for Treasury to have issued 30-years was several years ago, not now. This member queried what had changed since 2001 or even two years ago to cause Treasury to reconsider long-dated issuance. The member observed that the yield curve had been extremely flat when Treasury had discontinued the bond. He also observed the recent strength in tax receipts and questioned as to whether it made sense for Treasury to contemplate reintroduction when deficits appeared to have peaked.

Another member noted that Treasury needed to take a long-term perspective when making decisions and emphasized the importance of not reacting to short-term trends. In response, Assistant Secretary Bitsberger noted that Treasury was assessing possible structural changes related to pension reform.

One Committee member noted that pension demand had been identified by the Committee before as a reason to maintain 30-year issuance but that Treasury had argued that such demand could be met by the swaps market.

Another Committee member observed that given the expectation of continuing budget deficits it made sense for Treasury to increase issuance further out the curve to reduce risk. However, this member questioned whether increased 5- and 10-year issuance might be preferable to resumed 30-year issuance. This member

noted greater liquidity in these maturity points as well as greater futures activity in the intermediate portion of the curve as illustrated in the Committee's presentation on market trends. The member observed that a small program, of say $10 billion in semi-annual auctions of 30-year securities, could prove insufficient to revive liquidity in the long-end of the Treasury curve.

Assistant Secretary Bitsberger noted for the Committee that the two options Treasury was contemplating were either no reintroduction or semi-annual issuance of $20-$30 billion beginning in February. One Committee member observed that while issuance of $20-$30 billion would entail little loss of flexibility for Treasury that perhaps this level of issuance did not go far enough in terms of increasing average maturity.

Assistant Secretary Bitsberger asked whether Treasury's consideration of reintroduction of the 30-year was consistent with Treasury's policy of regular and predictable issuance. One Committee member observed that Treasury was unlikely to face buyback pressures in the medium-term. Another member felt it was important that if Treasury was to reintroduce the 30-year that it explain clearly why reintroduction made sense. This member stated that an abrupt change in policy would reflect poorly on Treasury's credibility and that Treasury should take time to consider reintroduction. This member also echoed the observation of other members that a modest benchmark 30-year did not dramatically impact average maturity.

This comment prompted several Committee members to question if Treasury sought to change the average maturity of its debt whether the 30-year was the best way to achieve that. The Chair reminded members that the charge specifically asked the Committee for advice about a nominal 30-year bond.

Assistant Secretary Bitsberger noted that Treasury had purposefully elected to talk about 30-year securities so as to put some parameters on the discussion. A Committee member noted that given budget deficits, Treasury should not let the average maturity of its debt fall further and should increase the duration of its issuance, which might include increasing issuance in coupons as well as reintroduction of the 30-year. Another Committee member observed that focusing on the 30-year sector as opposed to discussing possible 20-year or 50-year issuance made sense given that the 30-year had been a prior issuance point and that there remained a futures contract for the instrument.

Finally, the Committee discussed its borrowing recommendations for the May refunding and the remaining financing for this quarter as well as the July-September quarter. Charts containing the Committee's recommendations are attached.

The meeting adjourned at 4:42 p.m.

The Committee reconvened at the Hay-Adams Hotel at 6:45p.m. All members of the Committee were present. The Chairman presented the Committee report to Assistant Secretary Bitsberger. A brief discussion followed the Chairman's presentation but did not raise significant questions regarding the report's content.

The meeting adjourned at 7:00 p.m.

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Jeff Huther
Director
Office of Debt Management
May 3, 2005

Certified by:

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Ian Banwell, Chairman
Treasury Borrowing Advisory Committee

of The Bond Market Association
May 3, 2005

Attachments:

Treasury Borrowing Advisory Committee Quarterly Meeting - Committee Charge – May 3, 2005

Treasury's Public Debt Portfolio

Please discuss the characteristics of Treasury liability portfolio including average maturity of debt, steady state issuance, and rollover. Do these metrics adequately capture Treasury's policy concerns? Are there other metrics that we should be using to develop debt management policies?

Demand for Treasuries

Please describe any trends in the Treasury market that you believe are significant to Treasury as an issuer.

Nominal Long-Dated Debt

Should Treasury consider reintroducing regular 30-year bond issuance?

Financing this Quarter

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

- The composition of Treasury notes to refund approximately $40 billion of privately held notes and bonds maturing on May 15, 2005.
- The composition of Treasury marketable financing for the remainder of the April– June quarter, including cash management bills.
- The composition of Treasury marketable financing for the July -- September quarter.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 3, 2005
JS-2425

Remarks of Greg Zerzan, Acting Assistant Secretary for Financial Institutions Before the Federal Home Loan Bank Directors Conference Washington, DC

Thank you very much for inviting me to speak to you today. It is a privilege to appear before an audience of men and women dedicated to ensuring Americans have access to financial services. Of particular importance is the role that your institutions play in increasing homeownership opportunities by ensuring that mortgage credit and other programs are available for this purpose.

Increasing homeownership is near and dear to the heart of the President. Under the President's leadership a record number of Americans have come to own their own homes. In fact, over 69 percent of Americans have now realized the American dream of homeownership: that's over 73 million Americans, the most in our nation's history.

The President has also set a goal to increase the number of minority homeowners by 5.5 million families by the end of the decade, and through his homeownership challenge, he has called on the private sector to help in this effort. More than two dozen companies and organizations have made commitments to increase minority homeownership - including pledges to provide more than $1.1 trillion in mortgage purchases for minority homebuyers this decade. The President's efforts are already showing success: for the first time ever, over 50 percent of minorities have achieved homeownership.

The President and this Administration are committed to homeownership for a number of reasons. It is not simply the fact that the housing industry provides an important source of jobs and growth in our economy, though certainly this is important. It is because there is a societal good associated with homeownership that we must not forget – owning a home is an investment in one's family, one's future, and one's community. The President supports homeownership because he knows that homeowners make good citizens – people who are involved in the civic life where they live.

And it is because of the importance of homeownership that the President has called for reform of the regulation of our nation's housing government sponsored enterprises.

A little more than a year ago I appeared before many of you in this room to discuss the Administration's proposal for GSE reform. At that time, I told you that certain powers were so essential to any competent regulatory scheme that any attempt at reform would be incomplete without them. These powers included the ability of a regulator to set minimum and risk-based capital levels; the power to review and approve all business activities of a GSE, on both a prospective and on-going basis; and the power to place an entity in receivership, should that prove necessary. One year later it continues to be the case that these are essential to establishing a world-class GSE regulatory framework. Furthermore, since I last appeared before you, much has happened to not only reinforce the need for these critical reforms, but also to make clear that still more is needed.

Questions regarding accounting issues at Fannie Mae and Freddie Mac caused well publicized restatements and significant executive turnover at those companies. Meanwhile, among the Federal Home Loan Banks, increases in interest rate risk and decreased profitability caused credit downgrades for several banks. Also, some banks entered into consent agreements with the Federal Housing Finance Board to spur changes in their corporate governance regimes, capital structure, and other practices and procedures. Though none of these events posed serious threat to the long-term health of the housing finance system, they did once-and-for all abolish any misperception that the housing GSEs could forever continue operating without regard to the normal rules and regulations that apply to America's other financial services participants.

And particularly in the case of Fannie Mae and Freddie Mac, they highlighted the one persistent danger that the housing GSEs do pose to the long term health and vitality of the housing finance systems: the specter of unacceptable systemic risk. The nature of this risk is easily understood; as outlined by Secretary Snow and others, it starts with the fact that the market's mistaken belief that some form of government guarantee exists allows the housing GSEs to borrow at below-market rates. In turn, this creates arbitrage opportunities which take the form, particularly in the case of Fannie Mae and Freddie Mac, of the purchase of mortgages and mortgage related securities. As these assets carry interest rate and pre-payment risk, Fannie and Freddie hedge at least in part through the use of derivatives, almost all of which tend to be concentrated in five or six money center banks.

Adding to this web of concentrated risk is the fact that six out of ten institutions in the banking industry hold as assets GSE debt in excess of 50 percent of their capital. Because of the tremendous size of Fannie and Freddie's mortgage portfolio, the concentrated hedges they hold against them, and the widespread use of GSE debt for capital purposes by America's banks it should be obvious that a financial crisis at one of these entities will produce a ripple effect that could seriously harm the financial system. Unfortunately, allowing unrestrained growth in the GSEs mortgage portfolio only increases this risk.

In order to promote the safety and soundness of the housing finance system as a whole, and to mitigate systemic risk, the Administration has called for limiting the retained portfolios of the housing GSEs. As Secretary Snow has stated, the GSEs' mortgage portfolios should be limited to an amount of mortgage investments that are necessary to carry out their mission to create a liquid secondary market for mortgage backed securities.

Some have objected that holding large portfolios of mortgages does in fact help the GSEs carry out their mission, or are necessary for other reasons. These claims are unfounded. As a recent Federal Reserve study noted, the GSEs' mortgage investment portfolios do not provide any benefit in reducing mortgage interest rates beyond that provided by securitization. Additionally, the market for mortgage related investments is broad and deep; any reduction in demand created by reductions in the GSEs retained portfolio would likely be quickly replaced by private investors. And it is very important to remember that greater diversification of mortgage prepayment risk among a broader pool of investors addresses our fundamental concern by reducing systemic risk.

Giving the new regulator the power to place limits on the size of the GSEs retained mortgage portfolios, according to strict criteria defined in law, is a critical element of reform without which no reform package would be complete.

The Administration looks forward to continuing to work with Chairman Shelby, Chairman Oxley and Congressman Baker on their efforts for reform. Although there is more work to be done, the foundation for meaningful reform exists provided that the key elements outlined by the Administration are incorporated in any final legislative proposal. All of us should look forward to the day when we can stop worrying about the regulation of the GSEs and focus instead on their success in performing their mission of promoting homeownership in America.

It has been my privilege to appear before you today. Thank you again for the work which you do, and for inviting me to visit with you.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 4, 2005
JS-2426

Treasury Designates Charity Funneling Money to Palestinian Islamic Jihad --Action Marks 400th Designation of a Terrorist or Financier—

The U.S. Department of the Treasury today designated the Elehssan Society, including all its branches, as a charitable front for the Palestinian Islamic Jihad (PIJ). A deadly Palestinian terrorist group, PIJ has been named a Foreign Terrorist Organization (FTO) and a Specially Designated Global Terrorist (SDGT) by the U.S. Government and is also named on the European Union's list of terrorist entities.

"Elehssan masquerades as a charity, while actually helping to finance Palestinian Islamic Jihad's acts of terror against the Israeli people and other innocents," said Stuart Levey, the Treasury's Under Secretary for the Office of Terrorism and Financial Intelligence (TFI). "We will not hesitate to act against those who enable murderers, regardless of how they disguise themselves."

Today's action marks the 400th individual or entity designated under Executive Order 13224, President Bush's Order aimed at freezing the assets of terrorists and their support networks.

On February 25, 2005, PIJ, claimed responsibility for a terrorist attack in Tel-Aviv that killed five and wounded over 50. Evidence available to the U.S. Government corroborates that PIJ, based in Damascus, Syria, was implicated in planning the attacks. According to a significant volume of information available to the U.S. Government, PIJ leadership in Damascus, Syria controls all PIJ officials, activists and terrorists in the West Bank and Gaza.

According to a fifty-three count indictment filed in February 2003 in the United States District Court in the Middle District of Florida, beginning in the early 1990s, the Elehssan Society served as the fund-raising arm of PIJ in Gaza and the West Bank, soliciting, collecting and distributing donations. According to the indictment, PIJ and Elehssan's objectives include murder, extortion, money laundering, fraud and misuse of visas.

Elehssan also utilized Internet websites for the solicitation of funds, according to the Federal indictment. These sites featured PIJ claims of responsibility for terrorist acts and material on PIJ leaders, such as PIJ's Secretary General, Ramadan Abdullah Shallah. Shallah has been named a Specially Designated Terrorist by the U.S. Government.

According to a signed declaration filed in open court in the U.S. in October 2000, PIJ runs or supports a number of organizations, including Elehssan. As of 2004, information available to the U.S. indicates that Elehssan Society's leader played a primary role in PIJ's financial council. Notably, he coordinated with PIJ Secretary General Ramadan Shallah on organizational and operational issues.

As of late 2003, Elehssan cooperated with PIJ to distribute funds to the families of PIJ prisoners and deceased members, and was informed by PIJ when entitlements were sent. Information available to the U.S. shows that Elehssan maintains lists of PIJ-associated families who are to receive compensation – including the families of PIJ suicide bombers. For example, details of early 2004 financial transfers from PIJ

entities outside the Palestinian territories to PIJ members and supporters in the West Bank included a payment of $900 to benefit the family of a deceased PIJ operative, who died conducting a suicide attack.

Information available to the U.S. shows that to move money, select PIJ members serve as links between PIJ headquarters and members in the Palestinian territories. PIJ funds were deposited directly into PIJ members' accounts and into PIJ "charitable" accounts, including the Elehssan Society. PIJ funds for the Elehssan Society primarily came from outside the West Bank and Gaza.

In late 2001 and early 2002, the Palestinian Authority closed several offices belonging to PIJ in the Palestinian territories, including Elehssan. Despite this apparent set back, in 2003 PIJ initiated efforts to expand Elehssan's activities, notably making plans to open a branch in Ramallah.

As of 2005, information available to the U.S. Government shows that PIJ continues to fund activities via the Elehssan Society. Notably, in 2005 PIJ funds were provided to Elehssan Bethlehem and in 2004, information shows that PIJ provided funds to Elehssan in Gaza and Lebanon. In mid-2002, Elehssan received hundreds of thousands of dollars from abroad that were deposited into accounts in the West Bank.

In addition to its use as a financial conduit, Elehssan is used by PIJ to recruit for its operational cadre. In early 2003, Elehssan planned to open a youth center to support PIJ activity and conduct PIJ-related recruitment and training. Information available to the U.S. indicates that the absence of a PIJ youth center in that location was regarded as one reason behind a lack of PIJ activity in the area.

Also to support its recruitment efforts, in mid-2002, PIJ provided money to a run a summer camp project in the West Bank. In 2003, a PIJ leader, also identified as a senior official for Elehssan, reportedly said that PIJ summer camps emphasize, "culture, Islam and fun, with a marginal political dimension." Yet according to another source, the aim of at least one PIJ-run summer camp is reportedly the recruitment of suicide bombers.

Today's designation includes the entire Elehssan organization including its headquarters, believed to be in Gaza City, and all its branch offices including in Janin, Ramallah, Tulkaram, Hebron and Bethlehem, as well as in Lebanon.

Identifying Information
Elehssan

AKAs: ELEHSSAN SOCIETY
ELEHSSAN SOCIETY AND BIRR
ELEHSSAN SOCIETY WA BIRR
BIRR AND ELEHSSAN SOCIETY
BIR WA ELEHSSAN SOCIETY
IHSAN CHARITY
JAMI'A AL-AHSAN AL-KHAYRIYYAH
AL-AHSAN CHARITABLE ORGANIZATION
AL-IHSAN CHARITABLE SOCIETY
AL-BIR AND AL-IHSAN ORGANIZATION
AL-BAR AND AL-IHSAN SOCIETIES
AL-BAR AND AL-IHSAN SOCIETY
AL-BIRR WA AL-IHSAN WA AL-NAQA
AL-BIRR WA AL-IHSAN CHARITY ASSOCIATION
THE BENEVOLENT CHARITABLE ORGANIZATION

Addresses: Al-Muzannar St, Al-Nasir area
Gaza City, Gaza (Headquarters)

Jenin
Bethlehem

Ramallah
P.O. Box 398 Hebron
Tulkarm
Lebanon

Elehssan was designated today pursuant to Executive Order 13224 chiefly pursuant to paragraphs (d)(i) and (d)(ii) based on a determination that the organization 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.

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 and more costly and higher-risk means of financing their activities.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 4, 2005
JS-2427

Testimony of Stuart Levey, Under Secretary
Office of Terrorism and Financial Intelligence
U.S. Department of the Treasury
Before the House Financial Services Subcommittee on Oversight and Investigations
and the House International Relations Subcommittee on International Terrorism and Nonproliferation

Chairwoman Kelly and Chairman Royce, Ranking Member Gutierrez, Ranking Member Sherman, and distinguished members of these Subcommittees, thank you for inviting me to testify before you today about the progress the U.S. Government has made in its fight against terrorist financing in the Middle East. Your personal leadership and that of these subcommittees have been vital to our shared work to keep our nation safe and I am grateful for it.

As Under Secretary for the Office of Terrorism and Financial Intelligence, my highest priority is cutting off the flow of support to international terrorist groups. This has been the paramount focus of our office from day one, and we remain as fixated on it today as we were at our formation. Thanks to Congressional support, our office and our interagency colleagues grow stronger, more experienced, and more capable with each passing day.

I would like to take this opportunity to give you a sense of how we are doing. Scientific metrics are simply not available in our line of work. Al Qaida does not release financial statements, and we will never know precisely how much money intended for terrorists never reached their hands due to our efforts. We therefore find ourselves discussing proxies for the ultimate questions: how many donors and facilitators have been captured; how many channels for moving terrorist funds have been designated and blocked; or how many countries are equipped to monitor and interdict illicit financing channels. Each of these benchmarks points to only one aspect of the problem, though, and imperfectly at that. Most revealing, to my mind, is intelligence reporting that – although anecdotal – speaks to the difficulty with which terrorists are raising, moving, and storing money. The information available to us is encouraging. We are seeing terrorist groups avoiding formal financing channels and instead resorting to riskier and more cumbersome conduits like bulk cash smuggling. And, most importantly, we have indications that terrorist groups like al Qaida and HAMAS are feeling the pressure and are hurting for money.

This progress is a direct result of the Bush Administration's unrelenting efforts. As the President said again just last week, we must stay on the offensive in cutting off terrorist funding. The first-rate interagency team has made great strides against terrorist financing, identifying, capturing, prosecuting, or otherwise incapacitating key financial operatives. We are applying pressure on our international partners, particularly in the Middle East, to implement global standards and carry out their own targeted actions.

Of course, we are threatened not only by known financiers but also by those we don't know and those who may join their ranks in the future. A key advantage that we enjoy in the financial arena, however, is that our targets have something to lose. In contrast to terrorist operatives who may be willing to die for their hateful cause, terrorist financiers typically live public lives with all that entails: property, occupation, family, and social position. Being publicly identified as a financier of

terror threatens an end to all of this, lending our actions a real deterrent impact. Our reporting confirms this, indicating that once-willing donors are now thinking twice or balking altogether at sending money to terrorist groups.

We are tracking and disrupting the flow of funds to terror in every area of the globe. Today, however, I would like to focus on the work we are doing in the Middle East. In February, I headed a trip to the Middle East, intended to engage with and deliver a range of messages to leaders in Syria, Jordan, Israel, and the Palestinian Territories.

With respect to Syria, my proposed visit was intended to follow up on demands that we had made to the Syrian Government one year ago when we issued a proposed rule, designating the Commercial Bank of Syria (CBS) as a "primary money laundering concern" pursuant to Section 311 of the USA PATRIOT Act. This designation, premised on financial wrongdoing we observed at that bank including terrorist financing, has had a remarkable impact on an obstructionist regime. The bank represents Syria's gateway to the international financial system and its access to international currencies like the U.S. Dollar. In connection with the proposed rule, Deputy Assistant Secretary Daniel Glaser traveled to Damascus to deliver a series of demands to Syrian authorities, ranging from reform of their banking sector to immediate, effective action to cut the flow of funds and other support across the Syrian border to the Iraqi insurgency. We made clear that Syria would either take effective steps to address our long list of concerns, or we would cut it off from our financial system.

Over the past year, the Syrian Government has sought desperately to avoid finalization of this proposed rule and has taken some steps to address our concerns. At our urging, the Syrian Government joined us in recommending the designation of terrorist financier Sulayman Darwish at the United Nations, and placed his name on a Syrian wanted list. They have also worked to increase the oversight and transparency of their financial sector. In other respects, though, we have been nowhere near satisfied. The Syrian Government has released over $600 million of assets belonging to the Iraqi government to third parties, and thus far refused to return over $250 million of Iraqi assets that remain frozen.

Days before my planned February trip, I met with the Syrian ambassador to the United States and made clear that, above all, even if Syria met some of our requirements, the continued flow of money and personnel from Syria into the hands of terrorists and insurgents in Iraq was absolutely unacceptable. My dissatisfaction with the official Syrian response prompted me to cancel my planned visit. Our office continues its engagement, but we will not be satisfied until all of our requirements are met.

The remainder of the trip occurred as planned and was extremely productive. In Jordan, I met with the Prime Minister and other ministers to discuss regional terrorism and money laundering trends. As a key and valued ally in the war on terror, the Jordanians clearly appreciate the importance of these issues. In my meetings, I stressed the need for the Jordanians to ensure passage of an anti-money laundering law. The Jordanians recognize the importance of such a law in assuring investors of a transparent and secure financial system and they are working aggressively towards its passage. I also repeatedly emphasized to the Jordanians the need for rigorous oversight of their financial institutions to help prevent the type of serious deficiencies that have recently come to light. The Jordanians responded positively and we will continue to work with their government, the Central Bank of Jordan in particular, to assure that this oversight is as robust as it needs to be. Finally, the Jordanians agreed to work with FinCEN Director Bill Fox to create a Financial Intelligence Unit (FIU) in Jordan.

In Israel and in the Palestinian Territories, I met with high level officials to discuss the current status of regional terrorism and terrorist financing. In Israel, I was given an encouraging account of a substantial reduction of funds flowing to HAMAS, particularly from the Gulf region. In general, the mood on both sides is one of cautious optimism, with the political developments in the Palestinian Authority clearing the way for productive dialogue and the beginnings of trust.

In speaking with President Abbas and in several follow-up sessions with Finance Minister Fayyad, I noted serious commitment on their part to cutting off the flow of funds to terrorism, and welcomed the message that responsibility for accountable financial systems begins with the government.

A recurring theme in my meetings and a continual focus of our counter-terrorist financing efforts in the Middle East are charitable organizations. Terrorist groups have long exploited charities for several key reasons:

- The "legitimate" activities of these charities, such as the operation of schools, religious institutions, and hospitals, create fertile recruitment grounds, allowing terrorists to generate support for their causes and to propagate extremist ideologies.
- Charities attract large numbers of unwitting donors along with the witting, thus increasing the amount of money available to terrorists.
- To the extent that these charities provide genuine relief, which nearly all of them do, they benefit from public support and an attendant disinclination by many governments to take enforcement action against them.
- Charitable funds are meant to move in one direction only; accordingly, large purported charitable transfers can move without a corresponding return of value and without arousing suspicion.
- International charities naturally focus their relief efforts on areas of conflict, also prime locations for terrorist networks. Such charities provide excellent cover for the movement of personnel and even military supplies to and from high-risk areas.

Since September 11, the U.S. Government has confronted this problem head on. Our interagency efforts in this arena have been a team effort in every sense of the term. Two notable examples are the designations of the U.S. branches of the Al Haramain Islamic Foundation and the Islamic African Relief Agency (IARA), both al Qaida-linked charities operating in the United States. In February 2004, federal agents executed a search warrant on Al Haramain, pursuant to a joint investigation by IRS-CI, the FBI, and DHS/ICE. Simultaneously, Treasury's OFAC blocked the accounts of the organization pending investigation, freezing the organization's assets in place and ensuring that no money would flow through this group during further investigation.

A similar coordinated Treasury/law enforcement action was taken in October 2004 against the Islamic African Relief Agency (IARA) and its affiliates, including its U.S. alias, the Islamic American Relief Agency. Treasury designated this global network as well as five of its senior officials as Specially Designated Global Terrorists pursuant to E.O. 13224. On the same day, the FBI raided IARA's headquarters in Columbia, Missouri as part of a separate criminal investigation.

Thanks to the work of the State Department, we have persuaded other nations, including Saudi Arabia, to join us in bringing these and other charities to the United Nations Security Council for designation, and to shutter these dangerous organizations in their respective countries.

Persistent investigations by the intelligence and law enforcement communities have illuminated the illicit activities of multiple other charities, both at home and abroad. The Department of Justice and FBI-led Joint Terrorism Task Forces have taken action against several other U.S.-based charities, indicting organizations and their directors. Just last month, the Department of Justice secured the convictions of three brothers linked to the designated Holy Land Foundation on over twenty counts, including material support for HAMAS. These convictions, just the latest in a series of aggressive prosecutions coordinated by the Counterterrorism Section of the Justice Department's Criminal Division, are an enormous victory in the war on terrorism.

Treasury has designated dozens of other charities worldwide as supporters of terrorism. Some have criticized the use of designations against charities. I want to make clear that the designation process entails exhaustive research to ensure it is fair and fully supported by evidence. All judicial challenges to our designations have failed. Indeed, it has been the unanimous opinion of every judge to consider

these claims, including the appellate judges of the District of Columbia and the Seventh Circuits, that Treasury has acted properly and within the law. See Holy Land Foundation for Relief & Development v. Ashcroft, 333 F.3d 156 (D.C. Cir. 2003); Global Relief Foundation, Inc. v. O'Neill, 315 F.3d 748 (7th Cir. 2002). We are grateful to the top-notch team in the Civil Division of the Justice Department for advocating our position in these cases so expertly.

From a different vantage point, we hear the criticism that designations are ineffective, particularly if they are not endorsed by the U.N. or other multilateral bodies. We do seek to enlist international support for our designations as a matter of course, recognizing that multilateral action is exponentially more effective than action by ourselves. At the same time, there are cases where joint action is not possible and in those instances we must and will proceed by ourselves. As the world's financial center, the impact of U.S. sanctions carries tremendous weight in and of itself, and in most cases prevents foreign designated entities from carrying out transactions in U.S. Dollars, the international currency of choice.

But the ramifications of our actions extend even further, as we are seeing private banks in other jurisdictions voluntarily adopting the United States list of designated parties as a screen to protect them against terrorists and criminals, even when not required by law. Indeed, in Kuwait, a delegation from our office watched as a bank demonstrated how it uses Treasury's Office of Foreign Assets Control (OFAC) list to determine whether to complete a transaction. Such practices give wide-ranging effect to our actions, and are a result of sustained engagement.

Designations and law enforcement actions are making an impact and are serving as a valuable deterrent. Anecdotal evidence suggests that prospective donors are avoiding suspicious international charities altogether and are being far more watchful with their donations in general. This is a major success in its own right, as the donor community is best-positioned to demand reform and accountability from charitable organizations. The Treasury Department is doing all we can to encourage the charitable sector to police its own institutions against abuse and to combat it. In a similar vein, Treasury is also working with private sector watchdog groups to promote awareness of terrorist financing issues in the charitable sector.

We are of course cognizant that well-intentioned donors have given money to some of the same charities abused by terrorist organizations. It is painful when funds and services donated with the intention of providing legitimate relief do not reach their intended and needy beneficiaries. But frustration with this situation must be directed at those who have corrupted the charities that have – either through willfulness or willful blindness – been used to support terrorism.

We recognize that enforcement actions have sometimes also cut off sources of relief to communities in need and inadvertently decreased the support of charities and donors that deliver funds to legitimate causes. Our goal is not to deter charitable giving but instead to protect the charitable sector such that donors' generosity is not abused and they feel safe in providing their contributions. Well-meaning donors in the United States are as eager to deliver aid to international populations in need as the disadvantaged are to receive it. This situation is significantly complicated in the Palestinian Territories, where the intermingling of charitable activity, militant political activism, and terrorism has been a defining characteristic of HAMAS and other terrorist groups. There is therefore a particularly urgent need in this region for safe channels of assistance that donors can be assured will not be subverted by terrorists. I have explored this idea with both Palestinian and Israeli officials and I was gratified to find agreement that it is in the interests of all involved. We are currently working with the Palestinian Authority to develop options through which such aid could be provided in a safe and effective manner and I am hopeful that we will be able to do so.

Apart from my recent trip, our office is involved in several other engagements in the Middle East, both multilateral and bilateral.

One of the most promising developments in the region is the emergence of the Middle East North Africa Financial Action Task Force (MENA FATF). A delegation led by my office just returned from the first plenary session of this body, hosted by

Bahrain. Launched in November 2004, this FATF-style regional body of 14 member countries has taken on the charge of finding regional solutions to terrorist financing and money laundering based on the global guidelines set out by FATF. This important first session, attended by full delegations from each member country, was characterized by enthusiasm and optimism for the work which lies ahead of it. Lebanon currently holds the MENA FATF presidency and is leading it adeptly, based on its own progress in building anti-money laundering and counter-terrorist financing architecture at home. Strategies for dealing with the charitable sector made up a key portion of the 4-day conference, both within the working sessions themselves and as part of the 2-day IMF/World Bank seminar series. Kuwait, the UAE, Egypt, and Bahrain all took active leadership roles in the plenary, making presentations on the comprehensive nature of their anti-money laundering and counter-terrorist financing reforms, particularly in the charitable sector. The MENA FATF is addressing more than just the issue of charities. Alternative financing mechanisms such as hawalas and cash couriers are the subjects of three ad hoc working groups which were formed during the first plenary session.

The integration of the Middle East into a body like the MENA FATF serves the important purpose of setting standards and holding countries to those standards. We will continue to offer strong support to these initiatives as we attend these meetings in observer status, and we look forward to the second MENA FATF plenary in September of this year. We welcome the fact that countries are discussing standards and how to police themselves. But this is plainly just the beginning. Many of these countries have not passed their own money laundering and terrorist financing laws; many have not established Financial Intelligence Units (FIUs); many have no control over their informal hawala sectors; and many have failed to implement standards to stop the illicit flow of money through cash couriers. We see a long road ahead, but welcome the multilateral framework through which pressure to implement these standards can be applied.

Our office also recently led a delegation to Kuwait. We learned that Kuwait has taken measures to increase the oversight of its charitable sector. Earlier this year, Kuwait's Ministry of Labor and Social Affairs ordered five charities to remove unlicensed cash boxes which were collecting unregulated funds to evade government controls. Although Kuwait is taking steps in the right direction and we are told that processes are in place to protect charitable giving, Kuwait must do more to ensure that funds and extremist ideologies are not exported overseas in support of terrorist causes. Again, standards and guidelines may be in place, but what matters is what governments actually do with them. We have called upon Kuwait to intensify its battle against terrorist financing and will continue to do so.

Saudi Arabia, too, has worked with us to some extent to address vulnerabilities in its charitable sector. This progress is the result of focused interagency attention and cooperation, Treasury action, and Homeland Security Advisor Frances Townsend's consistent outreach directly to the Saudis on her many trips there. The Saudis have taken proactive steps including the banning transfers of money from charitable accounts abroad. Additional measures include:

- Enhancing customer identification requirements for charitable accounts;
- Restricting charities to a single account with withdrawal access;
- Eliminating cash disbursements from charitable accounts and instead requiring that payments be made by check and deposited into a Saudi bank.

The adoption of these measures has been the subject of much previous testimony. What continues to concern me are the measures which have not yet been taken. The Government of Saudi Arabia announced that it would freeze all international transfers until it had established an oversight commission to regulate its charitable sector. While that would represent a satisfactory short-term solution if actually implemented, it is important that the announced commission take shape. It is particularly important that charities like the International Islamic Relief Organization (IIRO), the World Association of Muslim Youth (WAMY), and the Muslim World League (MWL) – expressly excluded from the commission – become subject to its oversight once it is finalized.

In addition to the export of terrorist funds from Saudi Arabia, we are extremely

concerned with the export of terrorist ideologies that promote war and killing in the name of religion. These distorted ideologies are just as indispensable to terrorists as money, and possibly even more pernicious. We must do all we can to ensure that extremist, violent ideologies are not exported under the cover of religious organizations, charities, or schools.

We have also been advocating and eagerly anticipating the establishment of a Saudi FIU. The interaction of FIUs worldwide form the basis for cooperative action based on suspicious activity reports. When I testified here in August, I informed you that we had not seen progress on this front. And, despite some assurances of progress, Chairman Kelly recently confirmed that there still is no operational FIU in Saudi Arabia. Given the concentration of financial activity in Saudi Arabia and the grim reality of terrorist activity in its own cities, the lack of an FIU must be remedied, and we will continue to press for its establishment.

CONCLUSION

We have made real inroads in combating terrorist financing in the Middle East. Our actions with respect to charities, both targeted and systemic, have made a tangible difference. And, with the establishment of the MENA FATF, the Middle East is now subject to the leading counter-terrorist financing standards in the world. Enormous work remains, however. Perhaps our most important task in the region is ensuring implementation and enforcement. We do not measure success by the number of laws put on the books but by changes made on the ground. Real progress will come in the form of border stops, cash seizures, account blockings, and arrests. The challenges ahead are serious but we remain fully committed to combating terrorist financing in all of its forms wherever it may occur. We look forward to continuing our work with you on these issues, and I would be happy to answer your questions.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 6, 2005
JS-2428

UNITED STATES OF AMERICA
BOBBY J. PITTMAN (Temporary Alternate Governor, Head of Delegation)

It is an honor for me to be here in Istanbul for the 38th Annual Meeting of the Asian Development Bank, and I extend my deepest thanks to our Turkish hosts for their gracious arrangements. I would also like to congratulate and warmly welcome President Kuroda.

Recent Developments in Asian Economy

We meet at a time of great opportunity for East Asia. Growth rates in many East Asian economies are at their highest levels since the '97 crisis. And the number of poor in East Asia has declined at its most rapid pace since 1999. In this light, we believe there is no better time than the present to implement the critical structural reforms that are required to assure that the development record of this region is sustained in the future.

First, I urge countries to take advantage of this period of high growth to reduce their budget deficits, thus freeing up future resources for growth-enhancing investments including infrastructure. Second, it is critical for countries with a record of corruption and uneven application of regulatory burdens to strengthen their investment climate. Third, I note the importance of strengthening the financial sector and capital markets to improve the efficiency of financial intermediation, which has long been a bottleneck to growth and a systemic risk.

Finally, I want to stress the importance of increased exchange rate flexibility for large economies in the region. I want to be clear why we believe this is critical. This is important for the global economy – to ensure prompt and efficient transmission of price signals and to facilitate adjustments to international imbalances. It is also strongly in the interest of the economies themselves. This is because it enhances the ability of monetary authorities to focus on price stability and stable growth. It avoids the buildup of imbalances that can lead to abrupt adjustments.

Many economies in the region, such as Korea and Thailand, have made notable progress in establishing credible monetary policy frameworks with inflation targets and more flexible regimes. Others, such as China, have implemented important reforms to develop more liquid foreign exchange markets and instruments to manage foreign exchange risks. But macroeconomic imbalances in China are rising, as is the risk of another boom/bust cycle that could adversely affect the region. China is ready. It should move to a more flexible regime now.

The ADB has been a leading force in the region to help developing economies address these challenges. We welcome the ADB's critical role, particularly as the region has been coalescing around a core set of economic integration initiatives. We strongly support such regional financial initiatives, especially where there has been an urgent need to further develop and strengthen domestic financial markets – particularly domestic bond markets.

Economic Development Agenda of the United States

Let me now turn to broader, institutional matters. The ADF-9 replenishment agreement reached in May 2004 was a milestone for reform at the Bank. We are encouraged by the prospects for change that would make the ADB a more transparent, responsive and results-oriented institution. It is our job as shareholders to hold the ADB accountable and to set a high standard for achievement. It is our task now to see that this ambitious reform agenda is implemented. I would like to use this opportunity to take a closer look at three critical elements of the Bank's reform agenda: implementation of measurable results; grants; and the effort to fight corruption and increase transparency.

Rigorous Measurable Results

Results measurement needs to be strengthened at all levels if we are to achieve the goals set out in ADF-9. This means establishing new mechanisms and strengthening existing practices. At the institutional level, we fully supported the launch of a new human resources policy in October 2004 and expect, before the end of this year, a new performance management system will be in place that rewards staff for achieving development outcomes. A Results Management Unit has been established to guide implementation of the results measurement agenda, and it is essential it become fully operational as soon as possible.

Unfortunately, detailed and quantified targets are not yet consistently found in all ADB project documents. We want to see higher standards for results measurement adopted at all levels of the Bank. This means quantified, timebound indicators in all projects and programs. We hope President Kuroda and ADB senior management will communicate the importance of this agenda to Bank staff and the broader public.

Increased Grant Assistance

Last year, the Bank agreed to devote 21 percent of ADF-9 assistance for grants in the region's poorest and most-vulnerable countries starting in 2005. We applaud ADB's leadership and foresight on this issue. However, we are concerned that only 2 grant projects amounting to $38 million have been approved to date. This is less than 3 percent of the total grant envelope for ADF-9. We urge the Bank to accelerate efforts to identify and channel financing to grant projects. We should not delay in getting this assistance to the countries that need it most.

Fighting Corruption and Enhancing Transparency

In an environment of scarcity, every dollar lost to waste, fraud and misgovernance is a dollar not invested in poverty reduction and growth. ADB has already adopted some important anticorruption measures, including increased assistance for good governance, implementation of a more open disclosure policy, more corruption risk assessments in project and country papers, and a doubling of the number of procurement audits.

All of these elements are critical, but we believe much more can be done. We would like to see a more proactive and powerful role for ADB's Integrity Division. Whistleblower protections also need to be further strengthened to encourage staff to report allegations of fraud. ADB can establish an important deterrent by publishing the names of debarred firms and individuals and by automatically disqualifying those firms debarred by other financial institutions. At the project level, we would like to see a greater willingness to cancel loans where corruption is detected. We hope ADB will work with other MDBs to develop a set of tough, uniform anticorruption standards.

Responding to the Tsunami

ADB's remarkable response to the Asian Tsunami tragedy has shown the institution at its best. Over $700 million in grants and loans have already been approved for India, Indonesia, Sri Lanka and the Maldives. From the beginning, ADB worked closely with the World Bank, UNDP and other major donors to avoid duplication and

improve aid efficiency.

We hope flexibility and pragmatism will continue to be the hallmark of ADB's tsunami assistance. The challenge now is not lack of funds, but ensuring effective coordination and rapid disbursement of assistance. Recipient countries and donors (including civil society organizations) must focus on measuring the results of reconstruction efforts and ensuring that assistance is used efficiently, transparently and accountably. Participants to ADB's March 18 tsunami conference agreed to develop a Tsunami Results Matrix to monitor results and track funds. We believe this is a critical tool that will demonstrate that real results are being made on the ground to help tsunami victims.

Conclusion

Over the last year, ADB has begun to translate the ideals of the last replenishment into concrete action. However, the proof of whether the ADB has become a better institution will be in the development impact felt on the ground. Results measurement will have become a reality when we can account for every donor dollar in terms of development outcomes achieved in poor countries. The United States will continue to engage closely with the ADB on this reform agenda to see it to successful completion.

Thank you.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 6, 2005
JS-2429

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

Last month, 274,000 jobs were created and unemployment stayed below the average of the last three decades, a low 5.2%, even with a welcome rise in the participation rate. This illustrates President Bush's Jobs and Growth agenda has again produced results for Americans. Altogether, about 3.5 million jobs have been created since May 2003, with roughly 2.2 million in the past 12 months. This is more evidence of the underlying strength and resilience of the American economy.

President Bush is committed to keeping the economy on the path of healthy growth by cutting the deficit in half, enacting an energy policy, and strengthening social security. The President's leadership on economic policy is clearly moving the economy in the right direction.

FROM THE OFFICE OF PUBLIC AFFAIRS

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May 6, 2005
JS-2430

IRS and Treasury Issue Revenue Procedure on Change in Methods for Apportioning Interest Expenses

WASHINGTON, DC – Today the Treasury Department and the IRS issued Revenue Procedure 2005-28, making it easier for certain taxpayers to adopt a simpler method of allocating and apportioning interest expenses in determining their net U.S. and foreign source income for foreign tax credit purposes.

Taxpayers generally may elect to measure assets for purposes of apportioning interest expense between U.S. and foreign sources under the tax book value method or the fair market value method. Temporary and proposed regulations issued in March 2004 provide taxpayers with an elective alternative approach, the alternative tax book value method, which permits a taxpayer to determine the basis of its U.S. and foreign assets for interest allocation purposes without incurring the disparities that may arise under the regular tax book value method.

A taxpayer who has been using the fair market value method must obtain IRS consent to change to a different method. Revenue Procedure 2005-28 provides temporary rules, as suggested in the preamble to the temporary regulations, granting taxpayers automatic consent to change from the fair market value method to the alternative tax book value method. The revenue procedure authorizes taxpayers to switch from the fair market value method to the alternative tax book value method during the first two years in which the alternative tax book value election can be made.

REPORTS

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, §§ 864; 1.861-8T; 1.861-9T)

Rev. Proc. 2005-28

SECTION 1. PURPOSE

This revenue procedure sets forth the administrative procedure under which a taxpayer described in § 3 of this revenue procedure may obtain automatic consent to change from the fair market value method to the alternative tax book value method of valuing assets for purposes of apportioning expenses pursuant to § 1.861-9T(g) of the Temporary Income Tax Regulations. Accordingly, taxpayers that change from the fair market value method to the alternative tax book value method pursuant to this revenue procedure will be treated as expressly authorized by the Commissioner to change methods. This automatic consent procedure applies to changes in apportionment method requested for taxable years beginning on or after March 26, 2004 but before March 26, 2006 and for which a return has not previously been filed.

SECTION 2. BACKGROUND

.01 Section 864(e)(2) of the Internal Revenue Code provides that allocation and apportionment of interest expense is made on the basis of assets rather than on the basis of gross income. For this purpose, §§ 1.861-8T(c)(2) and 1.861-9T(g)(1)(ii) of the temporary regulations permit a taxpayer to elect to compute the value of its assets under either the tax book value method or the fair market value method. A taxpayer using the tax book value method may elect to change to the fair market value method at any time. See Rev. Proc. 2003-37, 2003-1 C.B. 950. However, § 1.861-8T(c)(2) provides that a taxpayer electing to use the fair market value method must continue to use that method unless expressly authorized by the Commissioner to change methods.

.02 On March 26, 2004, the Treasury Department and the Internal Revenue Service (IRS) published temporary regulations in the Federal Register (T.D. 9120; 69 FR 15673). These regulations amended §1.861-9T by adding §1.861-9T(i). Section 1.861-9T(i) provides an alternative method of determining the tax book value of assets (the "alternative tax book value method"). Prior to the issuance of the temporary regulations, a taxpayer could value assets under one of two methods: the fair market value method and the regular tax book value method. The alternative tax book value method set forth in the temporary regulations is a third method which allows a taxpayer to elect to determine the tax book value of its tangible property that is subject to a depreciation deduction under § 168 as though all such property had been depreciated using the straight line method, conventions, and recovery periods of the alternative depreciation system of § 168(g). The alternative tax book value method therefore provides a taxpayer with the option of determining the adjusted bases of both foreign and domestic

assets under one consistent depreciation method and helps minimize basis disparities that may arise under the regular tax book value method. The alternative tax book value method applies solely for purposes of apportioning expenses (including the calculation of the alternative minimum tax foreign tax credit pursuant to § 59(a) of the Code) under the asset method described in § 1.861-9T(g).

.03 Section 1.861-9T(i)(2)(i) generally allows a taxpayer to elect to value its assets using the alternative tax book value method with respect to any taxable year beginning on or after March 26, 2004. However, under § 1.861-8T(c)(2), a taxpayer using the fair market value method must obtain the consent of the Commissioner to change methods, including a change to the alternative tax book value method.

.04 The preamble to the temporary regulations states that the Treasury Department and the IRS intend to issue a revenue procedure to provide temporary rules granting taxpayers automatic consent to change from the fair market value method to the alternative tax book value method. Accordingly, this revenue procedure provides temporary rules for obtaining automatic consent to change from the fair market value method to the alternative tax book value method of valuing assets pursuant to § 1.861-9T(g)(1)(ii). Notwithstanding these temporary rules for obtaining automatic consent, a taxpayer may request, under the regular ruling process, the consent of the Commissioner to change from the fair market value method to the regular tax book value method or the alternative tax book value method. These temporary rules do not affect the ability of taxpayers currently valuing assets under the regular tax book value method to make a change to the alternative tax book value method with respect to any taxable year beginning on or after March 26, 2004.

SECTION 3. SCOPE

.01 This revenue procedure applies to any taxpayer requesting to change from the fair market value method to the alternative tax book value method of asset valuation for a taxable year beginning on or after March 26, 2004 but before March 26, 2006 for which no return has previously been filed.

SECTION 4. APPLICATION

.01 A taxpayer within the scope of this revenue procedure is granted the consent of the Commissioner to change to the alternative tax book value method provided that the other conditions of this § 4 are satisfied.

.02 A corporation described in § 3.01 shall request to change to the alternative tax book value method on a timely filed Form 1118 by selecting that asset valuation method on Part II of Schedule H and attaching to Form 1118 the statement set forth in § 4.04. In the case of such taxpayers electronically filing Form 1118, the statement must be included in the electronic version of Form 1118.

.03 A taxpayer, other than a corporation, described in § 3.01 shall request to change to the alternative tax book value method on a timely filed Form 1116 by attaching to Form 1116 the statement set forth in § 4.04. In the case of such taxpayers electronically filing Form 1116, the statement must be entered into the Election Explanation Record of the electronic version of Form 1040, Form 1041, or other relevant form.

.04 The statement referred to in §§ 4.02 and 4.03 shall provide as follows: "For the immediately preceding tax year, [name of taxpayer] valued assets for expense apportionment purposes using the fair market value method. Pursuant to Rev. Proc.

2005-28, [name of taxpayer] is changing from the fair market value method to the alternative tax book value method of asset valuation. This change to the alternative tax book value method applies prospectively beginning with [name of taxpayer]'s [XXXX] taxable year."

.05 Any taxpayer that changes to the alternative tax book value method under this revenue procedure must maintain all documentation necessary to establish its change in valuation methods and its eligibility for the benefits of this revenue procedure.

SECTION 5. EFFECTIVE DATE

.01 This revenue procedure is effective for requests to change from the fair market value method to the alternative tax book value method for taxable years beginning on or after March 26, 2004 but before March 26, 2006 for which no return has previously been filed.

SECTION 6. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. § 3507) under control number 1545-1944.

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

The collections of information in this revenue procedure are in § 4. They are required to enable the IRS to determine whether the taxpayer is eligible for an automatic change from the fair market value method to the alternative tax book value method. The information will also inform revenue agents as to the years for which the alternative

tax book value method is being adopted. The collections of information are required in order to obtain the benefit of the alternative tax book valuation method. The likely respondents are businesses.

The estimated total annual reporting and/or recordkeeping burden is 100 hours. The estimated annual burden per respondent and/or recordkeeper is an estimated average of .5 hours. The estimated number of respondents and/or recordkeepers is 200. The estimated frequency of response is occasional.

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

SECTION 7. DRAFTING INFORMATION

The principal author of this revenue procedure is Margaret A. Hogan of the Office of Associate Chief Counsel (International). For further information regarding this revenue procedure contact Margaret A. Hogan at (202) 622-3850 (not a toll free call).

FROM THE OFFICE OF PUBLIC AFFAIRS

May 6, 2005
JS-2431

Secretary Snow Visits Hartford, Connecticut on Monday to Discuss Strengthening and Preserving Social Security

U.S. Treasury Secretary John W. Snow will be in Hartford, Connecticut on Monday, May 9 to discuss the President's efforts to strengthen and preserve the U.S. Social Security system.

"To keep the promise of Social Security alive for our children and grandchildren, we need to fix Social Security now once and for all," said Secretary Snow. "We cannot pretend the problem doesn't exist. The fact is, Social Security will go broke when our young workers get ready to retire. Every year we wait the problem becomes worse for our children.

"If we do not act to fix Social Security now, the only solutions will be dramatically higher taxes, massive new borrowing or sudden and severe cuts in Social Security benefits or other government programs.

"The President is committed to saving Social Security and has laid out some basic principles. He wants to preserve benefits for current and near-retirees while saving and strengthening the system for future generations. The President has pledged to work with Congress to find the most effective combination of reforms."

The following event is open to credentialed media with photo identification (credentials must be visible at all times):

Roundtable with Connecticut Business and Industry Association
Remarks
350 Church Street
Hartford, CT
9:00 a.m. EDT
**** Media must RSVP to Nancy Andrews at 860-244-1957**
**** Media must arrive by 8:15 a.m. EDT**
**** A brief media availability will be held immediately following the event**

FROM THE OFFICE OF PUBLIC AFFAIRS

May 4, 2005
JS-2432

Deputy Assistant Secretary Iannicola Helps Launch Unique Public Awareness and Financial Education Campaign with D.C. Students

Treasury's Deputy Assistant Secretary for Financial Education, Dan Iannicola, Jr., today participated in the opening ceremony for the *Stash Your Cash* financial education program at the Kennedy Recreation Center in Washington, D.C. In addition to teaching young people about money in classrooms, the program will use large colorful piggy bank statutes to promote savings in the District of Columbia.

Iannicola addressed volunteers during the launch ceremony and visited with the children painting the large piggy banks, which will be displayed on D.C. sidewalks in May and June. "Having these figures on the street is a fun and imaginative way to emphasize savings," said Iannicola. "Parents can use them as a visible reminder for their children, and for themselves, about the importance of saving for their futures."

Iannicola also commended the classroom portion of the *Stash Your Cash* program. "Learning to save at an early age is an important lesson that will benefit young people their whole lives through," he said. "Whether it is saving for an education, a home or retirement, saving is something that everyone needs to do, but that many don't do. I'm glad to see today's effort to teach this crucial skill to our kids when it can truly change their lives."

Today's *Stash Your Cash* event marks the introduction of the interactive money management lesson in several D.C. middle schools. The purpose of the program is to engage the public and attract attention to the need of teaching students the important principles of saving, spending and sharing. Sponsoring the event were Capital One and the Federal Reserve Bank of Dallas.

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.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 6, 2005
js-2433

Secretary Snow to Announce $2 Billion in New Markets Tax Credit Awards

U.S. Treasury Secretary John W. Snow will join Community Development Financial Institutions Fund Director Arthur A. Garcia next week to announce which organizations were selected to receive the $2 billion available in the 2005 round of New Markets Tax Credits. The ceremony will take place at 10 a.m. EDT on May 11 in the Treasury's Cash Room.

The New Market Tax Credit (NMTC) Program attracts private-sector capital investment into urban and rural low-income areas to help finance community development projects, stimulate economic opportunity and create jobs in the areas that need it most.

The NMTC Program, established by Congress in December of 2000, permits individual and corporate taxpayers to receive a credit against federal income taxes for making qualified equity investments in investment vehicles known as Community Development Entities (CDEs). Substantially all of the taxpayer's investment must in turn be used by the CDE to make qualified investments supporting certain business activities in low-income communities. The organizations receiving tax credit allocations this year were selected through a competitive application and rigorous review process. More information on the NMTC program can be found at www.cdfifund.gov.

Media without Treasury press credentials (including media with White House credentials) planning to attend should contact Frances Anderson in Treasury's Office of Public Affairs at (202) 622-2439 or Frances.Anderson@do.treas.gov by 12 p.m. EDT Tuesday, May 10.

Please be prepared to provide her with the following information: full name, Social Security number and date of birth.

-30-

FROM THE OFFICE OF PUBLIC AFFAIRS

May 9, 2005
js-2434

The Honorable John W. Snow
Prepared Remarks
James Madison University Commencement
Harrisonburg, VA

Thank you so much for having me here on what is one of the most significant days of your lives... and of your parents' lives.

For you, today is about the future, and the enormous possibilities it holds. For those of you entering the world of work, yesterday's employment numbers bode well for you: with 274,000 jobs created in April, and the economy has created 3.5 million new jobs since May of 2003. This is an excellent time to be entering the workforce; job creation is strong.

Your futures are bright, indeed. I love what former New York Mayor Ed Koch once said in a commencement speech: "The fireworks begin today. Each diploma is a lighted match. Each one of you is a fuse."

For your parents, today is also about the future... one without tuition payments.

So congratulations to one and all.

I promise you that the future of my remarks... is a short one. It has been said that the greatest achievement of graduates is sitting through the commencement address, and that's not the challenge I want you to face today.

So I'll simply offer you a few thoughts and then let you get those diplomas that you have worked so very hard for.

I propose to you three things to think about today and in the months ahead as you set out into this wonderful world:

- First, a way of looking at your education and what it means.
- Second, a little bit of advice about living life to its fullest.
- And third, a touch of inter-generational perspective.

In terms of your education... what does it mean, this diploma, these years of classes, papers and exams?

This is very important: ***Education is not the knowledge you gain. It is the ability to learn.***

Your years at JMU have developed your ability to learn, to look hard at questions and have a disciplined mind.

An educated person has a spirit of inquiry... and that is far more important than a body of knowledge.

Because ultimately one must find answers through that spirit of inquiry, self-reliance and self-confidence – the things that lie at the heart of a good liberal arts education.

You're now equipped to enter into the unknown and use your critical mind to determine the best course.

Your education here has exposed you to so many different areas – from music to physics, poetry to psychology – you have by now learned how all facets of this life are somehow connected, and that will help you draw conclusions and make critical decisions.

Take your ability to learn and decide to use it pursuing a ***lifetime of learning.***

As an illustration of that, let me mention Alan Greenspan, the eminent chairman of the Federal Reserve, a man noted for his deep erudition and mastery of financial matters. In talking with Alan some years back, he told me he had gone back to the books, the mathematics books, and he was working hard to master some elements of mathematical theory. He explained that he felt compelled to do so because of the development of the derivatives market, which had taken on far reaching significance in the financial world. Alan explained that derivatives were becoming a bigger and bigger part of what the Federal Reserve System needed to be concerned about. And derivatives -- really sophisticated hedging on risks -- is based on a system of underlying set of mathematical constructs. Now think of that, the Chairman of the Federal Reserve Board, who years ago got a PhD in economics, and one of the leading financial figures in the world, going back to the books. But that is the world we are in, that is the world you are entering, so you can never be satisfied with what you know, but rather must draw strength from what you have learned about how to learn.

Let me put it this way: there's no roadmap for success. But you do have to know how to drive. And it doesn't hurt to know how to change a flat tire once in a while. You've earned your driver's license; you've gassed up the car. It's time to hit the road.

Keep your spirit of inquiry sharp. Learn about each place that you visit, and each person that you meet, each situation that you encounter.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 9, 2005
js-2435

Secretary John W. Snow Prepared Remarks Connecticut Business and Industry Association Hartford, CT

Thank you so much for having me here today; it's great to be in Hartford!

I appreciate the chance to talk with you about strengthening the nation's Social Security system. The President's leadership on this issue is providing our country with a tremendous opportunity to save Social Security for current and near retirees and improve it for younger generations. Conversations like this are an important part of reaching decisions as to what, exactly, should be done.

Before we get into Social Security, I do want to talk about the American economy a little bit. Social Security is such an important part of our economy – and the reform choices that are made in Washington will have such an impact – that I think it's important to start there. Furthermore, the strength of our economy is largely owed to businesses like yours, so I want you to know just how much of a difference your hard work is making.

We've seen amazing economic times in the last few years. Well-timed tax cuts, combined with sound monetary policy set by the Federal Reserve Board, got our economy moving when we needed it most. They gave business and industry the room you needed to grow, and you took over from there. As a result, economic growth was 4.4 percent last year, the strongest in five years.

We have had terrific news on jobs – 23 straight months of job growth. On Friday, the Labor Department announced that 274,000 jobs were created in April. The economy has created a total of 3.5 million new jobs since May 2003. That's great news – the best news – for 3.5 million families.

The President has made clear his commitment to strengthen our economy further. This includes reducing the budget deficit – as well as reforming Social Security and the tax system, reducing the regulatory burden on business, and passing energy legislation. We expect the deficit to total 3.5 percent of GDP this fiscal year. Tight controls on discretionary spending and increased revenue as a result of economic expansion are expected to cut the deficit by more than half, to well under two percent of GDP, by fiscal year 2009.

The Treasury announced last week that we expect to pay down $42 billion in debt in the second quarter of this year, which is very good news and is primarily the result of higher individual tax receipts.

I imagine you also heard that Treasury is considering whether or not to reintroduce regular issuance of a 30-year bond. A decision on 30-year nominal issuance will be announced at the next quarterly refunding on August 3rd. In considering such a change, we will examine if we have the flexibility to issue 30-year bonds while maintaining deep and liquid markets in our other securities, and determine if nominal bond issuance is cost effective.

All of the strong economic indicators, and our ability to pay down debt, point to the fact that reducing the tax burden proved to be a successful economic stimulus. And

when the economy is growing and spending is controlled, we can also reduce our deficit.

But the job of keeping our economy unencumbered is a never-ending one, indeed. From tax cuts to regulations and energy policy, we need to work on it every day, and we need to work on keeping it strong for the future, for the long-term. Reforming our Social Security and tax systems addresses some critical long-term economic issues.

I appreciate the President's leadership on tax reform, and I deeply admire his leadership when it comes to the national discussion on Social Security reform.

The President doesn't believe in burying one's head in the sand... which is essentially what you have to do to ignore the serious nature of the Social Security problem. The Social Security Trustees – for whom I serve as Board Chairman – issued our annual report on the financial health of the programs' trust funds on March 23rd, and the numbers contained in that report leave little doubt that the system is financially unsustainable, and in need of expeditious and lasting change.

The Trustees' report showed that Social Security cash flows peak in 2008 and turn negative in 2017, and the trust fund itself will be exhausted in 2041. The unfunded obligation, that is, the difference between the present values of Social Security inflows (plus the trust fund) and outflows, is $11.1 trillion on a permanent basis, and $4.0 trillion over the next 75 years.

Now, the President doesn't believe that we should make up that shortfall with tax increases. The report showed just how much we would have to raise taxes to achieve long-term balance: the payroll tax rate would have to be raised immediately by 3.5 percentage points to make the system whole on a permanent basis. In other words, the payroll tax would have to be increased by nearly 30 percent.

That kind of tax increase would have significant, negative economic repercussions. Americans would start taking home less pay, and that's bad for countless facets of our economy. I imagine that, as business owners, you appreciate what I'm saying. After all, you would shoulder half of that tax increase – because you pay that tax on all of your employees. For the smallest of employers I fear that much of a tax increase would force you to make terrible choices, from lay-offs to health benefit cuts. And it would make hiring new people even more difficult.

Increasing payroll taxes hurts the economy and it hurts job creation, period. We know this from talking to business leaders like you, and that's why the President is against it.

It is also worth noting that payroll tax increases have been the standard "solution" to Social Security's problems, and they have never solved the problem! Payroll taxes have been raised some 20 times since Social Security was established – and it has failed to make the system solvent.

Tax increases aren't the answer, so the President has encouraged the Congress to propose a variety of ideas that might be, and he has put a number of ideas on the table as well.

Two weeks ago, in his Thursday evening press conference, the President spoke very plainly about the realities of Social Security. Inevitably, workers face a reduction in benefits because the system will go broke in 2041. He suggested a progressive indexing plan to make sure that those who are most in need – low-income workers – will be protected from that reduction in benefits.

The President proposes that, in the future, benefits for low-income workers should grow faster than benefits for people who are better off. By slowing the rate of increase of benefits for wealthier Americans, most of the funding challenges facing Social Security would be solved and the government will make good on this commitment: If you work hard and pay into Social Security your entire life, you will

not retire into poverty.

A variety of other options are available to solve the rest of the solvency problem, and the President will work with Congress on any good-faith proposal that does not raise the payroll tax rate or harm our economy.

When the President took this issue to the country in his State of the Union Address, he said his objective was to engender a broad national dialogue to get people talking about this issue. He wanted Americans to talk about Social Security, and a national conversation has resulted.

People have been talking about the issue from the halls of Congress to the halls of local shopping malls. The President's leadership has drawn critical attention to the problem and is creating movement. Progress, real progress, is being made.

I imagine that you are talking about it with your spouse and family members, your business partners, customers and employees. Those conversations are critical, and I hope our meeting here today can help make them even more lively, more productive.

I know that you understand that if you are 55 or older your Social Security benefits are solid. They will not change. You know that you don't need to change your retirement plan or strategy because of Social Security reform, period.

But now I'll ask: how many of you have children or grandchildren? It's those children and grandchildren, those young workers and future workers, who we need to be worried about. They are the ones for whom we need to fix this system.

The issue of Social Security is really a matter of basic arithmetic, and the threat to Social Security in the near future makes more sense when you look at the simple arithmetic. Social Security has enough money now because for decades we have had more than enough workers paying into the system, supporting the retirees drawing benefits.

In 1950, there were 16 workers to support every beneficiary of Social Security - a very comfortable ratio of those paying in versus those drawing benefits. Today there are only 3.3 workers supporting every beneficiary. By the time today's youngest workers – many of you have children in that age group – turn 65, there will only be two workers supporting each retiree.

Just three years from now, in 2008, the first baby boomers will begin to retire. According to the new Trustees' report, the government will begin to pay out more in Social Security benefits than it collects in payroll taxes in 2017 – that's just 12 years from now. By 2041, when younger workers begin to retire, the system will be bankrupt.

We must make Social Security better for those younger workers.

Raising their payroll taxes won't make it better. What the President would like to see, instead, for future generations is an ability to save some of their payroll taxes, to build a nest egg that belongs to them, not to the government. Something they could pass on to their heirs. A nest egg that would give workers the prospect of a retirement that is far better than the rapidly-weakening promise of Social Security benefits.

Albert Einstein believed, and the President and I agree, that compound interest is one of the most powerful forces in the universe.

With voluntary personal accounts, younger workers would have the chance to learn about their financial choices, build a nest egg and benefit from sound long-term investment in the free market system without disrupting the system of benefits for today's retired beneficiaries.

Former Democratic Congressmen Tim Penny and Charlie Stenholm wrote something very important in a recent op-ed. They said that "opposing personal accounts is not a substitute for offering a positive solution for dealing with the challenges that face Social Security." They went on to say, astutely, that they "believe that if Social Security were being created from scratch today, Americans would want to include a way to help everyone build up a nest egg." The President and I couldn't agree more.

Social Security reform that doesn't raise payroll tax rates, that protects benefits for today's seniors, and that improves the system dramatically for our children and grandchildren can be achieved

We are part of an exciting moment in American history, where a President's courageous leadership has inspired a national discussion and, I'm confident, will lead to historic results. I encourage you to be involved, whether it's talking about the issue with your colleagues, with your children, or writing a letter to your Members of Congress.

Many of you in this room may want to pass your business on to your children or grandchildren. I know you'll want your business to be in top shape, financially, when that time comes.

Let's make sure we do the same with Social Security. If we act now, we can make sure that Social Security, and our economy, are on sound financial footing for our children and grandchildren.

A final issue that I think is of interest to so many businesses in this area is the status of the Treasury Department's study on Terrorism Risk Insurance Act.

The terrorism risk insurance program was 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. As you know, the Act required 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.

Thank you so much for having me here today to talk about the really historic policy efforts that are underway right now. This is an exciting time to be in government, and I'm extremely proud to be helping the President as we seek to achieve a safe and promising financial future for all Americans.

Thanks so much for having me here today.

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FROM THE OFFICE OF PUBLIC AFFAIRS

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May 10, 2005
JS-2436

Treasury and IRS Announce Second Set of Repatriation Guidance Under sec. 965

WASHINGTON, DC -- Today the Treasury Department and IRS announced the second in a series of notices that provide detailed guidance for U.S. companies that elect to repatriate earnings from foreign subsidiaries subject to the temporary reduced tax rate available under the American Jobs Creation Act (AJCA). The notice released today provides guidance to companies on what constitutes a qualifying dividend, the impact of mergers and acquisitions and issues related to the section 78 gross-up.

Internal Revenue Code section 965, enacted as part of the AJCA in October 2004, is a temporary provision that allows a U.S. company to repatriate earnings from its foreign subsidiaries at a reduced effective tax rate provided that specified conditions and restrictions are satisfied. Section 965 provides that a U.S. company may elect, for one taxable year, an 85 percent dividends received deduction for eligible dividends from its foreign subsidiaries, giving it an effective 5.25 percent tax rate on qualifying dividends.

In January 2005, Treasury and IRS issued a notice (Notice 2005-10) that provided guidance to companies on the domestic reinvestment plan requirement under the new provision. The notice specified permitted investments in the United States for which the repatriated funds may be used under this provision. The notice announced today (Notice 2005-38) provides additional guidance on the amount of dividends that qualify for the dividends received deduction. Further, Treasury and the IRS announced their intention to issue a third notice that will address the impact of section 965 on a corporation's computation of its tax liability.

A copy of the regulations and a fact sheet providing additional details are attached.

REPORTS

- N-2005-38
- Final Second Repatriation Fact Sheet

Part III - Administrative, Procedural, and Miscellaneous

Section 965 -- Limitations on dividends received deduction and other guidance

Notice 2005-38

SECTION 1. OVERVIEW

This notice is the second in a series of items of published guidance regarding new section 965 of the Internal Revenue Code (Code). It supplements guidance previously set forth in Notice 2005-10, 2005-6 I.R.B. 1, which primarily addressed requirements regarding a domestic reinvestment plan described in section 965(b)(4). This notice primarily addresses the limitations, described in section 965(b)(1), (2), and (3), on the amount of dividends that a corporation that is a U.S. shareholder of a controlled foreign corporation may treat as eligible for the dividends received deduction under section 965(a) (DRD or section 965(a) DRD), including the effects of certain transactions on such limitations.

The Treasury Department and the Internal Revenue Service (IRS) intend to issue additional guidance concerning section 965 to address certain issues arising with respect to a U.S. corporation's computation of its tax liability, including the availability of foreign tax credits, when section 965 is applied. The Treasury Department and the IRS expect to issue regulations that incorporate the guidance provided in Notice 2005-10, this notice, and any subsequent guidance addressing section 965.

The remainder of this notice is divided into 14 sections. Section 2 provides background with respect to the issues addressed in this notice. Section 3 sets forth general principles that apply in determining the amount of cash dividends received by a U.S. shareholder that is considered extraordinary for purposes of section 965(b)(2). Section 4 sets forth general principles that apply in determining the maximum amount of dividends eligible under section 965(b)(1) to be taken into account under section 965(a). Section 5 addresses the taxable year to which section 965 applies. Section 6 then addresses the effects of certain transactions on the determination of a U.S. shareholder's limitations determined under sections 3 and 4. Section 7 sets forth guidance and principles for determining under section 965(b)(3) the amount of related party indebtedness that reduces the amounts taken into account under section 965(a), including special adjustments made as a result of certain transactions. Section 8 provides guidance regarding the impact of certain transactions on domestic reinvestment plans. Section 9 addresses other issues arising under section 965, including the application of section 78, the expenses disallowed under section 965(d)(2), and the computation of the alternative minimum tax. Section 10 addresses reporting and other administrative requirements. Section 11 sets forth transition rules that apply to certain taxpayers that, prior to the issuance of this notice, either adopted a domestic reinvestment plan or filed a tax return for a taxable year to which section 965 applies. Section 12 describes the effect of this notice on other documents. Section 13 provides the effective date of this notice, and section 14 provides information required under the

Paperwork Reduction Act of 1995. Finally, section 15 provides drafting information.

SECTION 2. BACKGROUND

.01 *Section 965 -- In General*

The American Jobs Creation Act of 2004 (P.L. No. 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 of a controlled foreign corporation (CFC) may elect, for one taxable year, an 85 percent DRD with respect to certain cash dividends it receives from its CFCs.

Section 951(b) defines the term "U.S. shareholder" with respect to any foreign corporation as a U.S. person who owns (within the meaning of section 958(a)), or is considered to own (under the constructive ownership rules 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 965(c)(5)(A) provides that 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. For purposes of this notice, the term "U.S. shareholder" means, unless otherwise indicated, a domestic corporation that, at any time after the beginning of the base period (defined below), is a U.S. shareholder (as defined in section 951(b)) with respect to a CFC and that owns (within the meaning of section 958(a)) stock of such CFC.

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.[1] H.R. Conf. Rep. No. 108-755, at 314-15 (2004). Also for this purpose, a cash dividend includes a cash distribution from a CFC that is excluded from gross income under section 959(a) (regarding distributions of previously taxed income (PTI)) 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 from another CFC in such chain of ownership, but only 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.

Section 965(b) imposes four limitations on the section 965(a) DRD. These limitations are discussed in detail below in paragraphs .02 through .05 of this section.

Section 965(d) and (e) provide special rules that limit the use of foreign tax credits and the deduction of certain expenses to offset the nondeductible portion of section 965(a) dividends, respectively. See section 9.01 of this notice. These rules will be addressed in greater detail in a subsequent notice that the Treasury Department and the IRS expect to issue soon.

Section 965(f) provides that taxpayers may elect the application of section 965

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[1] 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 actually receives cash as part of the liquidation. Section 965(c)(3). A deemed liquidation effectuated through an election under Treas. Reg. §301.7701-3(c), however, does not by itself result in an actual distribution of cash as required under section 965. See H.R. Conf. Rep. No. 108-755, at 315, n. 108 (2004).

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. The election must be made on or before the taxpayer's due date (including extensions) for filing its Federal income tax return. See Notice 2005-10; see also H.R. Conf. Rep. No. 108-755, at 314, n. 107 (2004). The taxable year for which a taxpayer elects to apply section 965 will be referred to in this notice as the "election year."

.02 *Extraordinary Dividends*

Section 965(b)(2) provides that only those cash dividends (within the meaning of section 965(a)) received from CFCs during the U.S. shareholder's election year that are considered "extraordinary" are eligible for the section 965(a) DRD. Cash dividends received by the U.S. shareholder during the election year are considered extraordinary only to the extent such dividends exceed the annual average for the base period years of the following items reported on the U.S. shareholder's tax return as filed (including any amended returns that were filed on or before June 30, 2003): (1) dividends received during each base period year by such shareholder from CFCs[2]; (2) amounts includible in such shareholder's gross income for each base period year under section 951(a)(1)(B) (regarding investments in United States property under section 956) with respect to CFCs; and (3) amounts that would have been included for each base period

[2] For this purpose, both cash and non-cash dividends received are taken into account. See section 965(b)(2)(B)(i).

year but for section 959(a) with respect to CFCs.[3]

The term "base period" in this notice means the five most recent taxable years of the U.S. shareholder that end on or before June 30, 2003. The term "base period inclusion" in this notice means any amount described in (1), (2), or (3) of the preceding paragraph, for any of the U.S. shareholder's taxable years in the base period. Under section 965(c)(2)(A), the term "base period years" generally includes only three taxable years in the U.S. shareholder's base period, determined by disregarding the years in the base period for which the base period inclusions are the highest and the lowest. However, if the taxpayer has fewer than five taxable years ending on or before June 30, 2003, then all taxable years ending on or before that date are considered base period years. The average of the U.S. shareholder's base period inclusions for its base period years is referred to in this notice as the "base period amount."

Section 965(c)(2)(C)(i) sets forth a general rule applicable to companies entering and exiting corporate groups, which provides that for purposes of determining the base period inclusions (and ultimately the base period amount), rules similar to the rules of section 41(f)(3)(A) and (B) apply. Section 41 generally provides for an incremental credit for qualified research activities, but only to the extent that current year research expenditures exceed the base amount for that year. For purposes of section 41, the base amount is computed by multiplying a measure of the taxpayer's qualified research

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[3] For this purpose, distributions of PTI for any base period year do not include distributions excluded from gross income by reason of an amount described in section 965(b)(2)(B)(ii) (relating to investments in United States property) with respect to a prior taxable year.

expenses during a specified historical period by its average annual gross receipts for the four years immediately preceding the credit year. Section 41(f)(3)(A) and (B) generally provide that, as a result of certain acquisitions and dispositions, a taxpayer may increase or decrease the amount of its qualified research expenses and gross receipts to the extent that such amounts are attributable to the acquired or disposed of portion of a trade or business of the taxpayer.

In addition to the general references to section 41(f)(3)(A) and (B), section 965(c)(2)(C)(ii) provides a special rule for distributions during the base period of stock of a U.S. shareholder to which section 355 (or so much of section 356 that relates to section 355) applies. Under this special rule, the U.S. shareholder, the stock of which is distributed, is treated as having been in existence for the same period that the distributing corporation has been in existence. Further, the base period inclusions of the distributing and controlled corporations prior to the distribution are, in general, allocated between such corporations on the basis of their respective interests in the CFCs giving rise to such inclusions immediately after such distribution. Section 965(c)(2)(C)(ii) also provides that this rule does not apply if neither the controlled corporation nor the distributing corporation is a U.S. shareholder of such CFCs immediately after the distribution.

.03 *Maximum Amount Eligible for Section 965(a) -- Greater of $500 Million or Permanently Reinvested Earnings*

Section 965(b)(1) limits the amount of dividends eligible for the section 965(a)

DRD to the greatest of the following three amounts: (1) $500 million ($500 million limitation); (2) the amount shown on the taxpayer's applicable financial statement 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 but that does show a specific amount of tax liability attributable to such earnings, the amount of such liability divided by 0.35. If the applicable financial statement does not show a specific earnings or tax liability amount, then the $500 million limitation applies. The section 965(b)(1) amount shown on the taxpayer's applicable financial statement as earnings permanently reinvested outside the United States and the amount shown as a specific amount of tax liability attributable to such earnings divided by 0.35 is referred to in this notice as "APB 23 limitation."

Under section 965(c)(1), the term "applicable financial statement" means the most recently audited financial statement (including notes and other documents which accompany such statement) which is certified on or before June 30, 2003, as being prepared in accordance with generally accepted accounting principles, and which is used for the purposes of a statement or report to creditors or shareholders or for any other substantial nontax purpose. If the taxpayer is required to file with the Securities and Exchange Commission, the audited financial statement must be so filed on or before June 30, 2003, to qualify as an applicable financial statement. The legislative history states:

> [APB 23 limitation] refers to elements of Accounting Principles Board Opinion 23 ("APB 23"), which provides an exception to the general rule of comprehensive recognition of deferred taxes for temporary book-tax differences. The exception is for temporary differences related to undistributed earnings of foreign subsidiaries and foreign corporate joint ventures that meet the indefinite reversal criterion in APB 23.

H.R. Conf. Rep. No. 108-755, at 315, n. 111 (2004). The last day covered by the applicable financial statement is referred to in this notice as the "APB 23 determination date."

Section 965(c)(5) provides special rules for applying section 965 to controlled groups of corporations. First, section 965(c)(5)(B) provides that all corporations treated as a single employer under section 52(a) (section 52(a) group) are limited to one $500 million limitation, and the limitation must be divided among such corporations under regulations prescribed by the Secretary. A section 52(a) group includes all corporations that are members of a controlled group of corporations within the meaning of section 1563(a) substituting, however, "more than 50 percent" for "at least 80 percent" throughout section 1563(a)(1), and making the determination without regard to section 1563(a)(4) and (e)(3)(C). Second, section 965(c)(5)(C) provides that if a financial statement is an applicable financial statement for more than one U.S. shareholder, APB 23 limitation is divided among such shareholders under regulations prescribed by the Secretary.

.04 *Increase in Related Party Indebtedness*

Section 965(b)(3) provides that the amount of a U.S. shareholder's dividends otherwise eligible for the deduction under section 965(a) are reduced by any increase in

the indebtedness of the CFC to any related person (as defined in section 954(d)(3)) between October 3, 2004, and the close of the taxable year for which the election under section 965 is in effect. For this purpose, all CFCs with respect to which the taxpayer is a U.S. shareholder are treated as a single CFC and, therefore, indebtedness between CFCs is disregarded for this purpose. See H.R. Conf. Rep. No. 108-755, at 314, n. 109 (2004). Section 965(b)(3) is intended to prevent a deduction from being claimed with respect to a section 965 dividend where the dividend is financed, directly or indirectly, by the U.S. shareholder. In such a case, there may be no net repatriation of funds, and thus it is inappropriate to allow a deduction under section 965(a). H.R. Conf. Rep. No. 108-755, at 315 (2004).

.05 *Investment in the United States Pursuant to a Domestic Reinvestment Plan*

Section 965(b)(4) requires a U.S. shareholder claiming a section 965(a) DRD with respect to a dividend to invest the amount of the dividend in the United States pursuant to a domestic reinvestment plan. The domestic reinvestment plan must be approved by the taxpayer's president, chief executive officer, or comparable official before the payment of the dividend and 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 (2004). For additional guidance with respect to domestic reinvestment plans, see sections 8 and 9 of this notice and Notice 2005-10.

SECTION 3. BASE PERIOD AMOUNT -- GENERAL PRINCIPLES

.01 *Determination of Base Period Amount*

(a) *In general.* A U.S. shareholder determines its base period inclusions and its base period amount by applying the rules of section 965(b)(2)(B) and (c)(2) with respect to CFCs for which it was a U.S. shareholder at any time during its base period.

(b) *Consolidated groups.* A consolidated group[4] determines its base period inclusions by first aggregating the base period inclusions of each of the members in its group. It then determines its base period amount by determining the average of such inclusions as provided under section 965(b)(2)(B) and (c)(2).

(c) *Short taxable years.* Taxable years of fewer than 12 months are taken into account as taxable years for purposes of determining the base period years pursuant to section 965(c)(2). In addition, base period inclusions in a taxable year of fewer than 12 months are not annualized or otherwise adjusted for purposes of calculating the base period amount.

(d) *Intermediary pass-through entities.* The Treasury Department and the IRS expect to issue guidance soon on the treatment of distributions to intermediary pass-

[4] The terms "consolidated group," "member," "subsidiary," and "separate return year" are defined in Treas. Reg. §1.1502-1. In addition, the term "member" also refers, when the context so requires, to a member of a section 52(a) group.

through entities owned by U.S. shareholders for purposes of section 965(b)(2)(B)(i).

(e) *Example.* The following example illustrates the application of section 965(b)(2) and this section 3.01.

Example. (i) Facts. USP is the common parent of a consolidated group that includes USP's wholly owned subsidiaries US1 and US2. US1 and US2 each wholly owns a foreign corporation, CFC1 and CFC2, respectively. The USP consolidated group maintains a taxable year ending July 31. US1 received a $100x dividend from CFC1 in each of the consolidated taxable years ending July 31, 1996, 1997, and 1998. US2 received a dividend from CFC2 during each of the consolidated taxable years ending July 31, 1998, 1999, 2000, 2001, 2002, and 2003 in the amount of $150x, $150x, $200x, $100x, $50x, and $100x, respectively.

(ii) Result. USP first determines the base period inclusions of US1 and US2 to determine the consolidated group's base period inclusions. Pursuant to section 965(c)(2), the base period includes the five most recent taxable years of the USP group that ended on or before June 30, 2003, which are the group's taxable years ending July 31, 1998 (year 1) through July 31, 2002 (year 5). Accordingly, USP will have base period inclusions as follows:

Taxable year ending	USP group base period inclusions
July 31, 1998	$250x
July 31, 1999	$150x
July 31, 2000	$200x
July 31, 2001	$100x
July 31, 2002	$50x

To determine its base period years pursuant to section 965(c)(2), USP disregards the taxable years in its base period with the highest and lowest base period inclusions, which are 1998 ($250x) and 2002 ($50x). To determine it base period amount, USP then averages the base period inclusions for the remaining three taxable years (that is, the base period years). Therefore, USP's base period amount is $150x (($150x + $200x + 100x)/3).

.02 *Translation of Previously Taxed Income Distributed During the Base Period*

For purposes of determining the dollar amount of base period inclusions attributable to distributions of PTI described in section 965(b)(2)(B)(iii), distributions of

foreign currency are valued by multiplying the distributing CFC's foreign currency amount of the PTI distribution by the spot rate (as defined in Treas. Reg. §1.988-1(d)(1)) on the date of distribution.

SECTION 4. MAXIMUM AMOUNT ELIGIBLE FOR SECTION 965(a) -- GENERAL PRINCIPLES

.01 *Applicable Financial Statement*

As noted above, the amount of dividends eligible for the section 965(a) DRD may be limited by section 965(b)(1)(B) or (C) to either: (1) the amount shown on the taxpayer's applicable financial statement as earnings permanently reinvested outside the United States; or (2) in the case of an applicable financial statement that does not show a specific amount of earnings permanently reinvested outside the United States but that does show a specific amount of tax liability attributable to such earnings, the amount of such liability divided by 0.35. Also as noted above, the term "applicable financial statement" means the most recently audited financial statement (including notes and other documents which accompany such statement) which is certified on or before June 30, 2003, as being prepared in accordance with generally accepted accounting principles, and which is used for the purposes of a statement or report to creditors or shareholders or for any other substantial nontax purpose. For purposes of determining an amount shown on a taxpayer's applicable financial statement pursuant to section 965(b)(1)(B) or (C), the parenthetical reference to notes and other documents accompanying the statement only includes notes and documents that form an integral

part of the financial statement; it does not include work papers or other materials underlying or supporting the statement.

.02 *Determination of APB 23 Limitation of a U.S. Shareholder*

For purposes of section 965(b)(1)(B) and (C), the specific amount shown on the applicable financial statement that reflects the amount determined under paragraph 12 of APB 23 (or, in the case of section 965(b)(1)(C), a specific amount of tax liability) and that is disclosed as required under Financial Accounting Standards Board Statement 109, is treated as an amount of earnings permanently reinvested outside the United States (or, the amount of tax liability attributable to such earnings), regardless of the specific language used to describe such specific amount on the applicable financial statement.

.03 *Amount of Tax Liability Attributable to Earnings Permanently Reinvested*

If an applicable financial statement fails to show a specific amount of earnings permanently reinvested outside the United States, but instead shows a specific amount of tax liability attributable to such earnings, the APB 23 limitation under section 965(b)(1)(C) is the specific amount of such tax liability divided by 0.35. This amount may not be adjusted (for example, to take into account the foreign taxes imposed on such earnings).

The following example illustrates the application of section 965(b)(1)(C) and this section 4.03.

Example. (i) Facts. A CFC has earnings permanently reinvested outside the United States that have been subject to foreign tax of $10x. The applicable financial

statement of the U.S. shareholder that wholly owns such CFC does not show a specific amount of earnings permanently reinvested outside the United States, but instead shows a $25x tax liability attributable to such earnings.

(ii) Result. Although the applicable financial statement of the U.S. shareholder does not show an amount of permanently reinvested earnings, it does show a tax liability of $25x attributable to earnings permanently reinvested. Thus, the amount described in section 965(b)(1)(C) is $71.4x ($25x/0.35). This amount may not be adjusted to take into account the foreign taxes imposed on such earnings.

.04 *Allocation of APB 23 Limitation*

As noted above, section 965(c)(5)(C) provides that if a financial statement is an applicable financial statement for more than one U.S. shareholder, APB 23 limitation is divided among such shareholders under regulations prescribed by the Secretary. In such a case, the portion of the APB 23 limitation allocated to the U.S. shareholder is the amount from the separate company financial statements (or supporting work papers) of such U.S. shareholder that were prepared in connection with determining the amount described in section 965(b)(1)(B) or (C) shown on the applicable financial statement that included such U.S. shareholder.

Section 965(c)(5)(C) contemplates not only the situation where the financial statement reflects the operations of affiliated corporations that are not consolidated for tax purposes (for example, a U.S. corporation and a domestic subsidiary thereof that elects to apply section 936), but also the situation where the financial statement reflects the operations of corporations that were formerly affiliated and/or consolidated but are not in such relationship during a section 965 election year. See section 6 of this notice for rules regarding the allocation of APB 23 limitation in such a case.

The following example illustrates the application of section 965(b)(1) and this section 4.04.

Example. (i) Facts. USP is a domestic corporation that files a consolidated return with its wholly-owned subsidiaries US1 and US2. USP also wholly owns US3, which does not join in the USP consolidated return because an election under section 936 is in effect with respect to US3. US1, US2 and US3 each wholly owns a foreign corporation, CFC1, CFC2 and CFC3, respectively. Even though US3 is not part of the USP consolidated group for U.S. tax purposes, US3 is consolidated with USP, US1, and US2 for financial accounting purposes. On USP's applicable financial statement, USP reported $350x of earnings permanently reinvested outside the United States. The separate company financial statements of US1, US2, and US3 that were used in preparing the USP applicable financial statement reported earnings permanently reinvested by CFC1, CFC2 and CFC3 to be $100x, $50x and $200x, respectively.

(ii) Result. The portion of the USP APB 23 limitation allocated to US1, US2, and US3 is that portion reflected on the separate company financial statements (or supporting work papers) of US1, US2 and US3 that were used in determining the USP APB 23 limitation on its applicable financial statement. Thus, US1 is allocated $100x, US2 is allocated $50x, and US3 is allocated $200x of the $350x APB 23 limitation. Because US1 and US2 are members of the USP consolidated group and such group is treated as one U.S. shareholder, the USP consolidated group's APB 23 limitation equals $150x ($50x + $100x).

.05 *Allocation of $500 Million Limitation*

As noted above, section 965(c)(5)(B) provides that all corporations which are included in a section 52(a) group are limited to one $500 million limitation, which is divided among such corporations under regulations prescribed by the Secretary. Each qualified member of a section 52(a) group is allocated a portion of the section 52(a) group's single $500 million limitation if it is a qualified member on the last day of the election year of the qualified member with the last election year to end (apportionment date). A "qualified member" is either: (1) a domestic corporation that files a separate tax return and is a member of a section 52(a) group; or (2) a consolidated group that is part

of a section 52(a) group. Accordingly, if a consolidated group is not a part of a section 52(a) group, it has its own $500 limitation, and, if a consolidated group is part of a section 52(a) group, the portion of the $500 million allocated to the consolidated group is not further allocated between and among the members of the consolidated group.

The section 52(a) group's single $500 million limitation is allocated to all qualified members in proportion to the aggregate amount of total current and accumulated earnings and profits that are not previously taxed (non-PTI earnings and profits) of all CFCs owned (within the meaning of section 958(a)) by such qualified members. For purposes of this rule, a consolidated group is treated as owning CFCs within the meaning of section 958(a), if any member of the group owns CFCs within the meaning of section 958(a). The amount of non-PTI earnings and profits of a CFC owned (within the meaning of section 958(a)) by a qualified member is the sum of the amounts of earnings and profits of such CFC appropriately reported on Schedule J, items 7(a) and 7(b), of the last Form 5471 filed by or on behalf of such qualified member on or before the apportionment date with respect to such CFC, translated into U.S. dollars at the average exchange rate for the CFC's taxable year (see section 989(b)(3)).

The following example illustrates the application of section 965(b)(1) and the rules of this section 4.05.

Example. (i) Facts. FP, a foreign corporation, wholly owns two domestic corporations, US1 and US2. US1 and US2 each wholly owns a foreign corporation, CFC1 and CFC2, respectively. US1 and US2 each has a taxable year ending July 31, and they each make an election under section 965 for the taxable year ending July 31, 2006. US1 and US2 have APB 23 limitations of zero. On US1's last Form 5471 filed on or before the July 31, 2006 apportionment date with respect to CFC1, US1 reported an

amount of non-PTI earnings and profits for CFC1, translated into U.S. dollars using the average exchange rate, of $100x. On US2's last Form 5471 filed on or before the July 31, 2006 apportionment date with respect to CFC2, US2 reported an amount of non-PTI earnings and profits for CFC2, translated into U.S. dollars using the average exchange rate, of $300x.

(ii) Result. US1 and US2 do not have an APB 23 limitation and, thus, their maximum amount eligible for the section 965(a) DRD is $500 million. Because US1 and US2 are members of the same section 52(a) group, they are limited to one $500 million limitation, which is allocated between them. Pursuant to this section 4.05, the $500 million limitation is allocated in proportion to the aggregate U.S. dollar amount of non-PTI earnings and profits reported on the last Form 5471 filed on or before the apportionment date by US1 and US2 with respect to CFC1 and CFC2, respectively. The apportionment date for the FP group is July 31, 2006. Consequently, US1 is allocated $125 million of the $500 limitation ($100x/$400x x $500 million) and US2 is allocated $375 million of the $500 limitation ($300x/$400x x $500 million).

SECTION 5. TAXABLE YEAR TO WHICH SECTION 965 APPLIES

01. *In General*

Section 965(f) provides that a taxpayer may elect to apply section 965 to either the taxpayer's last taxable year beginning before October 22, 2004, or the taxpayer's first taxable year starting during the one-year period beginning on October 22, 2004 (eligible year). Thus, assuming that the other requirements of section 965 are met, a taxpayer may elect to apply the section 965(a) DRD with respect to cash dividends (as defined for purposes of section 965(a)) received by a U.S. shareholder from its CFCs in an eligible year. Except as otherwise provided in this section 5, an eligible year may include a short taxable year.

02. *Consolidated Groups*

For taxpayers that are members of a consolidated group, the common parent may elect on behalf of all the members to apply section 965 to one of the group's eligible years. The election applies to each member of the group that is included in the group's income tax return for that eligible year, but only for the portion of the eligible year during which such member is a member of the group. Further, every member can receive a cash dividend from a CFC that otherwise qualifies under section 965(a) during any period the recipient is a member of such group. This rule applies even if: (1) as a result of a subsidiary entering or leaving the group, the group's election year is, with respect to the particular subsidiary, neither the taxable year that includes October 22, 2004, nor the subsequent taxable year; or (2) a previous separate return year of the

subsidiary also was an election year for the subsidiary. This rule also applies as a result of the acquisition of a consolidated group by an unrelated consolidated group, where the previous separate return year of the acquired group was an election year.

Under the rules of the preceding paragraph, if a subsidiary leaves the group during the group's election year, cash dividends received from the subsidiary's CFCs during its short taxable year that ends within the group's election year are eligible for the group's election. As a result, dividends received by the subsidiary during that initial short taxable year can be eligible for the section 965(a) DRD. Moreover, dividends received by the subsidiary during its next short taxable year as part of an acquiring group may also be eligible for the section 965(a) DRD.

In addition, if the departing subsidiary is not immediately thereafter a subsidiary member of another group, it may treat its next short taxable year as an eligible year and make an election under section 965 for that year, even if that next taxable year is neither the taxable year for that subsidiary that includes October 22, 2004, nor the subsequent taxable year, provided that the two short taxable years together do not exceed twelve months (or an equivalent 52-53 week year).

General consolidated return principles apply to reverse acquisitions as defined in Treas. Reg. §1.1502-75(d)(3), so that the taxable year of the continuing group governs its available eligible years and the terminating group members are subject to the general rules for members leaving and entering groups, with the common parent in effect treated as having become a subsidiary of the continuing group.

03. *Examples*

The following examples illustrate the application of the rules of section 965(f) and this section 5.

Example 1. Member included in election year of different consolidated groups. (i) Facts. USP is the common parent of a calendar year consolidated group that elects to apply section 965 for its taxable year ending December 31, 2004. US1 is a member of the USP group and a U.S. shareholder. USB is the common parent of an unrelated consolidated group that elects to apply section 965 to its taxable year ending June 30, 2005. A member of the USB group acquires all the stock of US1 on November 15, 2004.

(ii) Result. Because US1 is included in the USP group during the USP group's section 965 election year (January 1, 2004 through December 31, 2004), US1's taxable year beginning January 1, 2004 and ending on November 15, 2004 is an election year during which cash dividends received from US1's CFCs may be eligible for the section 965(a) DRD. In addition, because US1 is included in the USB group during the USB group's election year (July 1, 2004 through June 30, 2005), cash dividends from US1's CFCs during US1's taxable year beginning on November 16, 2004 and ending June 30, 2005, may be eligible for the section 965(a) DRD of the USB group.

(iii) Alternative facts. If USB instead makes an election under section 965 for its taxable year ending June 30, 2006, cash dividends from US1's CFCs during the USB group's election year may still be eligible for the section 965(a) DRD. In this case, however, that election year is US1's taxable year from July 1, 2005 through June 30, 2006. Section 965 will not apply to US1's year beginning November 16, 2004 and ending June 30, 2005.

Example 2. Special rule for member departing but not joining a consolidated group. (i) Facts. Assume the same facts as in Example 1, except instead of being acquired by an unrelated consolidated group, the stock of US1 is distributed to the shareholders of USP on November 15, 2004, and US1 becomes the common parent of a new consolidated group which also maintains a taxable year ending December 31.

(ii) Result. Because the taxable year ending December 31, 2004 is the USP group's election year, US1's taxable year beginning January 1, 2004 and ending on November 15, 2004 is an election year during which cash dividends received from US1's CFCs may be eligible for the section 965(a) DRD. Further, because US1 ceased to be a member of the USP group during its election year and did not become a subsidiary member of another consolidated group, US1 may make an election under

section 965 for the subsequent short taxable year, which begins on November 16, 2004 and ends on December 31, 2004. This election will also apply to the other members of the US1 group during that short taxable year. US1 will not be able to make an election under section 965 for 2005.

Example 3. Acquisition of target resulting in single short election year. (i) Facts. USP is the common parent of a calendar year consolidated group that elects to apply section 965 for its taxable year ending December 31, 2004. US1 is a member of the USP group and a U.S. shareholder. On November 15, 2004, the stock of US1 is distributed to the shareholders of USP; after such distribution, US1 is not a member of a consolidated group and therefore files a separate return. USB is the common parent of an unrelated consolidated group that plans to apply section 965 to its taxable year ending December 31, 2005. On December 15, 2005, US1 purchases all the stock of USB for cash. US1 and its subsidiaries elect to file a consolidated return for the taxable year ending December 31, 2005.

(ii) Result. Because the taxable year ending December 31, 2004 is the USP group's election year, US1's taxable year beginning January 1, 2004 and ending on November 15, 2004 is an election year during which cash dividends received from US1's CFCs may be eligible for the section 965(a) DRD. Further, because US1 ceased to be a member of the USP group during its election year and did not become a subsidiary member of another consolidated group, US1 may make an election under section 965 for its short taxable year that begins on November 16, 2004 and ends on December 31, 2004. However, 2005 is not an eligible year for US1 or its consolidated group. The USB group's final taxable year ends on December 15, 2005, when it is acquired by US1. That short taxable year is an eligible year for which the USB group may make an election under section 965. Thereafter, the members of the former USB group will become members of the US1 group. Because the USB group was acquired after the US1 election year, the former USB group members may not participate in an election under section 965 for any period after December 15, 2005.

Example 4. Effect of reverse acquisition. (i) Facts. Assume the same facts as in Example 3, except that US1's acquisition of USB is for US1 stock rather than cash and the acquisition is a reverse acquisition described in Treas. Reg. §1.1502-75(d)(3).

(ii) Result. Under Treas. Reg. §1.1502-75(d)(3)(i), the USB group is treated as continuing to exist after the reverse acquisition with US1 as its common parent. The USB group's taxable year ending December 31, 2005 is an eligible year for which the group may make an election under section 965. This election applies to cash dividends received by US1 after the acquisition when US1 was in the USB consolidated group (the period beginning December 16, 2005 and ending December 31, 2005), as well as to dividends received by the USB group members during the calendar year while USB was

the common parent. As in Example 3, US1's short taxable year that begins on November 16, 2004 and ending on December 31, 2004 is an eligible year. However, US1's taxable year beginning January 1, 2005 and ending December 15, 2005 is not an eligible year for US1.

Example 5. Consolidated group included in election year of different consolidated groups. (i) Facts. Assume the same facts as in Example 1 (i), except that a member of the USB group acquires the USP group on November 15, 2004 and the USP group makes an election under section 965(a) for the taxable year January 1, 2004 through November 15, 2004.

(ii) Result. Because the USP group's election year is January 1, 2004 through November 15, 2004, USP's taxable year beginning January 1, 2004 and ending on November 15, 2004 is an election year during which cash dividends received from the USP group's CFCs may be eligible for the section 965(a) DRD. In addition, because USP is included in the USB group during the USB group's election year (July 1, 2004 through June 30, 2005), cash dividends from the USP group's CFCs during USP's taxable year beginning on November 16, 2004 and ending June 30, 2005 may be eligible for the section 965(a) DRD of the USB group. If, in the alternative, USB elects to apply section 965 to its taxable year ending June 30, 2006, cash dividends from the USP consolidated group's CFCs during USP's taxable year beginning July 1, 2005 and ending June 30, 2006 may be eligible for the section 965 DRD of the USB consolidated group.

SECTION 6. EFFECTS OF CERTAIN TRANSACTIONS ON BASE PERIOD INCLUSIONS AND MAXIMUM AMOUNT ELIGIBLE FOR SECTION 965(a) DRD

.01 *Base Period Inclusions and APB 23 Limitation as U.S. Shareholder Attributes*

(a) *In general.* For purposes of section 965, base period inclusions and APB 23 limitation are historical amounts that are treated as tax attributes particular to a U.S. shareholder as of the date these amounts are fixed under section 965(b)(1) and (2). See section 2.01 of this notice for the definition of the term "U.S. shareholder" for this purpose. Consequently, base period inclusions and APB 23 limitation remain with a particular U.S. shareholder (for example, when a U.S. shareholder ceases to be a

enters a U.S. consolidated group, adjustments are required to the selling[5] and/or acquiring group's base period inclusions and APB 23 limitation to reflect that base period inclusions and APB 23 limitation generally remain with a particular U.S. shareholder (that is, with the specific member rather than with the group itself). The selling group reduces its base period inclusions and APB 23 limitation by the amounts that are attributable to a departed member, and the acquiring group correspondingly increases its base period inclusions and APB 23 limitation to account for the new member. For exceptions to these general rules, see paragraph (2), below, and Examples 1, 4, 8 and 9 of section 6.01(d) of this notice. For specific rules addressing the determination of base period inclusions, see section 6.01(b)(3) of this notice.

When adjusting a consolidated group's base period inclusions to reflect the entry or exit of a U.S. shareholder, the consolidated group makes the adjustment to the specific base period inclusions (as opposed to the base period amount) for the group to reflect the particular base period inclusions of the acquired or disposed of U.S. shareholder or its successor. In the same way, the consolidated group makes an adjustment to its APB 23 limitation to reflect the APB 23 limitation attributable to the acquired or disposed of U.S. shareholder or its successor.

The rules of this paragraph that apply to dispositions or acquisitions of a member of a consolidated group also apply, as relevant, in the context of the acquisition of an

[5] For purposes of this section 6, the term "selling group" also includes a group in which a U.S. shareholder ceases to be included as a member as a result of transactions other than sales (for example, through the distribution of the stock of the member).

entire consolidated group.

(2) Special adjustment rules dependent upon timing of certain acquisitions or dispositions of U.S. shareholders. Certain adjustments to base period inclusions and/or APB 23 limitation provided under paragraph (b)(1) of this section are not made if certain transactions occur during the selling group's election year, or certain transactions occur before or after a selling group's or acquiring group's[6] APB 23 determination date. In addition, special rules are provided in section 6.01(c) of this notice with respect to certain spin-off transactions.

Specifically, under this paragraph (b)(2), when a U.S. shareholder ceases to be a member of a selling group during the selling group's election year, the selling group's base period inclusions and APB 23 limitation are not reduced by amounts attributable to the departing U.S. shareholder. Nonetheless, the acquiring group still increases its base period inclusions and, subject to the special rules of this paragraph (b)(2), its APB 23 limitation attributable to the acquired U.S. shareholder under the general rules of paragraph (b)(1) of this section. See Example 1 of section 6.01(d) of this notice. In addition, dividends received by the U.S. shareholder from its CFCs in any other election year may be taken into account in that year for purposes of section 965. See also section 5 of this notice for a discussion of taxable years to which section 965 applies.

This paragraph provides special rules to ensure that an acquiring consolidated

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[6] For purposes of section 6, the term "acquiring group" includes a consolidated group that comes into existence after the acquisition of a corporation.

group appropriately reflects an APB 23 limitation with respect to an acquired member when: (1) that member ceases to be a member of a selling consolidated group before the selling group's APB 23 determination date; and/or (2) that member joins an acquiring group before the acquiring group's APB 23 determination date. Specifically, if a U.S. shareholder joins a consolidated group before the acquiring group's APB 23 determination date, there is no adjustment to the acquiring group's APB 23 limitation because the U.S. shareholder's membership in the new group (and such U.S. shareholder's ownership of CFCs at the relevant time with permanently reinvested earnings) will be taken into account when determining the acquiring group's APB 23 limitation. Under the preceding sentence, if the selling group's APB 23 determination date has passed, the selling group reduces its APB 23 limitation to account for the departed U.S. shareholder. If a U.S. shareholder ceases to be a member of a consolidated group before the selling group's APB 23 determination date, there is no downward adjustment to the selling group's APB 23 limitation to reflect the departure because the selling group's APB 23 limitation will reflect such disposition. However, if a U.S. shareholder ceases to be a member of a consolidated group before the selling group's APB 23 determination date but after the acquiring group's APB 23 determination date, the acquiring group's APB 23 limitation is increased by the amount of the selling group's APB 23 limitation that would be allocated to the acquired U.S. shareholder under section 4 of this notice if the selling group substituted "the date of the acquisition" for "June 30, 2003" in applying section 965(c)(1).

The rules of this paragraph that apply to dispositions or acquisitions of a member of a consolidated group also apply, as relevant, in the context of the acquisition of an entire consolidated group.

(3) Determining the base period inclusions to be inherited. When an acquiring group adjusts its base period inclusions to take into account an acquisition of a U.S. shareholder or consolidated group, the acquiring group takes into account five taxable years in the relevant base period for any acquired shareholder or group, assuming at least five taxable years are available. The inclusions are aggregated for taxable years one through five without regard to whether they are short or full taxable years on either side. An acquired U.S. shareholder or group cannot contribute more than five taxable years of inclusions to the base period history of the acquirer. The fifth taxable year in the acquiring group's base period is the last potential taxable year in its base period.

If the acquired U.S. shareholder or group joins the acquiring group after the end of the acquiring group's base period, the acquired U.S. shareholder's or acquired group's base period inclusions in its last five taxable years ending on or before June 30, 2003 are aggregated with the acquiring group's base period inclusions in its five base period taxable years, on a year-by-year basis.

Similarly, if an acquired U.S. shareholder or group joins the acquiring group before the end of the acquiring group's base period, the acquiring group inherits a base period inclusion history for the acquired U.S. shareholder or group for each of the taxable years in the acquiring group's base period that end on or before the date of the

acquisition. The acquired U.S. shareholder's or acquired group's taxable year ending on the date of the acquisition shall correspond to the taxable year in the acquiring group's base period that ends on or before the date of the acquisition. The acquiring group then takes into account base period inclusions from the acquired U.S. shareholder's or group's taxable years prior to the taxable year ending with the date of the acquisition to the extent necessary to assemble a base period inclusion history for the inherited years. An acquired U.S. shareholder or acquired group may contribute five taxable years to the acquiring group's history even if the acquiring group did not itself exist for its full five taxable year base period. For illustrations of these rules, see Example 7 and Example 8 of section 6.01(d).

(c) *Special rules for spin-offs.* (1) In general. Except as provided in paragraphs (c)(2) and (3) of this section, a distribution to which section 355 (or so much of section 356 as relates to section 355) applies is treated in the same manner as a disposition of the stock of the controlled corporation (controlled) by the distributing corporation (distributing) for purposes of section 965 and this notice. See sections 5, 6.01(a) and (b) of this notice and Example 2 of section 6.01(d) of this notice.

(2) Spin-off of a U.S. shareholder that occurs during the base period -- allocation of base period inclusions. In the case of a spin-off of the stock of a U.S. shareholder to which section 355 (or so much of section 356 that relates to section 355) applies that occurs during the base period, and after which either distributing or controlled is a U.S. shareholder of a CFC (applicable base period spin-off), any base period inclusions

received by either distributing or controlled from such CFC are allocated as provided in section 965(c)(2)(C)(ii). For purposes of determining distributing's and controlled's base period inclusions and base period amounts under section 965(c)(2)(C)(ii), section 965(c)(2)(C)(ii)(I) treats controlled as having been in existence for the same period that distributing has been in existence. Further, section 965(c)(2)(C)(ii)(II) allocates base period inclusions that are received or includible by distributing and controlled from a CFC prior to an applicable base period spin-off of controlled based on the fair market values of distributing's and controlled's interests in such CFC immediately after such spin-off.

However, if stock of a member of a consolidated group is distributed pursuant to an applicable base period spin-off and, as a result of such distribution a controlled corporation leaves the consolidated group, the base period inclusions of the consolidated group with respect to each of the group's CFCs before the applicable base period spin-off are instead allocated between the members of the consolidated group that remain in the distributing corporation's group (distributing group) and the members, if any, that leave the group and thereafter file a consolidated return with the controlled corporation (controlled group) in proportion to the fair market values of the distributing group's and the controlled group's respective interests in each CFC owned by the distributing group and the controlled group immediately after the applicable base period spin-off. The base period inclusions allocated to the distributing group and the controlled group are further allocated amongst the members of such groups in

proportion to the fair market value of such members' respective interests in each CFC immediately after the applicable base period spin-off. See paragraph (c)(3) for the treatment of APB 23 limitations as a result of applicable base period spin-offs described in this paragraph (c)(2).

Section 965(c)(2)(C)(ii)(II) does not apply to any distribution that is not an applicable base period spin-off, such as a distribution that occurs after the base period; nor does it apply to allocate inclusions from CFCs with respect to which neither controlled not distributing is a U.S. shareholder at the time of the spin-off. Instead, the rules of section 6.01(c)(1) of this notice apply to such distributions or inclusions.

(3) Spin-off of a U.S. shareholder that occurs during the base period -- allocation of APB 23 limitation. If an applicable base period spin-off (as defined in paragraph (c)(2) of this section) occurs with respect to a U.S. shareholder that is not a member of a consolidated group after the APB 23 determination date of either distributing or controlled, the APB 23 limitation of distributing or controlled is adjusted to the extent that distributing's or controlled's APB 23 limitation is attributable to the stock of a CFC that is transferred between distributing and controlled in connection with the spin-off. Consistent with the treatment of base period inclusions, such adjustment is made by allocating the portion of any APB 23 limitation attributable to distributing or controlled with respect to the earnings of a CFC that is transferred between distributing and controlled in proportion to the fair market values of such corporations' respective interests as U.S. shareholders of such CFC immediately after the spin-off. If a spin-off

occurs before the APB 23 determination dates of both distributing and controlled, the general rules of section 4 apply. See <u>Example 3</u> of section 6.01(d) of this notice.

If the stock of a member of a consolidated group is distributed pursuant to an applicable base period spin-off and, as a result of such distribution a controlled corporation leaves the consolidated group and, the spin-off occurs after the APB 23 determination date of the consolidated group, the APB 23 limitation that is attributable to each CFC owned by the consolidated group before the applicable base period spin-off is, instead, allocated between the distributing group and the controlled group in proportion to the fair market values of the distributing group's and the controlled group's respective interests in each CFC owned by the distributing group and the controlled group immediately after the applicable base period spin-off. The APB 23 limitation allocated to the distributing group and the controlled group is further allocated between and among the members of such groups in proportion to the fair market values of such members' respective interests in each CFC immediately after the applicable base period spin-off.

(d) *Examples.* The following examples illustrate the application of section 965(b)(1) and (2) and this section 6.01. Unless otherwise indicated, the following facts are assumed for purposes of these examples. All corporations and consolidated groups maintain calendar taxable years and were in existence prior to 1997. USP is a domestic corporation and the common parent of the USP consolidated group. USP wholly owns US1 and US2. US1 and US2 are U.S. shareholders and members of the USP

consolidated group. US1 and US2 each wholly owns a foreign corporation, CFC1 and CFC2, respectively. USP elects to apply section 965 to its 2005 taxable year. USB is a domestic corporation and the common parent of the USB consolidated group, which is a consolidated group prior to any transactions described below. All domestic corporations acquired by the USB group that are eligible to do so elect to join in filling a consolidated return with the USB group. USB elects to apply section 965 for its 2005 taxable year. No elections are made under section 338 with respect to stock purchases.

Example 1. Sale of U.S. shareholder by consolidated group. (i) Facts. On December 31, 2003, USP sells the stock of US1 to an unrelated foreign person, FP. US1 files a separate return for the taxable years following such sale. On October 25, 2004 US2 sells CFC2 to USB for cash.

(ii) Result. On January 1, 2004, US1 is no longer a member of the USP consolidated group as a result of the sale of the US1 stock to FP. Accordingly, the USP group reduces its base period inclusions and APB 23 limitation attributable to US1. In addition, because US1 files a separate return after it ceases to be a member of the USP consolidated group, it takes into account its individual base period inclusions and APB 23 limitation. In contrast, US2's sale of CFC2 does not affect US2's base period inclusion history or APB 23 limitation, because base period inclusions and APB 23 limitation are not tax attributes of CFCs. Consequently, the USP group does not reduce its base period inclusions or APB 23 limitation as a result of the sale of CFC2. Similarly, USB does not make any adjustment to its base period inclusions or APB 23 limitation as a result of the acquisition of CFC2.

(iii) Alternative Facts. Assume the same facts as above, except that USP sells the stock of US1 to FP on February 15, 2005. On February 16, 2005, US1 is no longer a member of the USP consolidated group as a result of the sale of the US1 stock to FP. Because the transaction occurs within the USP election year, the USP group does not reduce its base period inclusions and APB 23 limitation attributable to US1. Further, US1 still takes into account its individual base period inclusions and APB 23 limitation should it make an election with respect to section 965(a) in its short taxable year following the acquisition (February 16, 2005 through December 31, 2005). The result with respect to USB is not changed under the alternative facts.

Example 2. Spin-off of U.S. shareholder by consolidated group. (i) Facts. The facts are the same as in Example 1, except that instead of USP selling the stock of US1, it distributes such stock in a distribution to which section 355 applies. US1 files a separate return for the taxable years following the distribution.

(ii) Result. The result is the same as that in Example 1. The special rules under section 965(c)(2)(C)(ii) and section 6.01(c)(2) of this notice do not apply because the distribution did not occur during USP's base period (which ended December 31, 2002).

Example 3. Section 368(a)(1)(D) reorganization/section 355 distribution. (i) Facts. USP owns CFC3. USP has base period inclusions and APB 23 limitation attributable to CFC3. On December 31, 2002, USP transfers the stock of CFC3 to controlled, a newly formed domestic corporation wholly-owned by USP, in a transaction to which section 368(a)(1)(D) applies, and immediately thereafter distributes the stock of controlled in a distribution to which section 355 applies.

(ii) Result. The distribution occurs during the USP group's base period and, therefore, the special rules under section 965(c)(2)(C)(ii) and section 6.01(c)(2) and (3) of this notice apply. As a result, USP's base period inclusions and APB 23 limitation that are attributable to CFC3 are allocated as provided in section 965(c)(2)(C)(ii) and section 6.01(c)(2) and (3) of this notice. Therefore, all of the base period inclusions and APB 23 limitation of USP attributable to CFC3 are allocated to controlled because controlled owns all the CFC3 stock immediately after the section 355 distribution.

(iii) Alternative facts. The facts are the same as in Example 3, except that the transaction occurs on December 31, 2003. Because the distribution does not occur during USP's base period, section 965(c)(2)(C)(ii) and section 6.01(c)(2) and (3) of this notice do not apply. Instead, the general rules of section 6.01(c)(1) of this notice apply. Therefore, none of the base period inclusions, and no portion of the APB 23 limitation, attributable to CFC3 are allocated to controlled; such amounts remain with USP.

Example 4. Internal spin-off of CFC followed by applicable base period spin-off. (i) Facts. US1 has base period inclusions with respect to CFC1. On June 30, 2002, US1 distributes the stock of CFC1 to USP in a transaction to which section 355 applies (first spin-off). On December 31, 2002, USP transfers the stock of CFC1 to controlled, a newly formed domestic corporation wholly owned by USP, in a transaction to which section 368(a)(1)(D) applies, and immediately thereafter distributes the stock of controlled in a distribution to which section 355 applies (second spin-off).

(ii) Result. The first and second spin-offs occur during the USP group's base period. Section 965(c)(2)(C)(ii)(II) does not apply to the first spin-off because CFC1 is not a United States shareholder. As a result US1's base period inclusions attributable

to CFC1 are not allocated between US1 and USP in accordance with US1's and USP's proportional ownership of CFC1 after the first spin-off. However, in the second spin-off controlled is distributed out of USP's consolidated group. Accordingly, the USP group's base period inclusions with respect to each of its CFCs before the spin-off of controlled are allocated between the USP group and controlled (or controlled's group if controlled's affiliated group files a consolidated return) in proportion to the USP group's and controlled's (or the controlled group's) interests in each CFC owned by the USP group and controlled (or the controlled group) immediately after the second spin-off.

Example 5. Merger of a U.S. shareholder and other transactions. (i) Facts. On January 3, 2003, US1 sells its stock in CFC1 to USB for cash. On December 31, 2003, in an unrelated transaction US1 merges into US2. The merger of US1 into US2 is a reorganization under section 368(a)(1)(A). On December 31, 2004, in a transaction unrelated to the merger of US1 into US2, USP sells the shares of US2 to USB for cash. The APB 23 determination date for the USP and USB groups is December 31, 2002.

(ii) Result. The sale of CFC1 stock to USB has no effect on the USP group's base period inclusions and APB 23 limitation. The merger of US1 into US2 on December 31, 2003 is a transaction described in section 381(a), and US2 therefore succeeds to and takes into account US1's base period inclusions and APB 23 limitation.

Because US2 ceases to be a member of the USP consolidated group as a result of the sale of its stock to USB, the USP group reduces its base period inclusions and APB 23 limitation attributable to US2, including those amounts US2 succeeds to and takes into account as a result of the merger. Further, because US2 becomes a member of the USB consolidated group on January 1, 2005, USB's base period inclusions and APB 23 limitation are increased by the same amounts by which USP's base period inclusions and APB 23 limitation amount were decreased.

(iii) Alternative facts. The facts are the same as Example 5 (i), except that instead of USP selling the shares of US2 to USB, US2 sells its assets to USB in exchange for cash (and the assumption of any liabilities of US2) and distributes the cash proceeds to USP pursuant to a liquidation described in section 332.

Under the alternative facts, the result is the same as Example 5 (ii), except as follows. USP does not make any adjustments to its base period inclusions or APB 23 limitation as a result of the sale of US2's assets to USB because the transaction with USB is not described in section 381(a) (this may not be the case, however, if the assets sold by US2 to USB include stock of a U.S. shareholder that is a member of the USP consolidated group). Further, USP continues to take into account the base period inclusions and APB 23 limitation attributable to US2 after the liquidation of US2 because the liquidation into USP is a transaction described in section 381(a). In addition, the

USB consolidated group does not take into account the base period inclusions and APB 23 limitation attributable to US2, because US2 does not become a member of the USB consolidated group (nor does the USB consolidated group acquire the assets of US2 pursuant to a transaction described in section 381(a)).

(iv) Alternative facts. The facts are the same as Example 5 (i), except that USP and USB make an election pursuant to section 338(h)(10) with respect to the sale of the stock of US2. The result under the alternative facts in this paragraph (iv) is the same as under the alternative facts of paragraph (iii) of this Example 5. This is the case regardless of whether an election under section 338 is made with respect to the CFC2 stock owned by US2.

Example 6. Acquisition of U.S. shareholder consolidated group. (i) Facts. USB acquires all the stock of USP on January 3, 2003, a date subsequent to the APB 23 determination dates for both the USP and USB groups. As a result of the acquisition, the USP group terminates and all the members of the USP group become members of USB consolidated group.

(ii) Result. USB's acquisition of all the stock of USP causes the USP consolidated group to cease to exist as of the end of January 3, 2003, a date after the end of the base periods of both the USP and USB groups. The USP group's base period inclusions for each of the five taxable years in its base period is added to the USB group's base period inclusions for each corresponding taxable year in its base period to determine the USB group's base period amount. In addition, because the acquisition occurs after the APB 23 determination dates of both the USB and USP groups, the USB group's APB 23 limitation is increased by the USP group's APB 23 limitation.

Example 7. Taking into account base period inclusions of acquired U.S. shareholder transferred after the end of the acquirer's base period. (i) Facts. The USB consolidated group uses a taxable year ending March 31. The USB group elects to apply section 965 to its taxable year that begins on April 1, 2005 and ends on March 31, 2006. On May 31, 2005, USB acquires from USP 100% of the stock of US1 for cash.

(ii) Result. The acquisition of US1 occurs during the section 965 election year of the USP group and the section 965 election year of the USB group. Therefore, the special rules set forth in section 6.01(b)(2) apply. Under those rules, the USB consolidated group takes into account the base period inclusions of US1 for purposes of determining its base period amount under section 965(b)(2). Because US1 ceases to be a member of the USP consolidated group during the election year of such group, the USP consolidated group will also take into account the base period inclusions of US1 for purposes of determining its base period amount under section 965(b)(2). Accordingly, there is no corresponding decrease by the selling group for the increase by the buying

group of base period inclusions and APB 23 amounts as a result of the transaction.

The USB consolidated group's base period includes the five taxable years ending on or before June 30, 2003 (that is, taxable years ending March 31, 1999 through March 31, 2003). Similarly, the base period of US1 and USP includes the five taxable years ending on or before June 30, 2003 (that is, the taxable years ending December 31, 1998 through December 31, 2002).

To determine the USB group's base period amount, US1's base period inclusions for each taxable year in its base period are added to the base period inclusions for each corresponding taxable year in the USB group's base period. Thus, US1's base period inclusions for its taxable year ending December 31, 2002 are added to the base period inclusions for the USB group's year ended March 31, 2003, and US1's base period inclusions for the other four years in its base period are added to the USB group base period inclusions for the other four corresponding years in the USB group's base period.

Because the acquisition of US1 occurs during the election years of both the USP group and the USB group, both groups will also take into account the APB 23 limitation attributable to US1.

Example 8. Taking into account base period inclusions of acquired U.S. shareholder transferred before the end of the acquirer's base period. (i) Facts. The facts are the same as Example 7, except as follows. USB acquired US1 on February 15, 2002, a date prior to the APB 23 determination dates of both USP and USB. The USB group's base period includes the five taxable years ending March 31, 1999, through March 31, 2003. As a result of its acquisition, the base period of US1 includes its five taxable years that end on the following dates: February 15, 2002; December 31, 2001; December 31, 2000; December 31,1999; and December 31, 1998.

(ii) Result. To determine the USB group's base period amount, US1's base period inclusions for each taxable year in US1's base period are added to the USB group's base period inclusions for each corresponding taxable year in the USB group's base period. US1's short taxable year ending February 15, 2002, corresponds to the last taxable year in the acquirer's base period that ends on or before the date of the acquisition (that is, the USB group's taxable year that ends March 31, 2001). The USB group also succeeds to that portion of US1's base period inclusion history for US1's taxable years that precede the short taxable year ending on February 15, 2002, that correspond to the USB group taxable years in its base period.

The corresponding taxable years in the respective base periods may be illustrated as follows:

US1 base period year-ends	USB group base period year-ends
3/31/03	3/31/03
3/31/02	3/31/02
2/15/02	3/31/01
12/31/01	3/31/00
12/31/00	3/31/99
12/31/99	
12/31/98	

US1's taxable years ending on December 31, 1999, and December 31, 1998, correspond to taxable years of the USB group that precede the USB group's base period. Accordingly, the USB group does not take into account the base period inclusions of US1 in those years. Nevertheless, the USP group will reduce its base period inclusions attributable to US1 for these taxable years.

US1's base period inclusions after February 15, 2002, are naturally taken into account by the USB group in determining its base period inclusions because such inclusions will occur during the time that US1 is a part of the USB consolidated group. That is, US1 base period inclusions for its taxable year that ends March 31, 2002, and March 31, 2003, are taken into account in determining the USB group's inclusions for such taxable years.

US1 ceased being a member of the USP consolidated group and joined the USB consolidated group before the APB 23 determination dates of both the USP and USB consolidated groups. As a result, no adjustment is made to the APB 23 amount of the USP or USB consolidated groups as a result of the sale of US1 stock as provided in section 6.01(a)(2) of this notice.

(iii) Alternative facts. The facts are the same as in Example 8, except that the USB group's first taxable year begins on April 1, 2000. The results are unchanged.

Example 9. Acquisition of U.S. shareholder stock before Acquirer's but after Seller's APB 23 determination date. (i) Facts. The USP group's applicable financial statement provides for an APB 23 limitation of $700 million. The limitation is comprised of, as of the APB 23 determination date (December 31, 2002), earnings permanently reinvested in CFC1 of $400 million and in CFC2 of $300 million. The $400 million of CFC1 earnings is attributable to US1, and the $300 million of CFC2 earnings is attributable to US2. USB maintains a taxable year ending January 31. On January 3, 2003, USP sells to USB 81% of US1's outstanding stock and 60% of the outstanding stock of US2. The USB group's APB determination date is January 31, 2003.

(ii) Result. By reason of the transactions, US1 and US2 cease to be members of the USP consolidated group on January 3, 2003, a date that is after the USP group's APB 23 determination date. Therefore, the USP consolidated group reduces its APB 23 limitation by $700 million because US1 and US2 are no longer members of the USP consolidated group. Similarly, the USP group reduces its base period inclusions to the extent they are attributable to US1 and US2. Further, the acquisition of US1 and US2 occurred prior to USB's APB 23 determination date. Therefore, the USB group does not increase its APB 23 limitation with respect to the transactions because the USB group will take into account permanently reinvested earnings of US1 and US2 for financial accounting purposes on its APB 23 determination date. Finally, USB inherits the relevant base period inclusion history of US1 because US1 joins the USB consolidated group. After the transaction, US2 is not a member of a consolidated group and therefore will file a separate return for subsequent taxable years. If US2 elects to apply section 965 in an eligible year, it will take into account its base period inclusion history and its APB 23 limitation.

(iii) Alternative facts. The facts are the same as in Example 9 (i), except that US1 and US2 are sold on February 1, 2003. The USB group's reported APB 23 limitation is increased by $400 million as a result of USB's purchase of 81% of the shares of US1 because US1 joins the USB consolidated group after the USB group's APB 23 determination date; it is not increased by the $300 million attributable to US2 because US2 does not join the USB consolidated group. The base period inclusion results are unchanged.

.02 *Allocated Portion of $500 Limitation*

Pursuant to section 4.05 of this notice, the $500 million limitation described in section 965(b)(1)(A) is allocated among qualified members of a section 52(a) group on a single date, the apportionment date (as defined in section 4.05 of this notice), and only amongst the qualified members of the group on such date. A corporation or consolidated group is not allocated any of the $500 million limitation and it has a $0 limitation for an election year during which the corporation or consolidated group was a qualified member of a section 52(a) group if, on or after the end of its election year but before the section 52(a) group's apportionment date (or, if none, the date that would

have been the apportionment date had the transaction not occurred), the corporation or consolidated group becomes unrelated to the other qualified members of the section 52(a) group or ceases to exist.

Once an allocation occurs on an apportionment date, the allocated limit applies to a corporation or consolidated group that is a qualified member of the section 52(a) group for its election years ending while it is a qualified member of such group, including those years that end before the apportionment date. However, if a corporation or consolidated group becomes unrelated to the other qualified members of a section 52(a) group before the end of an election year of such corporation or consolidated group, the corporation or group is entitled to its own $500 million limitation, unless it becomes part of a different section 52(a) group on or before that group's apportionment date. If it becomes part of a different section 52(a) group on or before that group's apportionment date, it may be allocated a portion of that section 52(a) group's $500 limitation. Accordingly, if a corporation or consolidated group is no longer a qualified member of a section 52(a) group, the former member does not retain any of the section 52(a) group's $500 million limitation after it leaves such group.

The following examples illustrate the application of section 965(b)(1) and this section 6.02. Unless otherwise indicated, it is assumed in each example that all U.S. shareholders have APB 23 limitations of zero.

Example 1. Disposition of a member which joins an unrelated consolidated group. (i) Facts. A, an individual, wholly owns two domestic corporations, US1 and US2. US1 and US2 in turn each wholly own a foreign corporation, CFC1 and CFC2, respectively. US1 and US2 maintain the calendar year as their taxable year.

On September 30, 2005, A sells US1 to USB. USB is an unrelated domestic corporation and the common parent of a consolidated group that maintains a June 30 taxable year.

US1 elects section 965 for its taxable year ending September 30, 2005. US2 elects section 965 for its taxable year ending December 31, 2005. The USB group elects section 965 for its taxable year ending June 30, 2006.

(ii) Result. US2 is entitled to a full $500 million limitation for its election year ending December 31, 2005, because it is not a member of a section 52(a) group on December 31, 2005. US1 has a limitation of $0 for its election year ending September 30, 2005, because US1 and US2 would have been members of a section 52(a) group on an apportionment date, December 31, 2005, but for the disposition of US1 on or after the end of US1's election year but before December 31, 2005. The apportioned limitation does not apply to US1's second election year as a member of the USB group. The USB group has its own $500 million limitation, which is not adjusted upward as a result of the acquisition of US1.

Example 2. Disposition of a member which does not join an unrelated consolidated group. (i) Facts. The facts are the same as in Example 1 except that the buyer of US1 is B, an individual unrelated to A. As in Example 1, US1 elects section 965 for its taxable year, which however ends on December 31, 2005.

(ii) Result. On December 31, 2005, there is no section 52(a) group, and the election year of neither corporation ended before that date. Therefore, US1 and US2 each has its own $500 million limitation.

Example 3. Merger into unrelated corporation. (i) Facts. The facts are the same as in Example 1 except that instead of the stock of US1 being sold, US1 merges into USB in a reorganization described in section 368(a)(1)(A).

(ii) Result. The result is the same as in Example 1.

Example 4. Merger into related corporation. (i) Facts. The facts are the same as in Example 3 except that US1 merges into US2 in a reorganization described in section 368(a)(1)(A).

(ii) Result. US2 is entitled to a full $500 million limitation for its election year ending December 31, 2005, because it is not a member of a section 52(a) group on December 31, 2005. US1 has a limitation of $0 for its election year ending September 30, 2005, because US1 and US2 would have been members of a section 52(a) group

on their apportionment date, December 31, 2005, but for the merger of US1 which results in the end of US1's election year before December 31, 2005.

Example 5. Spin-off resulting in unrelated corporation. (i) Facts. USP is a publicly held corporation and the parent of a consolidated group. C and US1 are wholly owned domestic subsidiaries of USP. US1 cannot be included in the USP consolidated group by virtue of section 1504(a)(3) (relating to the five-year period required to elapse before reconsolidation). The USP group and US1 each maintain the calendar year as their taxable years and USP, C and US1 are each U.S. shareholders of CFCs.

On September 30, 2005, USP distributes the stock of C to its shareholders. Thereafter, USP and C are not members of the same section 52(a) group.

The USP group and US1 each elect section 965 for their taxable years ending December 31, 2005. C also elects section 965 for its short taxable year starting on October 1, 2005, and ending on December 31, 2005.

(ii) Result. December 31, 2005 is the apportionment date for the section 52(a) group that consists of the USP group and US1, and the $500 million limitation is allocated between the USP group and US1 on that date. None of the limitation is allocated to C separately for its short taxable year ending September 30, 2005 (its limitation is $0), but the apportionment does not apply to C's second election year, the short taxable year ending December 31, 2005. C has its own $500 million limitation for that second election year.

Example 6. Spin-off resulting in related corporation. (i) Facts. The facts are the same as in Example 5 except that all the stock of USP is owned by A, an individual, and A acquires all the stock of C in the distribution. As a result, USP and C remain members of a single section 52(a) group after the distribution.

(ii) Result. December 31, 2005 is the apportionment date for the section 52(a) group that consists of the USP group, US1, and C, and the $500 million limitation is allocated between the USP group, US1, and C on that date. C's allocation applies to its second election year, the short taxable year ending December 31, 2005. During the time that C is a member of the USP group, it is not separately allocated any of the $500 million limitation of the section 52(a) group.

Example 7. Interaction of APB 23 limitation and $500 million limitation. (i) Facts. The facts are the same as in Example 1, except that US1 has an APB 23 limitation of $300 million, and USB has an APB 23 limitation of $400 million.

(ii) Result. The result is the same as in Example 1 with respect to the $500

million limitation. The maximum repatriations allowed under section 965 for US1 in its election year ending September 30, 2005, is the greater of its allocated portion of the $500 million limitation or its APB 23 limitation. US1's APB 23 limitation of $300 million exceeds its portion of the $500 million, which is $0. Thus, US1's maximum amount under section 965(b)(1) is $300 million. As in Example 1, the USB group's $500 million limitation is not adjusted as a result of USB's acquisition of US1. However, the USB group's APB 23 limitation is adjusted upward to reflect the $300 million APB 23 limitation attributable to US1. Because the maximum repatriations allowed under section 965 for the USB group is the greater of $500 million or APB 23 limitation, the USB group's APB 23 limitation exceeds $500 million as a result of the acquisition. Thus, USB's maximum amount under section 965(b)(1) is $700 million ($400 million + $300 million).

SECTION 7. REDUCTION OF BENEFIT FOR INCREASES IN RELATED PARTY INDEBTEDNESS

.01 *Background*

(a) *General.* Section 965(b)(3) provides that a U.S. shareholder reduces the amount of dividends otherwise eligible for the deduction under section 965(a) by any increase in the indebtedness of its CFC to any related person (as defined in section 954(d)(3)) between October 3, 2004 and the close of the taxable year for which the election under section 965 is in effect. For purposes of section 965(b)(3), all CFCs with respect to which the taxpayer is a U.S. shareholder are treated as a single CFC.

(b) *Definitions.* For purposes of section 965(b)(3) and this section 7, the following definitions apply:

(i) The term "CFC" means all CFCs with respect to which the taxpayer is a U.S. shareholder, treating such CFCs as a single CFC pursuant to section 965(b)(3).

(ii) The term "individual CFC" is used to refer to a single CFC (for example, to identify a single CFC that is acquired or disposed of by a consolidated group U.S.

shareholder).

(iii) The term "U.S. shareholder" as used in this section 7 is defined in section 951(b).

(iv) The term "related person" means a person that is related to a CFC within the meaning of section 954(d)(3).

(v) The term "related party indebtedness" means the amount of indebtedness of a CFC to a related person. However, indebtedness between individual CFCs of a U.S. shareholder is disregarded for purposes of section 965(b)(3).

(vi) The term "initial measurement date" means the close of October 3, 2004 or, if the U.S. shareholder so chooses, an alternative date which is provided as a matter of administrative convenience for taxpayers and the IRS. The alternative date is either: (i) the close of September 30, 2004, if such shareholder used a calendar year or a fiscal year as its taxable year; or (2) the close of the last day of such shareholder's fiscal-year month ending nearest October 3, 2004, if such shareholder used a 52-53 week taxable year. However, the U.S. shareholder uses the same date as its initial measurement date for all purposes of section 965.

(vii) The term "last measurement date" means the close of a U.S. shareholder's taxable year for which an election is in effect.

.02 *Definition of Indebtedness*

(a) *In general.* Except as provided in this section, for purposes of section 965(b)(3), "indebtedness" is defined under general Federal income tax principles.

Further, the amount of indebtedness of a CFC to any related person pursuant to section 965(b)(3) is not reduced or otherwise offset by indebtedness of any related person to the CFC. Thus, for example, if on the initial measurement date or the last measurement date, there is $100x of indebtedness of a CFC to its U.S. shareholder, and $10x of indebtedness from such U.S. shareholder to the CFC, the amount of indebtedness under section 965(b)(3)(A) as of such date is $100x (and not $90x).

For purposes of section 965(b)(3), indebtedness of a CFC to a foreign disregarded entity that is owned for Federal tax purposes by a related person is treated as related party indebtedness. Thus, for example, if on the initial measurement date there is $100x of indebtedness from a CFC to a foreign disregarded entity owned by a U.S. shareholder, which is a related person to the CFC, such amount is indebtedness described in section 965(b)(3)(B).

(b) *Exception for Intercompany Trade Payables*. For purposes of section 965(b)(3), the term "indebtedness" does not include indebtedness arising in the ordinary course of a business from sales, leases, or the rendition of services provided to or for a CFC by a related person, provided that such indebtedness is actually paid within 183 days.

.03 *Determination of Related Party Indebtedness*

A U.S. shareholder considers the indebtedness of its CFC to related persons only if the U.S. shareholder is a related person with respect to such CFC. For purposes of determining the related party indebtedness of a CFC pursuant to section 965(b)(3),

the relationship between the CFC, its creditors, and any of its U.S. shareholders is determined independently on the initial measurement date and the last measurement date, respectively. For example, if on such date the creditor of the CFC is a related person and a U.S. shareholder is a related person with respect to such CFC, the U.S. shareholder has an amount of indebtedness that is considered under section 965(b)(3) and the rules of this section.

.04 *Amount of Reduction under Section 965(b)(3)*

(a) *In General.* Pursuant to section 965(b)(3) and the rules of this section, a U.S. shareholder reduces the amount of cash dividends that would otherwise be taken into account under section 965(a) by the excess (if any) of its last measurement date RPI (as determined under section 7.05(b)) over its initial measurement date RPI (as determined under sections 7.05(a) and 7.05(c)). If two or more U.S. shareholders may otherwise be considered to have an amount that is considered under section 965(b)(3) attributable to the same CFC indebtedness, such shareholders take into account such indebtedness under the rules of 7.06 of this section.

(b) *Indirect Financing of Cash Dividend by a U.S. Shareholder.* Section 965(b)(3) is intended to prevent a U.S. shareholder from directly or indirectly financing a cash dividend qualifying under section 965(a). In addition to the application of the related party indebtedness rule under section 965(b)(3), general tax law principles such as the substance-over-form doctrine and circular cash-flow principles may apply to various financing structures. However, a related party guarantee of CFC indebtedness is not

considered to be an indirect financing of a cash dividend for purposes of section 965(b)(3), provided that the CFC is treated as the obligor on the indebtedness for Federal income tax purposes. *See Plantation Patterns, Inc. v. Comm'r*, 462 F.2d 712 (5th Cir. 1972), *cert. denied*, 409 U.S. 1076 (1972).

.05 *Amount of Related Party Indebtedness on the Initial Measurement Date and the Last Measurement Date*

(a) *Initial Measurement Date RPI -- General Rule.* A U.S. shareholder determines the amount of the related party indebtedness of its CFC on the initial measurement date and such amount is the "initial measurement date RPI" of such U.S. shareholder. The amount of the initial measurement date RPI is adjusted pursuant to section 7.05(c) of this notice in certain instances. See Example 1 of section 7.08 of this notice.

(b) *Last Measurement Date RPI -- General Rule.* A U.S. shareholder determines the amount of the related party indebtedness of its CFC on the last measurement date and such amount is the "last measurement date RPI" of such U.S. shareholder. Thus, to the extent that a CFC pays all or a portion of the principal on the related party indebtedness before the last measurement date and does not incur any new related party indebtedness before such date, the U.S. shareholder's last measurement date RPI will be less than its initial measurement date RPI. See Examples 4 and 6 of section 7.08 of this notice.

(c) *Special Adjustments to Initial Measurement Date RPI.* A U.S. shareholder

reduces its initial measurement date RPI to the extent the U.S. shareholder's initial measurement date RPI is attributable to any individual CFC with respect to which such shareholder ceases to be a U.S. shareholder or a related person as the result of a transaction before the last measurement date. However, the prior sentence does not apply to the extent, before or as a result of such transaction, all or a portion of the principal on the indebtedness is paid by the debtor (for example, as a result of the liquidation of an individual CFC).

A domestic corporation that becomes a U.S. shareholder and a related person with respect to an individual CFC after such corporation's initial measurement date, but before the last day of its election year (or a U.S. shareholder that files a separate return for its short taxable year immediately after a transaction during the same period), and that remains a U.S. shareholder and a related person with respect to such individual CFC on its last measurement date, increases its initial measurement date RPI by the amount of related party indebtedness of such individual CFC immediately after the transaction, excluding any indebtedness arising in connection with or as a result of the transaction (for example, as a result of the incorporation of a branch). See Example 3 and Example 10 of section 7.08 of this notice.

If two or more U.S. shareholders may otherwise be considered to have an amount that is considered under section 965(b)(3) attributable to the same CFC indebtedness, such shareholders take into account such indebtedness under the rules of section 7.06 of this notice.

.06 *Related Party Indebtedness -- Multiple U.S. Shareholders*

An increase in a CFC's related party indebtedness may not reduce the total amount of dividends otherwise eligible for the section 965(a) DRD on anything but a dollar-for-dollar basis. Consequently, if more than one U.S. shareholder is a related person with respect to a CFC, then the effect of the increase in the related party indebtedness of the CFC pursuant to section 965(b)(3) is allocated among and between such U.S. shareholders. For this purpose, such increase is allocated on a dollar-for-dollar basis to cash dividends received by such U.S. shareholders that are otherwise eligible for the section 965(a) DRD in the order that those dividends are received. If such dividends are received by more than one U.S. shareholder on the same day, each U.S. shareholder takes into account the remaining amount of the increase in related party indebtedness of such CFC based on the relative amount of cash dividends received on such day. The overall reduction in dividends of all U.S. shareholders eligible for the section 965(a) DRD under this rule may not exceed the total increase in related party indebtedness under section 965(b)(3). See Examples 8 and 9 of section 7.08 of this notice.

.07 *Translation of Foreign Currency-Denominated Related Party Indebtedness*

The initial measurement date RPI and the last measurement RPI of a U.S. shareholder is determined in U.S. dollars. The amount of any indebtedness on both the initial measurement date and the last measurement date is translated into U.S. dollars using the spot rate (as defined in Treas. Reg. §1.988-1(d)(1)) on the initial

measurement date. See Example 7 of section 7.08 of this notice.

.08 *Examples*

The following examples illustrate the application of section 965(b)(3) and this section 7. Unless otherwise indicated, the following facts are assumed for purposes of these examples. USP, a domestic corporation and the common parent of the USP consolidated group that uses the calendar year as its taxable year, wholly owns US1. US1 is a domestic corporation and a member of the USP consolidated group. US1 wholly owns CFC1, a foreign corporation that owes US1 $100x at the close of September 30, 2004 evidenced by a note ($100x note). USP wholly owns CFC2, a foreign corporation with no indebtedness owed to persons described in section 954(d)(3). The USP group chooses September 30, 2004 as its initial measurement date and it elects to apply section 965 to its 2005 calendar year tax year.

Example 1. Determination of the amount of initial measurement date RPI. (i) Facts. The general facts apply.

(ii) Result. US1 and USP are each U.S. shareholders with respect to CFC1 and CFC2 and are considered one U.S. shareholder for purposes of section 965(b)(3). Further, CFC1 and CFC2 are considered one CFC for purposes of section 965(b)(3). The USP group's CFC (CFC1 and CFC2) has indebtedness of $100x owed to the USP group (and directly to US1 as a member of that group), a related party. Therefore, the USP group has initial measurement date RPI of $100x.

Example 2. Determination of initial and last measurement date RPI when CFC transferred or sold. (i) Facts. On December 31, 2004, US1 sells all the stock of CFC1 and the $100x note to USB, an unrelated U.S. corporation that is the common parent of a consolidated group. Immediately after the transaction, CFC1 owes $100x to USB. USB makes an election under section 965 for its calendar year ending December 31, 2005. As of USB's last measurement date, it is a U.S. shareholder and related person with respect to CFC1.

(ii) Result. Under section 965(b)(3) all CFCs of a U.S. shareholder are treated as one CFC. Moreover, for purposes of section 965(b)(3), all U.S. shareholders that are members of a consolidated group are considered one U.S. shareholder. Therefore, CFC1 and CFC2 are considered one CFC and US1 and USP are considered one U.S. shareholder (the USP group). Only the relationship between CFC1, CFC2 and the USP group is taken into account for purposes of determining the initial measurement date RPI of the USP group, while only the relationship between CFC1 and USB is taken into account for purposes of determining the last measurement date RPI of the USB group.

As of the initial measurement date the USP group's CFC (CFC1 and CFC2) owes $100x to related parties. Therefore, under section 7.05(a), and without regard to the disposition of CFC1, the USP group's initial measurement date RPI is $100x. Under section 7.05(c), however, the USP group reduces its initial measurement date RPI to account for the disposition of CFC1. Therefore, the USP group's initial measurement date RPI is $0. As of the last measurement date, CFC1 is not related to the USP group. Accordingly, the USP group's last measurement date RPI is $0.

With respect to the USB group, CFC1 is not related to the USB group on the USB group's initial measurement date. Therefore, the USB group's initial measurement date RPI, without consideration of the acquisition of CFC1 is $0. Under section 7.05(c), however, the USB group increases its initial measurement date RPI by $100x, the amount of the CFC1's related party indebtedness immediately after the acquisition. Therefore, the USB group has initial measurement date RPI of $100x. Further, as of its last measurement date, CFC1 owes USB, a related party, $100x. Therefore, the USB group's last measurement date RPI is $100x.

(iii) Alternative facts. The facts are the same as in (i), except that USB does not purchase the $100x note due from CFC1. Under section 7.05(c), the USP group reduces its initial measurement date RPI from $100x to $0, to account for the disposition of CFC1 (the same result reached in (ii)). Under section 7.05, the USP group's last measurement date RPI is $0 (the same result reached in (ii)). Under the alternative facts, however, the USB group does not adjust its initial measurement date RPI to take into account the acquisition of CFC1 because immediately after the acquisition CFC1 will owe an indebtedness to US1, which is not a related person. As a result, the USB group has an initial measurement date RPI of $0. Further, the USB group has a last measurement date RPI of $0.

(iv) Alternative facts. The facts are the same as in (i) except that CFC1 liquidates (whether by reason of an actual liquidation or by reason of an election under Treas. Reg. §301.7701-3) into US1 instead of being sold to USB. Under section 7.05(c), the USP group does not decrease its initial measurement date RPI to account for the liquidation. Consequently, the USP group's initial measurement date RPI is $100x.

Under section 7.05(b), the USP group's last measurement date RPI is $0.

Example 3. Determination of initial and last measurement date RPI when a U.S. shareholder is transferred to an unrelated person. (i) Facts. The facts are the same as in Example 1, except that on December 31, 2004, all the stock of US1 (and indirectly CFC1), is sold to an unrelated U.S. shareholder, USB. US1 joins the USB consolidated group and USB makes an election under section 965 for the taxable year ending December 31, 2005. As of its last measurement date, USB is a U.S. shareholder and related person with respect to CFC1.

(ii) Result. Without regard to the disposition of US1, the USP group's initial measurement date RPI is $100x. Under section 7.05(c), the USP group's initial measurement date RPI is decreased by $100x, resulting in the USP group having initial measurement date RPI of $0.

USP computes its last measurement date RPI under section 7.05(b) of this notice. As of the last measurement date, CFC1 owes an indebtedness to US1, a party that is not related within the meaning of section 954(d)(3) to USP. Therefore, the USP group's last measurement date RPI is $0.

Without regard to the acquisition of US1, the USB group's initial measurement date RPI is $0. However, under section 7.05(c), the USB group increases its initial measurement date RPI by $100x, the amount of the related party indebtedness of its CFC (CFC1) immediately after the transaction. Further, the USB group's last measurement date RPI is $100x because as of its last measurement date, CFC1 owed $100x to US1, a related person.

(iii) Alternative facts. Assume that the stock of US1 is sold to USB on March 31, 2005, which is during the USP group's and the USB group's election year. The results are the same as set forth in (ii), above.

Example 4. Determination of initial and last measurement date RPI when a new CFC is formed. (i) Facts. The facts are the same as in Example 1, except that USP incorporates CFC2 on November 1, 2004, and during the USP election year USP acquires all the stock of USB (and indirectly all of USB's individual CFCs), an unrelated U.S. shareholder. Further, USB is a member of the USP consolidated group on the last day of the USP election year. In part, CFC2 is capitalized with $100x of related party indebtedness and USP is a U.S. shareholder and a related person with respect to CFC2 on its last measurement date. USB has initial measurement date RPI of $400x, attributable to its CFCs. Immediately after the acquisition, USB's CFCs continue to have indebtedness owed to USB in the amount of $400x.

(ii) Result. Without regard to the acquisition of USB or the formation of CFC2, under section 7.05(a), the USP group has initial measurement date RPI of $100x. Under section 7.05(c), the USP group increases its initial measurement date RPI by the related party indebtedness of the USB CFCs immediately after the transaction. Note, however, that no adjustment is made to the USP group's initial measurement date RPI to account for CFC2's related party indebtedness under section 7.05(c). Thus, after adjustment, the USP group's initial measurement date RPI is $500x. Under section 7.05(b), the USP group's last measurement date RPI is $600x, which includes the indebtedness of CFC1 ($100x), CFC2 ($100x), and the acquired CFCs of USB ($400x).

(iii) Alternative facts. The facts are the same as in Example 6 (i), except that CFC1 pays US1 $70x of the $100x indebtedness on November 1, 2005. The USP group's initial measurement date RPI is $500, the same as in (ii). Under section 7.05(b), the USP group's last measurement date RPI is $530x, which includes the indebtedness of CFC1 ($30x), CFC2 ($100x), and the acquired CFCs of USB ($400x). Under section 7.04 of this notice and section 965(b)(3), USP group reduces its dividends otherwise eligible for the section 965(a) DRD by $30x.

Example 5. Determination of initial and last measurement date RPI when a U.S. shareholder and its CFC are transferred but the note due from the CFC is left behind. (i) Facts. The facts are the same as in Example 1, except that all the stock of US1 (and indirectly CFC1) is sold to an unrelated U.S. shareholder, USB, on December 31, 2004, before USP group's election year ending December 31, 2005. Assume that CFC1's related party indebtedness on the initial measurement date ($100x) was the result of the indebtedness being owed to USP instead of US1. US1 is a member of the USB group on the USB group's last measurement date.

(ii) Result. Without regard to acquisitions and dispositions, the USP group has initial measurement date RPI of $100x. Because USP was a U.S. shareholder and a related person with respect to CFC1 on the USP group's initial measurement date, but is not a U.S. shareholder or a related person on its last measurement date, section 7.05(c) requires the USP group to reduce its initial measurement date RPI from $100x to $0.

On the USP group's last measurement date, CFC1 is not a related person. Therefore, the USP group's last measurement date RPI is $0.

USB has initial measurement date RPI of $0, without regard to the acquisition of US1 (and CFC1). No adjustment is made to this amount under section 7.05(c) because immediately after the acquisition CFC1 owed an indebtedness to USP, an unrelated party. Further, the USB group's last measurement date RPI is $0 because its CFC (CFC1) does not have an indebtedness to a related party on the last measurement

date.

Example 6. Determination of initial and last measurement date RPI when a U.S. shareholder is transferred without the debtor CFC. (i) Facts. The facts are the same as in Example 1, except that on December 31, 2004, before the USP group's election year, US1 distributed CFC1 to USP, and then US1 was sold to USB. In addition, CFC1's related party indebtedness on the USP group's initial measurement date was owed to USP instead of US1. Finally, USB has initial measurement date RPI of $0.

(ii) Result. Without regard to the distribution of CFC1 or the disposition of US1, the USP group has initial measurement date RPI of $100x. No adjustment is made under section 7.05(c) to the USP group's initial measurement date RPI as a result of the distribution of CFC1 because after the distribution the USP group is a U.S. shareholder and related person with respect to CFC1. Further, under section 7.05(c), the sale of US1 does not require the USP group to reduce its initial measurement date RPI because after the disposition USP is still a U.S. shareholder and related person with respect to CFC1. Therefore, USP has initial measurement date RPI of $100x. The USP group's last measurement date RPI is also $100x because on the last measurement date CFC1's indebtedness is owed to USP, a related party.

USB acquires US1, but US1 has no CFCs when it enters the USB consolidated group. Therefore, under section 7.05(c), the USB consolidated group does not increase its initial measurement date RPI. In addition, USB's last measurement date RPI is $0.

(iii) Alternative facts. The facts are the same as in (i), except that the CFC1 indebtedness is owed to US1. Under the alternative facts, the USP group would still have initial measurement date RPI in the amount of $100x. No adjustment is made to this amount under section 7.05(c) because on the USP group's initial measurement date and last measurement date the USP group was a U.S. shareholder and a related person with respect to CFC1. However, as of the last measurement date, CFC1 will owe an indebtedness to US1, an unrelated party. Therefore, the USP group's last measurement date RPI is $0. The results with respect to the USB group are the same as set forth in (ii).

Example 7. Translating RPI denominated in a non-U.S. dollar currency. (i) Facts. CFC1's indebtedness to US1 is denominated in currency u. As of the close of September 30, 2004 (the initial measurement date), CFC1 owed 100u to US1. As of the close of December 31, 2005, CFC1 continued to owe 100u to US1. As of September 30, 2004, the spot rate is 1u/$1. As of December 31, 2005, the spot rate is 1u/$1.5.

(ii) Result. Pursuant to section 7.05 of this notice, the indebtedness of CFC1 to

US1 on the initial measurement date and the last measurement date is converted into U.S. dollars on the spot rate on the initial measurement date. As a result, the indebtedness of CFC1 to US1 on both dates is $100x.

Example 8. U.S. shareholder not related to CFC (i) Facts. FP, a foreign corporation, wholly owns US1, a domestic corporation. US1 owns 60% of CFC. US2, a domestic corporation that is unrelated to FP or US1, owns the remaining 40% of CFC. As of the initial measurement date of US1 and US2, CFC has related party indebtedness in the amount of $100x that is owed to FP.

(ii) Result. US1 is a related person with respect to CFC on its initial measurement date. As a result, US1 takes into account the related party indebtedness of CFC for purposes of section 965(b)(3). Because US2 is not a related person with respect to CFC, the $100x of related party indebtedness is not taken into account by US2 for purposes of section 965(b)(3).

Example 9. Application of Section 965(b)(3) reduction to multiple U.S. shareholders (i) Facts. USP is a domestic corporation and the common parent of a consolidated group. USP wholly owns US1, a domestic corporation that is not a member of the USP group because an election under section 936 is in effect with respect to US1. USP and US1 wholly own CFC1 and CFC2, respectively. The USP group and US1 both maintain a calendar taxable year and elect to apply section 965 to the taxable year ending December 31, 2005. USP receives a cash dividend of $200x from CFC1 on February 1, 2005. US1 receives a cash dividend from CFC2 of $300x on March 1, 2005. Both cash dividends received by USP and US1 during 2005 are otherwise eligible for the deduction under section 965(a). There is a $300x increase in CFC1's related party indebtedness pursuant to section 965(b)(3). CFC2 does not have related party indebtedness at any time.

(ii) Result. Under section 965(d)(3), the USP group and US1 are both U.S. shareholders and related persons with respect to CFC1. Thus, both the USP group and US1 are required to take into account CFC1's increase in related party indebtedness. Based upon the rules set forth in section 7.06, above, CFC1's $300x increase in related party indebtedness reduces the amount of the USP group's and US1's dividends eligible for the deduction under section 965(a) based on the earliest cash dividends eligible for the section 965(a) DRD received by the USP group and US1 during the election year. As a result, the USP group takes into account $200x of the $300x increase in RPI because it received a cash dividend of $200x on February 1, 2005. US1 takes into account the remaining $100x of such increase because it received its cash dividend on March 1, 2005.

(iii) Alternative Facts. The facts are the same as Example 2, except that USP

and US1 received the cash dividends from CFC1 and CFC2, respectively, on the same day during the election year. Under section 7.06, the USP group and US1 take into account the $300x increase in RPI attributable to CFC1 in proportion to their receipt of cash dividends on such date. Thus, the USP group takes into account $120x of the increase (($200x/($200x + $300x)) x $300x). US1 takes into account the remaining $180x of the increase (($300x/($200x + $300x)) x $300x).

Example 10. Determination of initial and last measurement date RPI when related party indebtedness arises in connection with or as a result of a transaction. (i) Facts. The facts are the same as in Example 3, except that in connection with or as a result of USB's purchase of the stock of US1 (and indirectly CFC1), US1 lends CFC1 $50x.

(ii) Result. With respect to the USP group, the initial measurement date RPI and the last measurement date RPI are the same as in Example 3. The USB group's initial measurement date RPI and last measurement RPI are affected. Without regard to the acquisition of US1, the USB group's initial measurement date RPI is $0. However, under section 7.05(c), the USB group increases its initial measurement date RPI by $100x, the amount of the related party indebtedness of its CFC (CFC1) immediately after the transaction, but excluding the indebtedness arising in connection with, or as a result of, the transaction. The USB group's last measurement date RPI, however, is $150x because as of its last measurement date, CFC1 owes $150x to US1, a related person. Therefore, under section 7.04 of this notice and section 965(b)(3), the USB group reduces its dividends otherwise eligible for the section 965(a) DRD by $50x.

SECTION 8. EFFECT OF CERTAIN TRANSACTIONS ON DOMESTIC REINVESTMENT PLANS

.01 *In General*

This section addresses the effect of certain transactions on domestic reinvestment plans adopted pursuant to section 965(b)(4) and Notice 2005-10. Section 8.02 of this notice addresses the effect of members entering and exiting a consolidated group. Section 8.03 addresses the effect of certain asset acquisitions. Section 8.04 then provides rules that apply to a corporation that may make permitted investments pursuant to more than one domestic reinvestment plan. Finally, section 8.05 of this

notice provides reporting and administrative requirements for transactions addressed by this section 8.

.02 *Members Entering and Exiting a Consolidated Group*

A consolidated group may rely on any domestic corporation (regardless of whether such corporation is a U.S. shareholder) to fulfill the group's obligations to make permitted investments under a domestic reinvestment plan if that corporation is a member of the group at any time on or after the first day of the group's election year. For example, if a consolidated group adopts a domestic reinvestment plan and a member leaves the group during or after the group's election year, the group may rely on the former member's subsequent domestic investment activity to satisfy the group's obligations under its domestic reinvestment plan. Similarly, if a domestic corporation joins a consolidated group during or after the first day of the group's election year, the group may rely on the new member's domestic investment activity after it joins the group to satisfy the group's obligations under its domestic reinvestment plan. The rules of this paragraph apply regardless of the amount of cash or property held by the former member or new member at the time it leaves or joins the consolidated group, as the case may be.

In addition, a domestic corporation may rely on any other domestic corporation (regardless of whether such corporation is a U.S. shareholder) to fulfill its obligations to make permitted investments under a domestic reinvestment plan if both corporations are members of the same consolidated group at the time the investment is made, even

if they were not members of the same consolidated group during the corporation's election year. For example, if a corporation adopts a domestic reinvestment plan and the corporation joins a consolidated group after the end of the corporation's election year, the acquired corporation may rely on the subsequent domestic investment activity of any member of the acquiring consolidated group to satisfy the corporation's obligations under its domestic reinvestment plan. Similarly, if a consolidated group adopts a domestic reinvestment plan and the group is acquired by another consolidated group after the acquired group's election year, the acquired group may rely on the subsequent domestic investment activity of any member of its new consolidated group to satisfy the acquired group's obligations under its domestic reinvestment plan.

.03 *Asset Acquisitions*

In general, if a corporation acquires assets of another corporation, the acquiring corporation will not succeed to the obligations of the transferor corporation under a domestic reinvestment plan, and investments made by the acquiring corporation therefore are not eligible to satisfy such domestic reinvestment plan. However, if the corporation acquires the assets of a transferor corporation in a transaction described in section 381(a), subsequent investments made by the acquiring corporation (or by members of the acquiring corporation's consolidated group) therefore may be eligible to satisfy the transferor's domestic reinvestment plan.

If, prior to the transaction described in section 381(a), the acquiring corporation was also required or permitted to make permitted investments in order to satisfy a

domestic reinvestment plan, the acquiring corporation will continue to be required or permitted to satisfy obligations under that domestic reinvestment plan in addition to any obligations under the transferor's domestic reinvestment plan.

.04 *Designation of Permitted Investment Activity*

A single corporation may be able to make permitted investments in satisfaction of more than one domestic reinvestment plan. However, the same expenditure of funds may not satisfy the investment requirement of more than one domestic reinvestment plan. For example, a single $100x investment made by an acquired domestic corporation cannot be counted toward the investment requirements of both the selling consolidated group and the acquiring consolidated group. If a permitted investment by a corporation would satisfy the investment requirement of more than one domestic reinvestment plan, the corporation may designate which plan is being satisfied. If a corporation fails to so designate, its domestic investment activities will be treated as fulfilling domestic reinvestment plan obligations in the following order: first, under any plan adopted with respect to its own earliest election year; second, under any plan adopted with respect to its own subsequent election years, if any; and third, with respect to any plan adopted with respect to any other corporation (for example, a transferor in a transaction described in section 381(a) or a consolidated group the corporation later joined) in the order the corporation became required or permitted to make investments in satisfaction of such plan.

.05 *Reporting and Other Administration Requirements under Section 8 of Notice 2005-*

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If a former member of a consolidated group contributes to the completion of the group's domestic reinvestment plan (in whole or in part), the obligation to comply with the reporting and other administrative requirements contained in section 8 of Notice 2005-10 will remain with the group if such group continues to exist, or otherwise with the common parent (or successor agent) for the election year, or the common parent of any consolidated group that includes such former common parent (or successor agent).

.06 *Examples*

The following examples illustrate the application of section 965(b)(4) and this section 8. Unless otherwise indicated, the following facts are assumed for purposes of these examples: USP is a domestic corporation and the common parent of a consolidated group that uses the calendar year as its taxable year. USP wholly owns US1 and US2, which are domestic corporations and members of the USP consolidated group. US1 and US2 each wholly owns a foreign corporation, CFC1 and CFC2, respectively. The USP group elects to apply section 965 for its taxable year ending December 31, 2005. The domestic reinvestment plan approved pursuant to section 965(b)(4) and Notice 2005-10 on behalf of the USP group requires that an amount of cash equal to the $100x cash dividends that are received from the USP group's CFCs will be invested in the United States to fund research and development activities (performed in the United States) of the USP group over a two-year period. On

December 31, 2005, CFC1 and CFC2 each distributes $50x of dividends that are eligible for the section 965(a) DRD.

Example 1. Member exiting a consolidated group. (i) Facts. On July 1, 2006, all of the stock of US2 is acquired for cash by USB, a domestic corporation and the common parent of the USB consolidated group. Any permitted investments required to be made by the USB group under any domestic reinvestment plan (other than that of the USP group) are made prior to June 30, 2006. Between July 1, 2006 and December 31, 2007, US2 funds $100x of research and development activities.

(ii) Result. Because US2 is a member of the USP group after the beginning of the USP group's election year, US2's funding of $100x of research and development activities made while it is a member of the USB group will satisfy the USP group's obligations to make such permitted investments specified under the USP group's domestic reinvestment plan. However, the USP group satisfies the reporting and administrative requirements contained in section 8 of Notice 2005-10 with respect to such investment.

Example 2. Member entering a consolidated group. (i) Facts. On March 31, 2006, USP acquires for cash all the stock of US3, a domestic corporation that is not a member of a consolidated group. US3 elected to apply section 965 to its taxable year ending December 31, 2005. US3's domestic reinvestment plan requires that US3 expend $5x to compensate existing employees for services performed in the United States over a two-year period. Between April 1, 2006 and December 31, 2007, US3 funds $100x of research and development activities. During the same period, US2 expends $5x to compensate existing employees for services performed in the United States.

(ii) Result. Because US3 is a member of the USP group after the beginning of the USP group's election year, US3's funding of $100x of research and development activities after joining the group will satisfy the USP group's obligations to make such specified permitted investments under the USP group's plan. In addition, because US2 is a member of the same consolidated group as US3 when it expends $5 to compensate existing employees for services performed in the United States (a permitted investment pursuant to section 965(b)(4) and Notice 2005-10), US3 may rely on US2's expenditure to satisfy its obligation specified under its plan. USP is required to satisfy the administrative requirements with respect to investments under US3's plan.

Example 3. Asset acquisition of U.S. shareholder. (i) Facts. The facts are the same as in Example 2, except that instead of USP acquiring the stock of US3, US3 merges into US2 in a reorganization under section 368(a)(1)(A) and (a)(2)(D) on March

31, 2006, after which US2 remains a member of the USP group. Between April 1, 2006 and December 31, 2007, US2 funds $100x of research and development activities and pays $5x to compensate existing employees for services performed in the United States.

(ii) Result. Because US2 acquired the assets of US3 in a transaction to which section 381(a) applies, US2 succeeded to US3's domestic reinvestment plan obligations. US2's payment of $5x to compensate existing employees for services performed in the United States satisfies its obligation to make a permitted investment specified under US3's plan. The USP group may also rely on US2's funding of $100x of research and development activities to satisfy the USP group's plan obligations. The result would be the same if, after the merger of US3 into US2, US1, instead of US2, paid $5x to compensate existing employees for services performed in the United States, because US1 is a member of the same consolidated group as US2 and the compensation is a permitted investment pursuant to section 965(b)(4) and Notice 2005-10.

Example 4. Failure to designate sufficient investment activity to fulfill multiple domestic reinvestment plans. (i) Facts. The facts are the same as in Example 2, except that US3's plan also required US3 to expend $5x to fund research and development activities over a two-year period. The USP group fails to designate specific investment activities for purposes of section 8.04 of this notice to satisfy either the USP group domestic reinvestment plan or the US3 domestic reinvestment plan. Between March 31, 2006 and December 31, 2007, US3 funds $5x of research and development activities and US2 funds $95x of research and development activities.

(ii) Result. Because the USP group failed to designate specific investment activities to satisfy US3's and the USP group's domestic reinvestment plans, US3's permitted investments will first be taken into account under the US3 plan, and US2's permitted investments will first be taken into account under the USP group plan. Consequently, US3's $5x expenditure will satisfy the US3 plan and cannot be taken into account by the USP group to satisfy its obligation to conduct $100x of research and development activities. As a result, the USP group will have conducted only $95x of research and development activities and the USP group's 2005 qualifying dividend is reduced by $5x. If instead, US3 had merged into US2 on March 31, 2006, as in Example 3, and US2 spent the $100x without designating, all $100x would have satisfied the USP domestic reinvestment plan. In addition, the US3 plan would fail to have been satisfied, resulting in a $5x reduction in US3's qualifying dividends.

SECTION 9. *OTHER GUIDANCE*

.01 *Section 78 Gross-Up, Disallowance of Expenses Pursuant to Section 965(d)(2), and*

Computation of Alternative Minimum Tax in Election Year

Section 78 does not apply to any tax which is not allowable as a credit under section 901 by reason of section 965(d).

The disallowance of expenses in section 965(d)(2) applies only to expenses that are "directly allocable" to the deductible portion described in section 965(d)(1).

For purposes of calculating alternative minimum tax for the election year under section 55(a) in accordance with section 965(e)(1)(B), the taxpayer's regular tax described in section 55(c) and tentative minimum tax determined under section 55(b)(1)(B) do not include tax attributable to nondeductible CFC dividends.

The IRS and Treasury will incorporate the rules in this section 9.01 into subsequent guidance. This subsequent guidance will provide detail regarding these and related rules.

.02 *Contiguous Country Branches of Domestic Life Insurance Companies*

Amounts added to the life insurance company taxable income of a domestic life insurance company by reason of section 814(e)(2) (dealing with contiguous country branches of a domestic life insurance company) are not eligible for the section 965(a) DRD.

.03 *Cash Dividends in Excess of Amounts Covered by Domestic Reinvestment Plans*

A domestic reinvestment plan may provide for the investment in the United States of an amount that is less than the entire amount of cash dividends that are otherwise eligible for the section 965(a) DRD. In such a case, the section 965(a) DRD

applies only to the amount of eligible dividends that are reinvested pursuant to the plan (assuming that all the other requirements under section 965 are satisfied).

.04 *Section 958(a) Chain of Ownership -- Stock Deemed Issued Pursuant to Section 304(a)(1)*

If stock of an acquiring CFC is deemed to be issued to another CFC pursuant to section 304(a)(1), the acquiring CFC is treated as being in a chain of ownership described in section 958(a) for purposes of applying section 965(a)(2).

The following example illustrates the application of section 965(a)(2) and this section 9.04:

Example. (i) Facts. USP, a domestic corporation, wholly owns two foreign corporations, CFC1 and CFC2. CFC1 wholly owns a foreign corporation, CFC3. CFC2 has $100x of current and accumulated earnings and profits described in sections 304(b)(5)(A) and 959(c)(3). During USP's section 965 election year, CFC1 sells all its CFC3 stock to CFC2 for $100x. Also during USP's election year, CFC1 distributes $100x to USP that is excluded from gross income under section 959(a).

(ii) Result. Because CFC1 is in control of both CFC3 and CFC2 and receives property from CFC2 in exchange for its CFC3 stock, CFC1's sale of CFC3 stock to CFC2 is subject to section 304(a)(1). Accordingly, CFC1 is treated as receiving $100x as a distribution in redemption of CFC2 stock. Because CFC1 actually owns 100% of CFC3 before the sale and is treated as owning 100% of CFC3 after the sale, pursuant to section 302(d), section 302(a) does not apply to the deemed redemption distribution and the proceeds of the deemed redemption are treated as a distribution to which section 301 applies. Therefore, CFC1 is treated as transferring its CFC3 stock to CFC2 in exchange for CFC2 stock in a transaction to which section 351(a) applies. The CFC2 stock CFC1 is treated as receiving in the deemed section 351 exchange is then treated as redeemed by CFC2 for $100x. Under section 302, that redemption is treated as a distribution to which section 301 applies because CFC1 owns directly 100% of CFC3 before the redemption of the CFC2 stock that was deemed issued and is treated as owning 100% of CFC3 after the redemption. The deemed redemption proceeds are treated as a distribution to which section 301 applies, and CFC1 is treated as receiving a dividend of $100x from the current and accumulated earnings and profits of CFC2. For purposes of section 965(a)(2), because CFC1 is treated under section 304(a)(1) as

receiving CFC2 stock in the deemed section 351 exchange, CFC1 is treated as receiving the $100x dividend from another CFC that is in a chain of ownership described in section 958(a).

.05 Acquisitions of Interests in Business Entities -- Modification of Section 5.06 of Notice 2005-10

Section 5.06 of Notice 2005-10 provides, in part, that in valuing assets with respect to certain acquisitions of interests in business entities, the taxpayer must use the same methodology that it uses, under section 864(e) and Treas. Reg. §1.861-9T(g) (that is, tax book value, alternative tax book value, or fair market value), for purposes of allocating and apportioning its interest expense for the taxable year. Notwithstanding that section of Notice 2005-10, the Treasury Department and the IRS have decided that taxpayers may elect to use the fair market value methodology under Treas. Reg. §1.861-9T(g) for purposes of valuing assets pursuant to section 5.06 of Notice 2005-10, even if they use the tax book value or alternative tax book value methodology for purposes of allocating and apportioning interest expense under section 864(e). Such election is made on the annual report (required under section 8.02(a) of Notice 2005-10) filed by the taxpayer for the taxable year of the acquisition.

.06 *Distributions to Intermediary Disregarded Entities – Clarification of Section 3.02 of Notice 2005-10*

Section 3.02 of Notice 2005-10 provides that for purposes of section 965(a), a cash dividend paid by a CFC to a pass-through entity that is owned by a U.S. shareholder is 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. For this purpose, a disregarded entity need not actually distribute cash to a U.S. shareholder of the CFC, provided that the U.S. shareholder otherwise receives the cash from the disregarded entity and there is no legal obligation for the U.S. shareholder to repay the cash to the disregarded entity.[7] For purposes of the preceding sentence, the term U.S. shareholder is defined in section 951(b).

Example. (i) Facts. USP, a domestic corporation, wholly owns DE, a disregarded entity. DE wholly owns CFC, a foreign corporation. Since Year 1, USP has held a $200x obligation of DE. CFC pays a $100x dividend to DE during Year 3, USP's election year. Also during Year 3, DE repays $100x of its obligation to USP.

(ii) Result. The $100x dividend paid by CFC is paid to DE, a pass-through entity that is owned by USP. As a result, pursuant to section 3.02 of Notice 2005-10, such dividend is treated as a cash dividend for purposes of section 965 only if and to the extent that USP receives $100x from DE during Year 3 without an obligation to repay those funds to DE. DE's repayment of $100x of its $200x obligation held by USP satisfies this requirement, and the $100x dividend paid by CFC during the election year therefore qualifies as a cash dividend for purposes of section 965. The result is the same regardless of whether the $100x repayment by DE is of principal, accrued interest, or both.

(iii) Alternative Facts. The facts are the same except that instead of using the $100x to satisfy a portion of an obligation held by USP, DE uses the $100x cash to acquire an asset from USP. The result is the same.

SECTION 10. REPORTING AND OTHER ADMINSTRATIVE REQUIREMENTS

Pursuant to section 6001, the taxpayer must prepare, maintain, and, upon a

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[7] See section 3.02 of Notice 2005-10 (providing that a loan of cash from the disregarded entity to the U.S. shareholder is not considered a distribution of cash for this purpose because there is a legal obligation for the U.S. shareholder to repay the cash to the disregarded entity).

request by the Commissioner, make available within 30 days of such request, a general description of any transaction that results in: (1) an adjustment to base period inclusions or APB 23 amounts pursuant to section 6 of this notice; (2) an adjustment to initial measurement date RPI pursuant to section 7 of this notice; or (3) a permitted investment being made by a U.S. shareholder that, at the time of such investment, is not a member of the consolidated group that adopted the domestic reinvestment plan pursuant to which such investment is made, as provided under section 8 of this notice. The description must include, as applicable, the name, address, and tax identification number (if available), of all parties relevant to the transaction (for example, selling group, departing or joining member, and acquiring group). In addition, it must include all relevant dates and the amount of adjustments resulting from the transactions.

In addition, pursuant to section 6001, the taxpayer must prepare, maintain, and, upon a request by the Commissioner, make available within 30 days of such request: (1) a list of investments that may satisfy more than one domestic reinvestment plan and the taxpayer designation of which plan the investment satisfies; and (2) those domestic corporations that have participated in more than one election year.

In the case of an adjustment to base period inclusions pursuant to section 6 of this notice, such adjustments may be determined by reference to the separate Form 1120 prepared for the departing U.S. shareholder for the base period years in question, without regard to the fact that the separate Form 1120 does not constitute a processed return, and was prepared to determine the consolidated return of the group of which it

was a member.

SECTION 11. TRANSITION RULES

.01 *Domestic Reinvestment Plans Approved Prior to May 10, 2005*

If a domestic reinvestment plan is approved prior to May 10, 2005, the taxpayer may modify such plan to take into account the guidance herein not later than July 11, 2005, even if the dividend to which the domestic reinvestment plan relates has already been paid. Any 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.

.02 *Tax Returns filed Prior to May 10, 2005*

If, prior to May 10, 2005, a taxpayer has filed its tax return for the taxable year for which it acquires an interest in a business entity that qualifies, in whole or in part, as a permitted investment pursuant to section 5.06 of Notice 2005-10, such taxpayer may make the election to use the fair market value methodology pursuant to section 9.05 of this notice with respect to such acquisition on an amended tax return that is filed on or before December 31, 2005.

SECTION 12. EFFECT OF THIS NOTICE ON OTHER DOCUMENTS

Sections 9.05 and 9.06 of this notice modify section 5.06 and clarify section 3.02 of Notice 2005-10, respectively. See also section 11 of this notice, pursuant to which domestic reinvestment plans approved prior to May 10, 2005 (including domestic

reinvestment plans adopted or modified pursuant to the guidance included in Notice 2005-10), may be modified to take into account the guidance in this notice.

SECTION 13. EFFECTIVE DATE

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

SECTION 14. 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 [1545-1943].

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 5, 8, 9, 10, and 11 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 and whether the taxpayer has properly determined the maximum amount of cash dividends eligible for the DRD under section 965(a), taking into account the limitations on the DRD that are imposed by section 965(b)(1), (b)(2), and (b)(3). The collections of information are required to obtain the benefit of section 965 for a taxable year. 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: 1,250,000 hours.

Estimated average annual burden hours per respondent: 50 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 June 9, 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 15. DRAFTING INFORMATION

The principal authors of this notice are Jeffrey L. Vinnik of the Office of Associate Chief Counsel (International) and Krishna P. Vallabhaneni, formerly of the Office of Associate Chief Counsel (Corporate). 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

May 10, 2005

FACT SHEET:
Second Notice Providing Guidance on Repatriation of Foreign Earnings Under the American Jobs Creation Act

Overview:
Today the Treasury Department and IRS announced the second in a series of notices that provide detailed guidance for U.S. companies that elect to repatriate earnings from foreign subsidiaries subject to the temporary reduced tax rate available under the American Jobs Creation Act (AJCA). The notice released today provides guidance to companies on what constitutes a qualifying dividend, the impact of mergers and acquisitions and issues related to the section 78 gross-up.

Background
Internal Revenue Code section 965, enacted as part of the AJCA in October 2004, is a temporary provision that allows a U.S. company to repatriate earnings from its foreign subsidiaries at a reduced effective tax rate provided that specified conditions and restrictions are satisfied. Section 965 provides that a U.S. company may elect, for one taxable year, an 85 percent dividends received deduction for eligible dividends from its foreign subsidiaries giving it an effective 5.25 percent tax rate on qualifying dividends.

In January 2005, Treasury and IRS issued a notice (Notice 2005-10) that provided guidance to companies on the domestic reinvestment plan requirement under the new provision. The notice specified permitted investments in the United States for which the repatriated funds may be used under this provision. The notice announced today (Notice 2005-38) provides additional guidance on the amount of dividends that qualify for the dividends received deduction. Further, Treasury and the IRS announced their intention to issue a third notice that will address the impact of section 965 on a corporation's computation of its tax liability.

How it works

- Under the new section 965, for one year only, companies that repatriate earnings from foreign subsidiaries and reinvest them in the United States are subject to a reduced effective 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 dividends may qualify for the deduction. A qualifying dividend must, for example, be paid in cash and exceed the amount that a company has historically repatriated from its foreign subsidiaries.

Dividends qualifying for the deduction

- ✓ The qualifying dividends must be paid in cash.
- ✓ The qualifying dividends must exceed the amount a company has historically repatriated from its foreign subsidiaries.
- ✓ Qualifying dividends may not exceed the greater of $500 million or the amount a company has previously reported on its financial statement as permanently reinvested overseas.
- ✓ The amount of dividends otherwise qualifying for the deduction is reduced to the extent of the total debt outstanding from the foreign subsidiaries to related parties at the end of the company's election year exceeds the amount of debt owed by its foreign subsidiaries to related parties on October 3, 2004.
- ✓ The amount of the dividends must be invested in the United States in accordance with an approved investment plan (as outlined in Notice 2005-10).

Historical Threshold of Repatriations

The dividends that qualify for the deduction must be extraordinary in that they exceed the amount that a company has historically repatriated. The notice provides guidance on how to define the historical threshold above which dividends may qualify for the deduction.

- ✓ In general, a domestic company must determine its threshold repatriation level based on the annual average repatriations by its foreign subsidiaries during the five most recent taxable years ending prior to June 30, 2003, taking out the high and low years.

- ✓ The repatriations by a foreign subsidiary during the five most recent taxable years ending prior to June 30, 2003 are treated as a tax attribute of a domestic company that owns such foreign subsidiary. Accordingly, this attribute remains with the domestic company upon the sale of its stock.

Maximum Repatriations

- ✓ In general, the statute limits the maximum repatriations qualifying for the deduction to the greater of the amount of earnings permanently reinvested overseas as indicated on its financial statement or $500 million.

- ✓ To the extent the earnings reported as permanently reinvested overseas are attributable to the foreign subsidiaries held by a domestic company, these amounts are treated as a tax attribute of such company. Accordingly, this attribute remains with a domestic company upon the sale of its stock.

Related party indebtedness

- ✓ The amount of dividends otherwise eligible for deduction under section 965 must be reduced by the amount of the increase in related party debt between October 3, 2004 and the last day of the election year.

- ✓ This rule is intended to prevent a deduction from being claimed in cases in which a domestic company directly or indirectly finances the payment of a dividend from a foreign subsidiary.

- ✓ The notice provides detailed rules on how certain transactions after October 3, 2004 may effect the general rules for calculating a foreign subsidiaries indebtedness to related persons for purposes of section 965.

Sec. 78 gross-up

- ✓ Under section 78 of the Internal Revenue Code, a U.S. company is required to include in its income an amount of foreign taxes it is deemed to have paid during the taxable year.

- ✓ Section 965 does not allow a foreign tax credit, including the foreign taxes deemed paid, for the deductible portion of the dividend.

- ✓ The notice provides that a section 78 gross-up does not apply to any foreign tax for which a foreign tax credit is disallowed under section 965.

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 would, for example, mean 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 qualifying 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 later years?
The provision applies only for the year specified and cannot be used in later years.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 10, 2005
2005-5-10-15-39-22-23520

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 $79,512 million as of the end of that week, compared to $79,483 million as of the end of the prior week.

I. Official U.S. Reserve Assets *(in US millions)*						
	April 29, 2005			May 6, 2005		
TOTAL	79,483			79,512		
1. Foreign Currency Reserves [1]	Euro	Yen	TOTAL	Euro	Yen	TOTAL
a. Securities	11,941	15,032	26,973	11,863	14,991	26,854
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	11,652	3,022	14,674	11,579	3,013	14,592
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]			15,184			15,418
3. Special Drawing Rights (SDRs) [2]			11,610			11,607
4. Gold Stock [3]			11,041			11,041
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets						
	April 29, 2005			May 6, 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		
	April 29, 2005	May 6, 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						

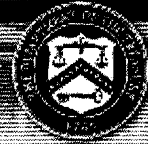
Notes:

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

May 11, 2005
JS-2437

Randal K. Quarles
Acting Under Secretary for International AffairsTestimony before the House Appropriations Subcommittee on
Foreign Operations, Export Financing, and Related Programs
FY2006 Budget Request for Treasury International Programs

Chairman Kolbe, Ranking Member Lowey, Members of the Subcommittee, thank you for the opportunity to testify this morning on President Bush's FY2006 budget request for Treasury's International Programs.

Treasury's International Programs – which include the multilateral development banks (MDBs), debt reduction, and technical assistance – are critical instruments in promoting the Administration's international economic agenda. The MDBs promote global economic growth and poverty reduction, thereby helping to create stronger markets for U.S. goods and services. They also support specific U.S. foreign policy priorities, such as combating money laundering and terrorist financing, rebuilding conflict-torn economies such as Iraq and Afghanistan, and assisting recovery from natural disasters. Similarly, debt reduction can help poor countries remove debt overhang, which inhibits a country's economic growth. A sustainable level of debt, if properly structured, can end the cycle of lend and forgive. Our technical assistance helps countries institute the sound budget and financial systems needed for economic growth.

The FY2006 request for Treasury's International Programs totals $1.46 billion. It includes $1.33 billion to fully fund our annual commitments to the MDBs, $6.6 million towards clearing a portion of U.S. arrears to these institutions, $99.75 million towards Treasury debt reduction programs, and $20.0 million for technical assistance.

Measurable Results, Debt Sustainability and Accountability at the MDBs

When former Under Secretary John Taylor testified before this Committee last year, he highlighted an IDA education project in Kenya as an example of how more development projects should be done. This particular project – which provided a $50 million grant to buy textbooks – had a detailed timeline outlining how to: (1) provide the funding to 18,000 schools across the country; (2) to give parents and teachers the authority to buy the books; and (3) to keep track of the funds. In fact, one of the schools visited during the former Under Secretary's trip included its financing and expenditures to the last shilling on one of the school's blackboards. Thus, the financing was provided on terms appropriate to the country's debt situation, was tied to explicit performance targets and timelines, and was executed in a completely transparent manner. The Bush Administration has strivend to ensure that more MDB projects have these critical components, which will maximize effectiveness and results on the ground.

Our work has produced considerable progress, particularly as a result of the recent replenishment agreements, the International Development Association (IDA), the African Development Fund (AfDF), and the Asian Development Fund (AsDF), all of which include enhanced results measurement provisions to this effect. As a result of strong U.S. leadership – and drawing upon broad congressional support – these institutions will now use significantly expanded results measurement systems, increase grant assistance to poor countries, use improved performance allocation

systems, focus more on private-sector development, fight corruption, and improve transparency and accountability.

Measuring Results: The U.S. has led a high-priority campaign for the establishment of results-based systems that set quantifiable performance targets and measure results at the project, sector, country and institutional levels of operations. It is not enough to say that a medical clinic has been built to provide vaccinations for children. What matters is whether the vaccines actually get given to the children who need them and their health improves. This requires establishing a pervasive results culture in the MDBs by incorporating a measurable results agenda into all operations, including staff evaluations and incentives; strongly encouraging and building capacity in developing countries to collect the data necessary to measure results; and emphasizing the need to establish outcome indicators and monitoring systems early in the design of country assistance strategies and individual projects.

As a result of U.S. leadership, the MDBs are changing their operating style to focus on results and are continuing to strengthen their systems of measurement and accountability. All of the MDBs have begun to mainstream mechanisms to measure and report the results of their projects. The new reforms emphasize development outcomes in addition to process indicators. For example, the recent IDA Replenishment (IDA-14) significantly expands the existing results measurement system. The IDA-14 Agreement instructs World Bank Management to use a two-tiered system to monitor: (1) progress on aggregate country outcomes, and (2) IDA's contribution to country outcomes. In addition, it commits World Bank Management to working to ensure that 100 percent of IDA loans and grants include indicators connected to a timeline with baseline data and periodic assessments of projects and programs. At the Asian Development Fund, results measurement was a centerpiece of the AsDF-9 replenishment negotiations, which concluded in May 2004. As part of the African Development Fund Replenishment (AfDF-10), every project and strategy coming to the Board of Directors will have a fully operational results-based management system by mid-2006. These replenishment agreements illustrate that U.S. efforts to improve the efficiency and effectiveness of MDB operations are working.

Debt Sustainability and Increased Grants: For the last twenty-five years, the international community has attempted to address the unsustainable debt burdens of poor countries through a series of stop-gap measures. During this period, a number of countries have needed and received repeated debt reduction and reschedulings from the "Paris Club" of major bilateral creditors. Numerous poor countries, including Cote d' Ivoire, Democratic Republic of Congo, Madagascar, Mauritania, Mozambique, Niger, Senegal, Sierra Leone, Togo, Uganda, and Zambia have received 8 or more Paris Club agreements each.

All of these responses were understandable in light of countries' debt problems; however, they have not comprehensively addressed the longer term systemic determinants of debt distress, such as perverse incentives for excessive lending and excessive borrowing. The result has been that as debt is cleared through forgiveness and re-schedulings, the IFIs have stepped in and provided new loans, often exceeding the amount of debt relief and with little regard for a country's capacity to pay. For example, between 1989 and 2002, countries eligible for the Heavily Indebted Poor Countries initiative (HIPC) received a total of $40 billion in debt relief but accumulated nearly $93 billion in new debt.

The Bush Administration strongly believes that grant financing is a critical component of any long-term debt sustainability solution. In 2001, President Bush called on the MDBs to provide 50 percent of their assistance to the poorest countries in the form of grants. As a result of strong U.S. leadership, the recently agreed IDA and AfDF replenishments stipulate that approximately 45 percent of IDA and AfDF assistance to the poorest countries will be provided on grant terms. These breakthrough achievements build on the significant progress that the U.S. secured during the previous replenishment negotiations, which stipulated that IDA and the AfDF would provide between 18 and 21 percent of total assistance in the form of grants. Before then, less than one percent of assistance was provided as grants. Clearly, we are making substantial progress toward ending the lend-and-

forgive approach to multilateral assistance and toward facilitating long-term debt sustainability in poor countries.

The U.S. is continuing to have constructive discussions with the G-7 and other MDB shareholders about moving this important issue even further. The shift to greater use of grant financing will reduce unsustainable debt burdens over the long-term. However, debt will continue to act as a constraint on economic growth in the interim. To address this problem, the Bush Administration has put forth a concrete and doable proposal that would relieve the debt burdens of poor countries and fundamentally fix the multilateral system. Our proposal calls for immediate action to provide up to 100 percent relief on IDA and AfDB loans to the HIPCs without additional cost. Net assistance levels would, at a minimum, remain unchanged from current levels. In addition, those bilateral creditors not providing 100 percent relief on pre-Cologne Summit (June 20, 1999) debt should take action immediately to do so. Following debt relief, IDA and AfDF assistance to HIPCs would be provided on grant terms. Over time, the HIPCs would gradually be eased into new borrowing based upon their capacity to repay. These actions will serve to conclusively end the lend-and-forgive approach to multilateral assistance; put these poor countries on a sustainable path over the long-term; and eliminate the need for future rounds of debt relief. In other words, the proposal not only drops the debt of yesterday, but prevents debt from burdening countries again well into the future.

For our part, the U.S. committed to provide 100 percent bilateral debt reduction to eligible countries under the HIPC Initiative. While we have completed our funding obligations for the majority of participating HIPC countries, some work remains. This includes fully financing bilateral debt reduction for the Democratic Republic of Congo and providing HIPC relief for Liberia and other countries if they achieve political peace and make progress on their economic programs. The U.S. also provides funding to the HIPC Trust Fund, which helps finance the HIPC debt reduction costs of the regional multilateral institutions. In addition, the U.S. provides debt reduction through the Tropical Forest Conservation Act (TFCA), which relieves certain debts owed the U.S. while generating funds to support local tropical forest conservation activities. To date, eight countries have TFCA agreements: Bangladesh, Belize, Colombia, El Salvador, Jamaica, Panama (two agreements), Peru, and the Philippines. These deals will generate over $95 million for tropical forest conservation in these countries over the life of the agreements. A number of other countries have qualified for or expressed interest in the TFCA.

Performance-Based Allocations: Assistance is effective when it is provided to countries that are committed to and successful in implementing sound pro-growth economic policies. A sound policy environment also attracts investment because it increases private sector confidence. On the other hand, providing assistance to countries that are not committed to good policies can actually be counterproductive. As a result, the U.S. has urged the MDBs to focus their efforts on projects that contain measurable results and raise living standards through higher productivity. This means placing a greater emphasis on private sector development - particularly small and medium sized enterprises – as well as on health and education, to help individuals realize their full potential. It also means aggressively promoting pro-growth policies that enable countries to use assistance effectively. Because of U.S. leadership, the concessional windows of all the MDBs – which are devoted to the poorest countries – have established performance-based allocation systems. Such systems provide more resources to countries with sound growth-oriented policies and fewer resources to countries without them, with an extra emphasis on governance to promote transparency and fight corruption. For example, the best policy performers in IDA receive almost seven times more resources per capita than the poorest performers.

Fighting Corruption: Governance, Transparency and Accountability. Good governance is essential for a vibrant private sector and for economic growth. Poor governance, the lack of rule of law or enforceable contracts, and the prevalence of corruption create disincentives to invest, to start new firms, and to expand existing firms with high-productivity jobs. This has a negative impact on capital formation and entrepreneurial activity. In too many cases, potential entrepreneurs and investors in developing countries are deterred by arbitrary rules, corrupt bureaucracies, and weak judiciary systems. For these individuals to succeed, governments must fairly enforce laws and contracts and respect human rights and

property. As a result of strong U.S. urging, more diagnostics on governance issues are being undertaken by the MDBs, governance and corruption are routinely discussed in MDB country strategies, and more assistance is being provided to help countries tackle corruption issues. Efforts to fight anti-corruption are focused on three levels: the country level, the project level, and the institutional level.

At the country level, U.S. efforts to strengthen anti-corruption activities are focused on enhancing the transparency and accountability of recipient countries' governance systems and disclosure in MDB operations and analysis, and to channel MDB resources towards countries that have good governance in place. At the project level, U.S. efforts are focused on encouraging the MDBs to conduct analysis and design projects that help reduce opportunities for corruption, strengthen fiduciary and procurement standards, and help ensure that MDB funds will be well spent. At the institutional level, U.S. efforts are focused on improving the MDB internal control processes for internal auditing, investigative mechanisms, whistleblower protections, and corporate procurement, as well as increasing the disclosure of information and the accountability of MDB operations.

Transparency at the MDBs allows the kind of public scrutiny that is essential to ensuring accountability and results. The U.S. continues to press the MDBs to release more documents, especially those relating to Board decisions, country strategies, measurable results, and anti-corruption measures. Section 581 of Division D of the Consolidated Appropriations Act, 2004, directs the Secretary of the Treasury to instruct the United States Executive Director at each multilateral development institution to inform his or her respective institution of certain policy goals pertaining to transparency and accountability and to use the voice and vote of the United States to achieve such goals.

Only one year after the legislation was passed, Ssubstantial progress has been made on these goals since the legislation was passed a little over one year ago. All the MDBs except two now publish the minutes of their Board meetings or are moving forward with proposals to do so. All the institutions except one now either post on their website an annual report containing statistics and case studies of fraud and corruption investigations or are moving forward with proposals to do so. All the institutions have taken measures to increase public involvement in, and awareness of, project and policy proposals that will be the subject of Board decisions. And all the institutions are reviewing their whistleblower protections to see how they can be enhanced. F or example, the World Bank makes publicly available considerable information on all its projects. This includes summary information on all projects for approval by the Board of Directors, information on the progress of individual projects during implementation, and detailed information on output and outcome indicators upon project completion. In addition, the IDA-14 Replenishment Agreement calls on the World Bank Board to take steps to: (i) publish project and program assessment reports; (ii) complete and publish an independent assessment of the World Bank's internal controls; (iii) strengthen documentation of stakeholder feedback from consultations required under the World Bank's safeguard policies; and (iv) enhance public access to information on World Bank Board proceedings, including the disclosure of Board minutes. Similar reforms have been achieved at the other MDBs. We will continue to work tirelessly to see these important reforms to fruition.

The FY2006 Request

There are four basic components of our FY2006 request: (1) annual funding for the MDBs, (2) arrears clearance for the MDBs, (3) funding for debt relief programs, and (4) technical assistance.

(1) Annual Funding for the MDBs: $1.33 billion

The Administration's request of $1.33 billion for the MDBs includes the first annual commitment to three new replenishments: IDA ($950.0 million), the AfDF ($135.7 million), and the AsDF ($115.3 million). Negotiations of these three replenishment were very successful in achieving key U.S. reform objectives. Each of these replenishments includes profound advances in improving debt sustainability through increased grants. IDA and the AfDF will increase the share of new funding

distributed to the poorest countries through grants, rather than loans, to about 45 percent from approximately 25 percent and 20 percent, respectively. The AsDF established a grant window for the first time and approximately 30 percent of assistance to the poorest countries will be in the form of grants. Success was also achieved in the areas of debt sustainability, measurable results, transparency, and support for the private sector. U.S. contributions leverage significant resources in the MDBs, for the new replenishment of IDA every $1 provided by the U.S. provides more than $9 from other sources.

(2) Arrears Clearance for the MDBs: $6.6 million

The $6.6 million request for arrears clearance is part of an effort to pay down U.S. arrears to the institutions, which now total $687.0 million. It is critical for the U.S. to meet its international commitments, thus helping to ensure U.S. leadership and credibility on policy direction, program priorities, and institutional reform.

(3) Debt Relief: $99.75 million

The Administration's request for debt restructuring is $99.75 million to be available for bilateral HIPC and poorest country debt reduction, contributions to the HIPC Trust Fund, and TFCA debt reduction, with flexibility in determining the amount for each program. Under the enhanced HIPC initiative, the requested funding could be used towards covering a portion of the cost of bilateral debt reduction for HIPCs, including the Democratic Republic of the Congo and possible new countries such as Liberia, and/or completing the U.S. pledge of $150 million in additional contributions to the HIPC Trust Fund.

(4) Technical Assistance: $20.0 million

The request also includes $20.0 million for Treasury's technical assistance programs, which form an important part of our efforts to support countries facing economic development or financial security issues, and whose governments are committed to fundamental reforms. The FY2006 request will allow us to continue current programs in the Middle East, Africa, Asia, and Central and South America, as well to expand into new countries committed to sound economic reform policies. Of the FY2006 request, we expect to use $10.0 million of the funds on programs that focus on anti-terrorist initiatives, to be spent in coordination with other U.S. Government agencies, and we will use $2.8 million on programs in Afghanistan.

Authorization Requests

For FY2006, the Administration is seeking authorization for the replenishments of three concessional windows of the MDBs: the fourteenth replenishment of IDA; the tenth replenishment of the AfDF; and the eighth replenishment of the AsDF. Additionally, the Administration will be seeking authority to reduce lend-lease debt for Liberia under the HIPC initiative in order to be able to meet the Administration's commitment to forgive 100 percent of debt for HIPC countries. Draft authorization legislation has been sent to the Speaker of the House and the President of the Senate. I look forward to working with you as well as the authorizing committees to achieve the authorization of these critical programs.

Conclusion

We will continue to work with the MDBs to make progress on implementing our strong reform agenda. I ask for your support as we strengthen these institutions in ways that increase their effectiveness in utilizing U.S. taxpayers' financing and in serving vital U.S. economic and security interests around the world. Our debt reduction and technical assistance programs also serve key U.S. reform and growth objectives in very important ways.

Thank you very much. I look forward to working with you on funding this request, and I would be happy to respond to your questions.

FROM THE OFFICE OF PUBLIC AFFAIRS

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May 11, 2005
JS-2438

Treasury Department Announces $2 Billion to Help
Nation's Low-Income Communities
Awards Announced Under 3rd Round of New Markets Tax Credit Program

Treasury Secretary John W. Snow today announced that 41 organizations have been selected to receive $2 billion in tax credit allocations under the New Markets Tax Credit (NMTC) Program in a ceremony held at the Treasury Department. The NMTC Program attracts private-sector capital investment into the nation's urban and rural low-income areas to help finance community development projects, stimulate economic growth and create jobs.

"Today's announcement promises more jobs and a brighter future for the Washington, DC area and for every community where NMTCs are allocated," said Secretary Snow. "By providing businesses with critical investments, job creation will be stimulated in communities that are very much in need."

The NMTC program, established by Congress in December of 2000, permits individual and corporate taxpayers to receive a credit against federal income taxes for making qualified equity investments in investment vehicles known as Community Development Entities (CDEs). The credit provided to the investor totals 39 percent of the cost of the investment and is claimed over a seven-year period. Substantially all of the taxpayer's investment must in turn be used by the CDE to make qualified investments in low-income communities. The 41 organizations were selected through a competitive application and rigorous review process. The NMTC program is administered by Treasury's Community Development Financial Institutions (CDFI) Fund.

"The New Markets Program is doing what it is suppose to do – attracting sources of capital to our nation's low-income communities," said CDFI Fund Director Art Garcia. "By partnering with the private sector and community organizations, previous recipients have already leveraged their credits into more than $2 billion in equity from investors."

The CDFI Fund anticipates announcing the opening of the application period for the next round of the NMTC Program during the summer of 2005.

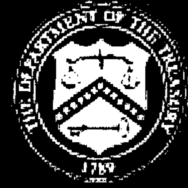
A complete list of the 41 organizations selected can be found at the link below; additional information on the NMTC Program can be found on the CDFI Fund's web site at: www.cdfifund.gov.

REPORTS

Third Round (2005) NMTC Allocation Recipients

Name of Allocatee	Headquarters	Service Area	Predominant Market	Allocated Amount	Predominant Financing Activity
Advantage Capital Community Development Fund, LLC	New Orleans, LA	National	AL, FL, HI, LA, MO, NY, TX	$50,000,000	Business
Appalachian Fund For Growth II, LLC	Chattanooga, TN	Multi-state	GA, NC, TN	$17,000,000	Business
Bethany Square, LLC	Los Angeles, CA	Local	Los Angeles, CA	$11,000,000	Real Estate (Mixed Use)
Biotech Research Center, LLC	Kailua, HI	Local	Honolulu, HI	$28,000,000	Real Estate (Office)
CCG Community Partners, LLC	Princeton, NJ	National	CA, FL, IN, MO, NJ, TX, VA	$50,000,000	Real Estate (Office)
CDF Development, LLC	Baltimore, MD	National	KY, MD, MO, NJ, NY, TX, VA	$60,000,000	Real Estate (Retail)
Chase Community Development Corporation	New York, NY	National	AZ, IL, MI, NJ, NY, OH, TX	$75,000,000	Financing CDEs
Chevron NMTC Fund, LLC	San Francisco, CA	National	CA, IL, LA, MD, NY, OR, PA	$20,000,000	Real Estate (Mixed Use)
Cincinnati Development Fund	Cincinnati, OH	Local	Cincinnati, OH	$52,000,000	Real Estate (Mixed Use)
Clearinghouse CDFI, The	Lake Forest, CA	Local	Los Angeles, CA metropolitan area	$75,000,000	Real Estate (Retail)
Colorado Growth and Revitalization Fund, LLC	Denver, CO	Statewide	Colorado	$40,000,000	Real Estate (Mixed Use)
Community Ventures Corporation, Inc.	Lexington, KY	Statewide	Kentucky	$12,000,000	Business
CSDC New Markets Fund, LLC	Washington, DC	National	AZ, CA, FL, IN, MN, NM, TX	$40,000,000	Business
Ecotrust CDE, LLC	Portland, OR	Multi-state	CA, OR, WA	$50,000,000	Business
ESIC New Market Partners, LP	Columbia, MD	National	CA, FL, MD, NY, OH, TX, DC	$80,000,000	Real Estate (Mixed Use)

Name of Allocatee	Headquarters	Service Area	Predominant Market	Allocated Amount	Predominant Financing Activity
Forest City Community Development Entity, LLC	Brooklyn, NY	National	CT, MA, NJ, NY, OH, PA, RI	$51,000,000	Real Estate (Retail)
Genesis LA CDE, LLC	Los Angeles, CA	Local	Los Angeles, CA	$80,000,000	Real Estate (Retail)
Hampton Roads Ventures, LLC	Norfolk, VA	Statewide	Virginia	$35,000,000	Real Estate (Retail)
Inner City Ventures CDE, LP	Atlanta, GA	Local	Atlanta, GA	$40,000,000	Real Estate (Mixed Use)
Kentucky Highlands Investment Corporation	London, KY	Local	Southeastern Kentucky	$22,000,000	Business
Kista NMTC Fund, LLC	Frankfort, KY	Statewide	Kentucky	$25,000,000	Business
Lenders for Community Development	San Jose, CA	Local	San Francisco-Oakland-San Jose, CA	$25,000,000	Real Estate (Facilities)
Local Initiatives Support Corporation	New York, NY	National	CA, FL, IL, MI, MN, NY, WI	$90,000,000	Real Estate (Retail))
Louisville Development Bancorp, Inc.	Louisville, KY	Local	Louisville, KY	$8,000,000	Real Estate (Mixed Use)
Massachusetts Housing Investment Corporation	Boston, MA	Statewide	Massachusetts	$54,000,000	Real Estate (Mixed Use)
Michigan Magnet Fund	Lansing, MI	Statewide	Michigan	$60,000,000	Real Estate (Mixed Use)
Milwaukee Economic Development Corporation	Milwaukee, WI	Local	Milwaukee, WI	$18,000,000	Business
MK La Charitable Healthcare Facilities Fund, LLC	New Orleans, LA	Statewide	Louisiana	$60,000,000	Financing CDEs
NAB Bank	Chicago, IL	Local	Chicago, IL	$5,000,000	Business
National Cities Fund, LLC	New Orleans, LA	National	FL, LA, MD, MO, MS, NC, VA	$25,000,000	Real Estate (Mixed Use)
National New Markets Tax Credit , Inc.	Minneapolis, MN	National	AL, CA, CO, MN, NJ, OR, PA	$100,000,000	Loan Purchases
New Markets Redevelopment LP	Oklahoma City, OK	Local	Oklahoma City, OK	$34,000,000	Real Estate (Office Space)



Name of Allocatee	Headquarters	Service Area	Predominant Market	Allocated Amount	Predominant Financing Activity
NYCB Community Development Corp	Westbury, NY	Local	New York City, NY metropolitan area	$42,000,000	Real Estate (Mixed Use)
REI New Markets Investment, LLC	Durant, OK	Statewide	Oklahoma	$56,000,000	Business
Self Help Ventures Fund	Durham, NC	National	FL, GA, NC, NY, TX, VA, DC	$95,000,000	Real Estate (Mixed Use)
Structured Products Group CDE, LLC	Denver, CO	National	CA, CO, FL, MD, NJ, TX, DC	$90,000,000	Real Estate (Retail)
Sun Trust Community Development Enterprises, LLC	Atlanta, GA	National	FL, GA, MD, NC, TN, VA, DC	$75,000,000	Real Estate (Retail)
Telesis CDE Corporation	Washington, DC	National	FL, IL, NJ, NY, OH, PA, DC	$60,000,000	Real Estate (For Sale Housing)
UA LLC	New York, NY	National	CA, FL, MA, MD, NY, PA, TX	$50,000,000	Real Estate (Mixed Use)
Valued Advisor Fund, LLC, The	Chicago, IL	National	GA, IL, IN, KS, MI, MO, TN	$50,000,000	Financing CDEs
Wachovia Community Development Enterprises, LLC	Charlotte, NC	National	FL, GA, NC, NJ, PA, TX, DC	$90,000,000	Financing CDEs

CDFI Fund • 601 Thirteenth Street, NW • Suite 200 South • Washington, DC 20005 • (202) 622-8662

FROM THE OFFICE OF PUBLIC AFFAIRS

May 11, 2005
JS-2439

The Honorable John W. Snow
Remarks on the New Markets Tax Credits Program

Good morning, everyone, and congratulations to all of today's awardees. Communities across the country are fortunate to have each and every one of these groups working on its behalf.

One of the President's top priorities is to have a growing economy that creates lots of good jobs. He is especially interested in promoting economic growth and entrepreneurship in economically distressed areas. This is where the New Markets Tax Credits come in.

In this, the third round of the New Markets Tax Credits (NMTC) program, 41 awardees nationally will receive an aggregate total of $2 billion in New Markets Tax Credits equity allocations. Each one was selected through an intensely competitive process; you should be extremely proud of this accomplishment.

We believe that you best know the answer to some vital questions: What is good for the communities you serve? What type of new venture would create the most jobs and help the most people?

For instance, the people who live and work here in this area know the answers to those questions better than the federal government. Although it is the Capital, the case with Washington is no different than any other locality in the country – the people closest to the community, the people who know the neighborhoods and their residents, those are the people who know best what the community needs.

The desire to encourage business investment and job creation in areas of need is the idea behind the NMTC program. Its simple but vital purpose is to stimulate economic and community development and job creation in the nation's low-income communities by attracting capital from the private sector.

The NMTC program is an important community and economic development tool because it should stimulate job creation – and nothing is more important to our economy, to individuals, and to families than the creation of new jobs.

Self-Help Ventures Fund (SHVF), for example, creates jobs by making commercial loans to businesses, community facilities and commercial real estate projects located in low-income communities. With its allocation, SHVF will continue to expand its geographic lending territory and offer loan products that provide better terms and conditions, such as loans at interest rates up to two percent lower than SHVF's regular, risk adjusted loan rates.

Another example is the good that Wachovia Community Development Enterprises (WCDE) will do by using the value of the NMTC to subsidize the cost of financing real estate transactions by lowering the interest rate to qualified real estate and non-real estate businesses. They will use the capital to finance the construction, rehabilitation and operation of office, retail, industrial, mixed-use and community service properties and businesses. And that's terrific news for the communities where that development will take place.

The infusion of capital that groups like SHVF and WCDE brings to local business is a recipe for success. I look forward to seeing the results that NMTCs can bring to this wonderful city, and communities across the nation, with the help of these tax credits.

The message the New Markets Tax Credit program sends is: "This community is open for business." I am thrilled that message is going out in the city that houses the nation's Capitol on this day.

Today's announcement is a step toward a brighter future for this area, and for every community that is home to an NMTC awardee.

FROM THE OFFICE OF PUBLIC AFFAIRS

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May 11, 2005
JS-2440

**Treasury Designation Targets North Valle
Cartel Associates, Businesses
-Sixty-three Individuals, Entities Named
Colombian Narcotics Traffickers-**

The U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) today added 32 companies and 31 individuals to its list of Specially Designated Narcotics Traffickers (SDNTs). The companies named form the Grajales business group, known in Colombia as *Grupo Grajales*. Also designated today was the head of *Grupo Grajales*, Raul Alberto Grajales Lemos.

"Today's designation dealt another serious blow to the financial network of the North Valle cartel," said Robert Werner, Director of OFAC. "By breaking the financial backbone of groups like North Valle, we help thwart the ability of cartels to traffic lethal narcotics in the United States and abroad."

"Actions like today's weaken the viability of rogue groups and reduce their ability to undermine the legitimate, democratic governments of countries in which they operate, like Colombia. The designation process is a truly important tool that furthers the national security and foreign policy interests of the Untied States by helping to promote stability abroad," Werner continued.

Raul Grajales Lemos, the head of Grupo Grajales, is the subject of a cocaine trafficking indictment filed in the Southern District of Florida. In addition, he has been associated with various leaders of the North Valle drug cartel for many years, including SDNT principal individuals Ivan Urdinola Grajales (deceased 2002) and Carlos Alberto Renteria Mantilla (a.k.a. Beto Renteria). The North Valle drug cartel is the target of a Racketeer Influenced and Corrupt Organizations (RICO) Act indictment filed in the District of Columbia.

Lorena Henao Montoya (SDNT since February 2000), the widow of confessed narcotics trafficker Ivan Urdinola Grajales, was captured in Panama in January 2004. Documents seized from Lorena Henao Montoya's properties and associates demonstrate her financial links to principal *Grupo Grajales* companies, including *Grajales S.A.* (fruit cultivation), *Casa Grajales S.A.* (winery), *Frexco S.A.* (fruit processing and exports) and *Hotel Los Vinedos* (La Union, Valle, Colombia). Other documents seized in Panama exposed Lorena Henao Montoya's bribery of Colombian officials involved in asset forfeiture cases against her. She pleaded guilty to these charges and is now serving a prison sentence in Colombia.

Beto Renteria, a fugitive who was named as a leader of the North Valle drug cartel in the RICO indictment, also has a financial interest in *Grupo Grajales* companies. Beto Renteria's key financial front man, Mauricio Pardo Ojeda (SDNT since March 2005), is involved in the holding and management companies that operate *Casa Estrella*, a Colombian department store chain. In addition, the wife of Beto Renteria, Maria Nury Caicedo Gallego (SDNT since March 2005), is involved in *Salome Grajales y Cia. Ltda.*, a company named after the sister of Raul Grajales Lemos. The *Casa Estrella* department store chain was once known as "*Casa Grajales*" and remains a part of *Grupo Grajales*.

SDNTs are subject to the economic sanctions imposed against Colombian drug cartels in Executive Order 12978. Today's action freezes any assets found in the United States and prohibits all financial and commercial transactions between the designees and any U.S. person.

The assets of a total of 1,215 business and individuals in Aruba, Colombia, Costa Rica, Ecuador, Panama, Peru, Spain, Vanuatu, Venezuela, the Bahamas, the British Virgin Islands and the Cayman Islands are now blocked under E.O. 12978. The 460 SDNT businesses include agricultural, aviation, consulting, construction, distribution, financial, investment, manufacturing, mining, offshore, pharmaceutical, real estate and service firms. The SDNT list includes 18 kingpins from the Cali, North Valle and North Coast drug cartels in Colombia, including newly named North Valle cartel leader Raul Alberto Grajales Lemos.

For more information on recent Treasury actions against the North Valle cartel, please visit the following links:

Treasury Designation Targets North Valle Drug Cartel Leader

http://www.treas.gov/press/releases/js2324.htm

Treasury Designates North Valle Drug Cartel Traffickers

http://www.treas.gov/press/releases/js2031.htm

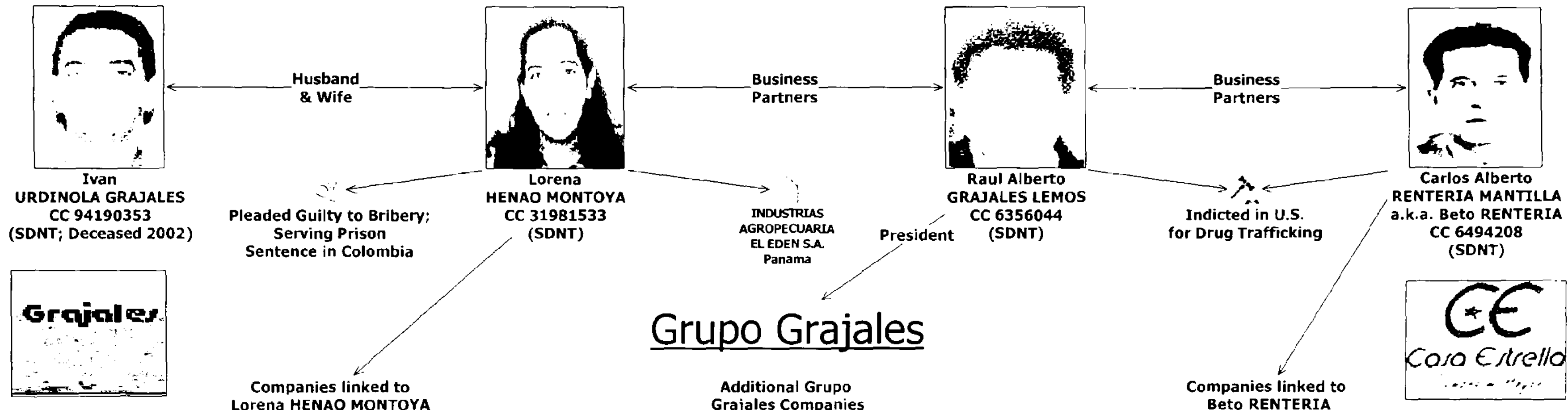
A complete list of the entities identified today can be found at:
http://www.treas.gov/offices/enforcement/ofac/actions/.

REPORTS

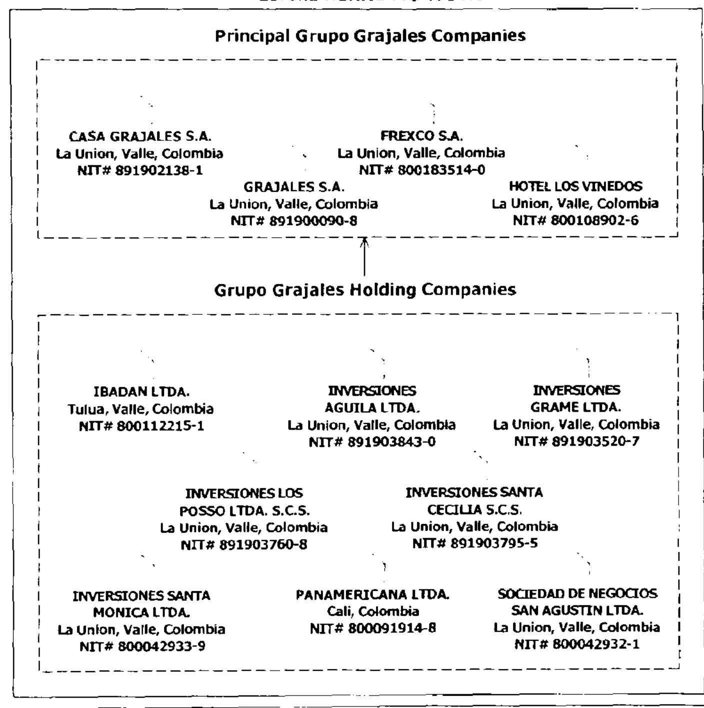
- A diagram of the individuals and businesses designated today

North Valle Cartel Financial Network
May 2005

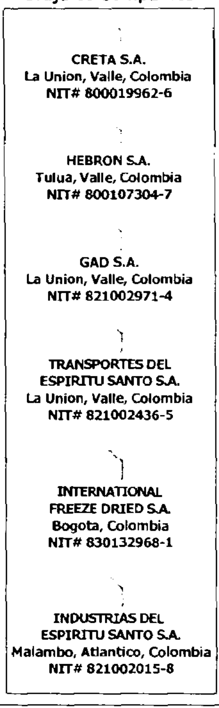
U.S. Department of the Treasury
Office of Foreign Assets Control
Specially Designated Narcotics Traffickers (SDNTs)



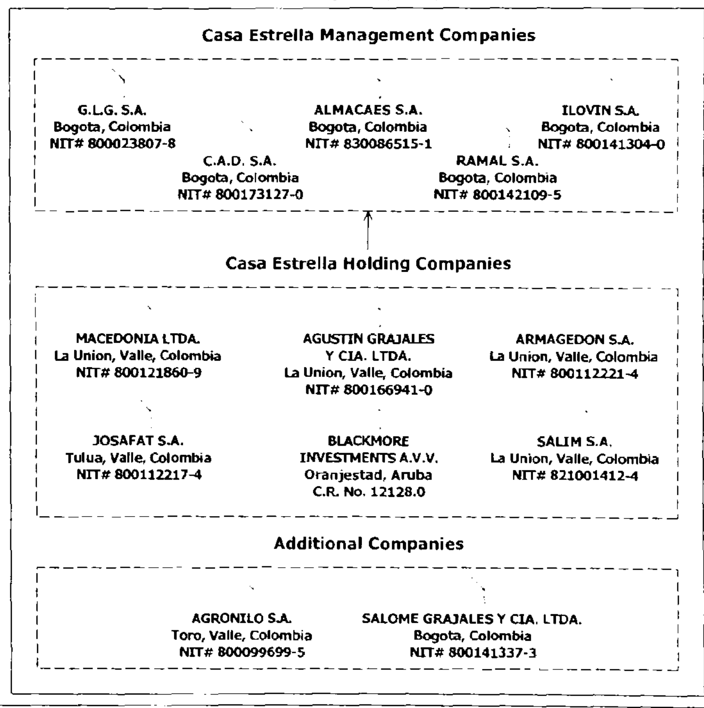
Companies linked to Lorena HENAO MONTOYA



Additional Grupo Grajales Companies



Companies linked to Beto RENTERIA



FROM THE OFFICE OF PUBLIC AFFAIRS

May 12, 2005
JS-2441

Treasury Designates Jemaah Islamiyah's Emir, Top Bomb Maker and Military Commander

The U.S. Department of the Treasury today designated three individuals for their role in Jemaah Islamiyah (JI), a terrorist group in Southeast Asia with links to al Qaida.

"JI, as a terrorist franchise of al Qaida, has demonstrated its wanton desire to kill innocent civilians of every race, religion and creed and continues to pose a real threat to security in Southeast Asia. We will continue to work with our colleagues in the region and the international community to identify and isolate key members of JI, like those we have designated today," said Juan Zarate, Treasury's Assistant Secretary for Terrorist Financing and Financial Crimes.

The Treasury's Office of Terrorism and Financial Intelligence (TFI) utilizes its financial tools, including the Office of Foreign Assets Control's (OFAC) designation powers, to safeguard the financial system through the financial isolation of rogue actors.

Abu Rusdan, Zulkarnaen and Joko Pitono were designated under Executive Order 13224, President Bush's Order aimed at freezing the assets of terrorists and their support networks. The U.S. is submitting the individuals to the United Nations 1267 Committee, which will consider adding them to the consolidated list of terrorists tied to al Qaida, UBL and the Taliban.

JI's stated goal is to create an Islamic state comprised of Malaysia, Singapore, Indonesia and the southern Philippines. Members of JI have been trained, funded and directed by al Qaida leadership to pursue al Qaida's agenda across the region.

The U.S. Government possesses credible evidence that these individuals are key officials in JI and support and/or commit acts of terrorism on behalf of JI and JI's support for al Qaida. **Identifying Information**

ABU RUSDAN

AKAs: Abu Thoriq
Rusdjan
Rusjan
Rusydan
Thoriquddin
Thoriquiddin
Thoriquidin
Toriquddin

DOB: August 16, 1960
POB: Kudus, Central Java, Indonesia

Information available to the U.S. Government shows Abu Rusdan replaced Abu Bakar Bashir as the "Emir" or leader of JI after Bashir's arrest. As Emir, Rusdan chaired JI leadership meetings and organized the group's affairs.

In February 2004, Rusdan was convicted by an Indonesian court of helping hide Bali bomber Huda bin Abdul Haq Aka Mukhlas (SDGT) and was sentenced to three and a half years in jail.

ZULKARNAEN

AKAs: *Zulkarnan*
Zulkarnain
Zulkarnin
Arif Sunarso
Aris Sumarsono
Aris Sunarso
Ustad Daud Zulkarnaen
Murshid

DOB: *1963*
POB: *Gebang Village, Masaran, Sragen, Central Java, Indonesia*
Nationality: Indonesian

According to information available to the U.S. Government, Zulkarnaen is a member of the JI central command and the head of its military section. As military commander, Zulkarnaen is authorized to launch terrorist attacks and is responsible for intelligence operations and military training. Zulkarnaen was one of the first JI members to go to Afghanistan and reportedly spent a decade there training other JI members.

JOKO PITONO

AKAs: *Joko Pitoyo*
Joko Pintono
Dulmatin
Dul Matin
Abdul Martin
Abdul Matin
Amar Umar
Amar Usman
Anar Usman
Djoko Supriyanto
Jak Imron
Muktamar
Novarianto
Topel

DOB: *June 16, 1970*
ALT *DOB: June 6, 1970*
POB: *Petarukan Village, Pemalang, Central Java, Indonesia*
Nationality: Indonesian

Information available to the U.S. Government shows that Joko Pitono is a top bomb-maker for JI. Notably, Pitono was involved in making bombs for the Christmas Eve 2000 attacks on churches in Indonesia, which killed 19 people and injured approximately 120. He was also involved in the August 2000 bombing of the Philippine ambassador's house in Jakarta, which killed two people and seriously injured the Philippine ambassador.

Prior to the Bali bombings of 2002, a meeting to plan the attack was held at Pitono's house in Solo, Indonesia. Pitono is also suspected of being involved in the J.W. Marriott bombing in August 2003. Along with JI's Azahari bin Husin (SDGT), Noordin Mohamed Top (SDGT) and Zulkarnaen, Pitono is one of the most wanted men in Southeast Asia.

Background on Jemaah Islamiyah (JI)

In December 2001, Singapore authorities arrested thirteen JI members, eight of whom had trained in al Qaida camps in Afghanistan, who planned to bomb the U.S. and Israeli embassies, British and Australian diplomatic buildings and U.S. and Singapore defense targets in Singapore. Members of the group had conducted videotaped surveillance of potential targets and had already acquired explosives in preparation for the attacks. A copy of the videotape made by members of the group and showing intended targets in Singapore was found in Afghanistan in the wreckage of an al Qaida leader's house that same month.

JI members carried out the near-simultaneous bombings in Bali, Indonesia that killed 202 people on October 12, 2002. Two of the three blasts occurred in a busy nightclub in a popular tourist district, and one occurred near the U.S. consular agency. Citizens from over 20 countries were killed in the bombings. Australia suffered the greatest number of casualties with 88 Australian nationals killed.

JI has been blamed for the suicide bombing of the J.W. Marriott hotel in Jakarta, Indonesia on August 5, 2003 that killed 12 people. The attack took place during the busy lunch hour in Jakarta's central business district.

JI is also believed to be responsible for the September 9, 2004 suicide bomb attack outside the Australian embassy in Jakarta that killed nine people and injured 182.

The United States named JI a Specially Designated Global Terrorist (SDGT) and a Foreign Terrorist Organization (FTO) on October 23, 2002. Two days later, JI was added to the United Nations 1267 Committee's consolidated list of terrorists tied to Usama bin Laden (UBL), al Qaida or the Taliban. Notably, 36 countries supported the UN listing of JI, the single largest designation action to occur since the attacks of September 11, 2001.

These JI individuals were designated today under Executive Order 13224, chiefly pursuant to paragraphs (d)(i) and (d)(ii) based on a determination that they assist in, sponsor or provide financial, material, or technological support for, or financial or other services to or in support of, or are otherwise associated with, persons listed as subject to E.O. 13224. These individuals also meet 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 to them. 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.

For more information on Treasury actions against JI, please visit the following links:

Designation of Two Leaders of Jemaah Islamiyah:
http://www.treas.gov/press/releases/kd3796.htm?IMAGE.X=24\&IMAGE.Y=15

Snow Announces Designation of 10 Jemaah Islamiyah (JI) Terrorists:
http://www.treas.gov/press/releases/js700.htm?IMAGE.X=24\&IMAGE.Y=15

FROM THE OFFICE OF PUBLIC AFFAIRS

May 12, 2005
js-2442

Deputy Assistant Treasury Secretary Iannicola Encourages Credit Card Lenders to Support Financial Education at Industry Meeting in Nevada

Treasury's Deputy Assistant Secretary for Financial Education, Dan Iannicola, Jr. today spoke to more than 40 Credit Card Bank Compliance Association (CCBA) members about the importance of improving financial education across the country, and about how credit card issuers can work with the federal government to achieve common objectives in this area.

"The credit card industry has the expertise and the distribution channels to make a strong and positive impact on national levels of financial literacy," said Iannicola. " Some credit card issuers have used their unique positions to advance financial education, while other issuers are just beginning to recognize the need to educate customers and others on financial topics."

Iannicola continued, "The Department of Treasury stands ready to work with any credit card company that wants to help Americans learn more about managing their money."

Today's event was hosted by the CCBA. The CCBA is a non-profit educational association comprised of individuals who work for banks engaged primarily in consumer credit card lending. The primary activity of the CCBCA is to conduct two educational seminars per year focusing on legal, regulatory and compliance issues pertaining to consumer credit card lending.

The Department of the Treasury is a leader in promoting financial education. Treasury established the Office of Financial Education ("Office") in May 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:

FROM THE OFFICE OF PUBLIC AFFAIRS

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May 16, 2005
JS-2443

Treasury International Capital Data for March

Treasury International Capital (TIC) data for March are released today and posted on the U.S. Treasury web site (www.treas.gov/tic). Tl which will report on data for April, is scheduled for June 15, 2005.

Long-Term Domestic Securities

Gross purchases of domestic securities by foreigners were $1,531.0 billion in March, exceeding gross sales of domestic securities by fc billion during the same month.

Foreign purchases of domestic securities reached $60.1 billion on a net basis in March, relative to $98.1 billion during the previous mor reached $74.5 billion in March. Net private purchases of Treasury Bonds and Notes increased to $42.9 billion from $31.2 billion the pre private purchases of Government Agency Bonds were $6.5 billion, down from $10.9 billion the previous month. Net private purchases o $23.4 billion, down from $29.9 billion the previous month. Net private purchases of Equities declined to $1.7 billion from $7.4 billion.

Official net purchases of U.S. securities were minus $14.4 billion in March, relative to plus $18.7 billion in February. Official net purchas and Notes of minus $15.0 billion accounted for the bulk of official outflows in March, down from a positive $11.3 billion inflow the previo

Long-Term Foreign Securities

Gross purchases of foreign securities owned by U.S. residents were $337.2 billion in March, relative to gross sales of foreign securities $351.6 billion during the same month.

Gross sales of foreign securities to U.S. residents exceeded purchases by $14.4 billion, highlighting a net U.S. acquisition of $14.4 billic and insignificant net U.S. purchases of Foreign Bonds.

Net Long-Term Securities Flows

Net foreign purchases of both domestic and foreign long-term securities from U.S. residents were $45.7 billion in March compared with February. Net foreign purchases of long-term securities were $800.4 billion in the twelve months through March 2005 as compared to $ twelve months through March 2004.

The full data set, including adjustments for repayments of principal on asset-backed securities, as well as historical series, can be founc http://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. Residents
(Billions of dollars, not seasonally adjusted)

	2003	2004	12 Months Through		Dec-04	Jan-0
			Mar-04	Mar-05		

1	Gross Purchases of Domestic Securities	14,383.6	15,270.2	15,009.7	15,772.6	1,318.5	1,305..
2	Gross Sales of Domestic Securities	13,644.9	14,366.2	14,177.9	14,845.9	1,235.1	1,213.
3	**Domestic Securities Purchased, net** (line 1 less line	**738.8**	**904.0**	**831.8**	**926.7**	**83.5**	**91.**
4	**Private, net /2**	**595.7**	**669.9**	**618.0**	**764.0**	**73.2**	**77.**
5	Treasury Bonds & Notes, net	163.2	150.9	191.5	203.0	1.4	23.
6	Gov't Agency Bonds, net	135.1	206.1	132.2	208.2	25.6	19.
7	Corporate Bonds, net	261.5	286.5	253.5	303.0	39.2	17.
8	Equities, net	35.9	26.4	40.7	49.8	7.0	17.
9	**Official, net**	**143.1**	**234.2**	**213.8**	**162.7**	**10.3**	**14.**
10	Treasury Bonds & Notes, net	113.5	201.1	183.0	126.8	7.0	7.
11	Gov't Agency Bonds, net	24.3	20.3	25.3	22.1	1.0	6.
12	Corporate Bonds, net	5.6	11.4	6.3	12.4	1.6	1.
13	Equities, net	-0.3	1.4	-0.8	1.4	0.6	-0.
14	Gross Purchases of Foreign Securities	2,893.8	3,119.8	3,134.1	3,116.9	262.2	250.
15	Gross Sales of Foreign Securities	2,959.7	3,228.6	3,201.4	3,243.2	282.7	250.
16	**Foreign Securities Purchased, net** (line 14 less line	**-65.9**	**-108.9**	**-67.3**	**-126.3**	**-20.5**	**0.**
17	Foreign Bonds Purchased, net	18.9	-25.5	15.3	-21.7	-6.4	5.
18	Foreign Equities Purchased, net	-84.8	-83.4	-82.6	-104.5	-14.1	-5.
19	**Net Long-Term Flows** (line 3 plus line 16)	**672.9**	**795.2**	**764.5**	**800.4**	**63.0**	**92.**

/1 Net foreign purchases of U.S. securities (+)

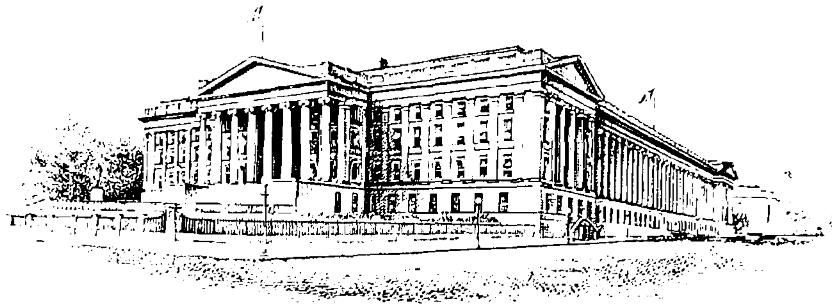
/2 Includes International and Regional Organizations

/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 seasonally adjusted)



DEPARTMENT OF THE TREASURY

OFFICE OF PUBLIC AFFAIRS

May 16, 2005 **Contact: Tony Fratto**
EMBARGOED UNTIL 9:00 AM **202-622-2910**

Treasury International Capital Data for March

Treasury International Capital (TIC) data for March 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 April, is scheduled for June 15, 2005.

Long-Term Domestic Securities

Gross purchases of domestic securities by foreigners were $1,531.0 billion in March, exceeding gross sales of domestic securities by foreigners of $1,470.9 billion during the same month.

Foreign purchases of domestic securities reached $60.1 billion on a net basis in March, relative to $98.1 billion during the previous month. Private net flows reached $74.5 billion in March. Net private purchases of Treasury Bonds and Notes increased to $42.9 billion from $31.2 billion the preceding month. Net private purchases of Government Agency Bonds were $6.5 billion, down from $10.9 billion the previous month. Net private purchases of Corporate Bonds were $23.4 billion, down from $29.9 billion the previous month. Net private purchases of Equities declined to $1.7 billion from $7.4 billion.

Official net purchases of U.S. securities were minus $14.4 billion in March, relative to plus $18.7 billion in February. Official net purchases of Treasury Bonds and Notes of minus $15.0 billion accounted for the bulk of official outflows in March, down from a positive $11.3 billion inflow the previous month.

Long-Term Foreign Securities

Gross purchases of foreign securities owned by U.S. residents were $337.2 billion in March, relative to gross sales of foreign securities to U.S. residents of $351.6 billion during the same month.

Gross sales of foreign securities to U.S. residents exceeded purchases by $14.4 billion, highlighting a net U.S. acquisition of $14.4 billion in Foreign Equities and insignificant net U.S. purchases of Foreign Bonds.

Net Long-Term Securities Flows

Net foreign purchases of both domestic and foreign long-term securities from U.S. residents were $45.7 billion in March compared with $84.1 billion in February. Net foreign purchases of long-term securities were $800.4 billion in the twelve months through March 2005 as compared to $764.5 billion during the twelve months through March 2004.

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					
		2003	2004	Mar-04	Mar-05	Dec-04	Jan-05	Feb-05	Mar-05
1	Gross Purchases of Domestic Securities	14,383.6	15,270.2	15,009.7	15,772.6	1,318.5	1,305.3	1,376.4	1,531.0
2	Gross Sales of Domestic Securities	13,644.9	14,366.2	14,177.9	14,845.9	1,235.1	1,213.5	1,278.4	1,470.9
3	**Domestic Securities Purchased, net** (line 1 less line 2) /1	**738.8**	**904.0**	**831.8**	**926.7**	**83.5**	**91.8**	**98.1**	**60.1**
4	**Private, net /2**	**595.7**	**669.9**	**618.0**	**764.0**	**73.2**	**77.2**	**79.4**	**74.5**
5	Treasury Bonds & Notes, net	163.2	150.9	191.5	203.0	1.4	23.1	31.2	42.9
6	Gov't Agency Bonds, net	135.1	206.1	132.2	208.2	25.6	19.9	10.9	6.5
7	Corporate Bonds, net	261.5	286.5	253.5	303.0	39.2	17.3	29.9	23.4
8	Equities, net	35.9	26.4	40.7	49.8	7.0	17.0	7.4	1.7
9	**Official, net**	**143.1**	**234.2**	**213.8**	162.7	**10.3**	**14.5**	**18.7**	**-14.4**
10	Treasury Bonds & Notes, net	113.5	201.1	183.0	126.8	7.0	7.6	11.3	-15.0
11	Gov't Agency Bonds, net	24.3	20.3	25.3	22.1	1.0	6.1	5.2	1.0
12	Corporate Bonds, net	5.6	11.4	6.3	12.4	1.6	1.3	2.1	-0.4
13	Equities, net	-0.3	1.4	-0.8	1.4	0.6	-0.6	0.1	0.0
14	Gross Purchases of Foreign Securities	2,893.8	3,119.8	3,134.1	3,116.9	262.2	250.7	281.2	337.2
15	Gross Sales of Foreign Securities	2,959.7	3,228.6	3,201.4	3,243.2	282.7	250.1	295.2	351.6
16	**Foreign Securities Purchased, net** (line 14 less line 15) /3	**-65.9**	**-108.9**	**-67.3**	**-126.3**	**-20.5**	**0.6**	**-14.0**	**-14.4**
17	Foreign Bonds Purchased, net	18.9	-25.5	15.3	-21.7	-6.4	5.6	1.4	0.0
18	Foreign Equities Purchased, net	-84.8	-83.4	-82.6	-104.5	-14.1	-5.0	-15.3	-14.4
19	**Net Long-Term Flows** (line 3 plus line 16)	**672.9**	**795.2**	**764.5**	**800.4**	**63.0**	**92.4**	**84.1**	**45.7**

/1 Net foreign purchases of U.S. securities (+)
/2 Includes International and Regional Organizations
/3 Net U.S. acquisitions of foreign securities (-)

Source: U.S. Department of the Treasury

FROM THE OFFICE OF PUBLIC AFFAIRS

May 16, 2005
JS-2444

**Deputy Assistant Secretary D. Scott Parsons
Remarks before the Identity Management in Financial Services Summit
Scottsdale, AZ
Beating Identity Crime: How the Public and Private Sectors are
Working Together to Help Consumers and Put Fraudsters Behind Bars**

Good morning, ladies and gentlemen. It is a privilege to be here.

President Bush aptly stated, "The crime of identity theft undermines the basic trust on which our economy depends." I know that all of you understand that trust is at the heart of our financial system.

This morning I want to talk with you about the risks of identity theft; outline the actions of the public and private sectors; and finally, challenge each of you to accelerate your efforts to protect personal information.

Identity theft is fraud, plain and simple. But it's fraud in an often sophisticated fashion with a vast web of victims. According to the Federal Trade Commission, in 2003 about 10 million Americans had their identities stolen by criminals. Secretary Snow has stated that "it is important to realize that such crimes exact a heavy toll on our economy. Every such crime weighs on our entire system of credit, raising the cost of doing business and subtly but surely impeding economic growth." The ability to collect, use, and disclose reliable information securely is essential to the effectiveness of our financial system.

For example, record numbers of Americans have bought or refinanced a home in the past five years. Securing a mortgage at a favorable interest rate likely required the lender--many of you in the audience today--to check the credit rating. The rating was based in part on information in credit reports. Hopefully, that was a relatively quick and painless process for the consumer. But we know that the mortgage lending process would cost more, would take longer, and would be more difficult if that underlying information about our credit worthiness were not reliable and accessible.

Another risk of identity theft is the potential "chilling effect" on e-commerce. Surveys suggest that some consumers are wary of buying online because they fear identity theft. When fraud discourages Americans from taking advantage of one of the greatest innovations of our age, we all suffer. Online banking, for example, not only enables efficiency and cost-savings for financial institutions, these electronic transactions increase consumers choice and enhance competition in the industry. An erosion of trust can threaten the effectiveness of our financial system.

Collectively, we understand the concern of our citizens, customers, and business partners. We must communicate, though, that millions and millions of financial transactions are processed daily without incident. Americans, as well as our trading partners around the globe, should know that our financial system is the most reliable in the world.

There is no single solution to this challenge. Nor is there a "one size fits all" solution. Fighting identity theft requires a cooperative effort among all of the stakeholders. There is an army of protectors in the public and private sectors. Businesses large and small, technology vendors, financial institutions, government agencies and consumers all play a vital role in winning the fight against this 21st century form of fraud.

President Bush recognized the threat of identity theft early in his first term and has displayed a record of leadership in combating it. The President signed the Fair and Accurate Credit Transactions Act, known as the FACT Act in December of 2003. For consumers, it provides preventive resources and also help to "clean up" your record if you become a victim of identify theft.

By September 1 of this year, anyone may obtain a free copy of his or her credit report from each of the three nationwide credit bureaus by contacting a centralized request system. You will find the information needed to do this at www.annualcreditreport.com. Reviewing one's credit record is one of the best ways to catch identity theft early.

Every American can put fraud alerts on his or her credit files with the major credit bureaus if you believe that you may be a victim of identity theft or become one.

Victims of identity theft can get additional free credit reports. And with proper documentation, consumers can stop financial institutions and credit bureaus from passing along information resulting from an identity theft incident.

The President also signed into law the Identity Theft Penalty Enhancement Act in 2004. This statute created a new crime of "aggravated identity theft" and increased federal criminal penalties for this crime. Identity thieves can be sentenced for an underlying crime, like mail fraud, and face an additional, consecutive sentence for identity theft. This encourages prosecutors to pursue the identity crime as well as the underlying or related ones.

Recently, the federal banking regulatory agencies issued guidance about the response plans that banks need to combat unauthorized access to or misuse of customer information. The response plans must address when customers will be notified that sensitive information about them has been breached.

As you know, banks are highly regulated institutions when it comes to the collection, use, and disclosure of consumer data. The Gramm-Leach-Bliley Act governs the disclosure of consumer information to non-affiliated third parties. It also requires policies and procedures for the security of customer information, and prohibits obtaining information from financial institutions under false pretenses.

The Fair Credit Reporting Act (FCRA) can have an impact on financial institutions' disclosure of information to affiliated entities. And the FACT Act helps consumers enhance the accuracy of information about them and restrict its disclosure.

While regulation influences financial institutions' responses to identity theft, the actions freely chosen by financial institutions are significant. We appreciate the financial sector's effort and investment to preserve confidence in the security of all financial transactions, online and off.

Today you would be hard pressed to find a financial institution that does not offer its customers information on how to prevent identity theft and what to do about it. The financial sector trains employees to protect the security of customer information to assist customers who become victims.

Members of the Financial Services Roundtable and others developed the Identity Theft Assistance Center (ITAC). Supported by about 50 of the largest financial services companies, ITAC offers individualized assistance to customers of the member institutions and to victims who find that accounts have been opened at those institutions due to an identity theft crime.

We have also seen an explosion of promising technological innovation, evident by the exhibits on the latest and greatest solutions on display here today. We applaud the opportunity for a market based solution versus a more heavily regulated environment. Anti-phishing and anti-spyware software, software updates, and firewalls all exist to help spot the crime, spot the origin of the Internet scam, and slow the amount of potentially dangerous spam email that gets through to users.

Financial institutions also have developed sophisticated, automated anti-fraud technologies that can spot unusual or risky transactions and stop them quickly.

From a legal perspective, there are federal criminal and civil statutes for prosecuting identity thieves, including criminal penalties for computer, wire, and mail fraud, as well as anti-spam penalties. States have anti-fraud statutes as well, and some states have specific identity theft laws.

Law enforcement is committed to stopping ID thieves and capturing those who commit crimes. Networks of anti-fraud and identity theft task forces bring federal, state, and local enforcement together to tackle some of the largest or most complex cases.

Identity theft knows no borders. We've become a "connected world" and benefited enormously from the Internet age. But unparalleled access has spawned previously unimaginable threats. I've seen cases of crooks from one country using computers from a series of other countries to create an elusive criminal organization that is difficult to find and then prosecute across geographic boundaries. Fighting cyber-crime in the global theater is a daily challenge for law enforcement.

Some of you here today are bankers. Others are corporate security experts or technology innovators. But we are all consumers. And we are empowered to help protect ourselves. Understanding the crime, acting to protect your identity, and knowing what to do quickly if you become a victim is the most critical defense. Informed, proactive consumers will enable us to win the war on identity theft.

At the Treasury, we are passionate about fighting fraud. From partnership with the private sector to direct consumer education – such as the upcoming release of a DVD on how consumers can protect themselves from identity theft – Treasury is committed to equipping our country to protect personal information. And each of you is at the center of the action. We need innovative ideas, game-changing technology and a cooperative spirit. I challenge you today to continue to work cooperatively to assure the confidence that fuels our economic engine.

Thank you all for your attention.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 13, 2005
JS-2445

Deputy Assistant Secretary Iannicola Teaches Personal Finance Skills to Middle School Students in Las Vegas

Treasury's Deputy Assistant Secretary for Financial Education Dan Iannicola, Jr. today spoke to Garside Middle School students about the importance of planning for their financial futures. He taught them a personal finance lesson, which focused on savings, controlling spending and credit management.

Iannicola praised the classroom teacher for her efforts to integrate financial education lessons into her course.

"Ms. Bautista understands the importance of financial education for young people and she's doing something about it," said Iannicola. "By integrating financial concepts into her math lessons, she has found a way to teach her students what they need to know in both disciplines without having to choose between the two."

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

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

FEDERAL FINANCING BANK May 31, 2005

Brian D. Jackson, Chief Financial Officer, Federal Financing Bank (FFB) announced the following activity for the month of April 2005.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $27.5 billion on April 30, 2005, posting an increase of $63.2 million from the level on March 31, 2005. This net change was the result of a decrease in holdings of agency assets of $65.0 million and an increase in net holdings of government-guaranteed loans of $128.2 million. The FFB made 31 disbursements and received 12 prepayments during the month of April. The FFB also reset the interest rate for one loan guaranteed by the Department of Education.

Attached to this release are tables presenting FFB April loan activity and FFB holdings as of April 30, 2005.

JS-2446

FEDERAL FINANCING BANK
APRIL 2005 ACTIVITY

Borrower	Date	Amount of Advance	Final Maturity	Interest Rate
GOVERNMENT-GUARANTEED LOANS				
GENERAL SERVICES ADMINISTRATION				
San Francisco Bldg Lease	4/06	$2,369,707.62	8/01/05	3.017% S/A
Foley Services Contract	4/12	$8,925.52	7/31/25	4.737% S/A
San Francisco OB	4/12	$158,875.11	8/01/05	2.967% S/A
San Francisco OB	4/14	$98,122.98	8/01/05	2.972% S/A
DEPARTMENT OF EDUCATION				
*Shaw University	4/01	$9,398,445.90	10/03/05	3.135% S/A
RURAL UTILITIES SERVICE				
Washington Electric #655	4/01	$840,000.00	1/02/35	4.733% Qtr.
Brown County Elec. #687	4/04	$400,000.00	1/02/35	4.696% Qtr.
Missoula Elec. #688	4/04	$594,000.00	12/31/29	4.677% Qtr.
Navopache Electric #2021	4/04	$3,000,000.00	6/30/10	4.111% Qtr.
Golden West Tele. Coop. #2197	4/06	$5,114,192.39	12/31/13	4.173% Qtr.
Kankakee Valley Elec. #857	4/08	$2,700,000.00	12/31/36	4.747% Qtr.
South Miss. Elec. #2109	4/11	$1,965,000.00	1/03/34	4.735% Qtr.
East Texas Elec Coop Inc #2205	4/13	$19,700,000.00	1/03/33	4.635% Qtr.
East Texas Elec Coop Inc #2206	4/13	$24,869,000.00	12/31/20	4.562% Qtr.
East Texas Elec Coop Inc #2207	4/13	$34,415,000.00	12/31/35	4.634% Qtr.
Niobrara Electric Assoc. #860	4/13	$275,000.00	12/31/36	4.588% Qtr.
North Georgia Elec. #2135	4/14	$3,974,000.00	12/31/37	4.648% Qtr.
Red River Valley Elec. #2095	4/14	$2,000,000.00	12/31/37	4.648% Qtr.
Cental Virginia Elec. #2126	4/15	$1,000,000.00	1/03/39	4.670% Qtr.
Endless Mtns. Wireless #2103	4/15	$894,021.00	3/31/10	4.231% Qtr.
High West Energy #2102	4/15	$1,750,000.00	1/03/39	4.670% Qtr.
Cornbelt Power #565	4/18	$864,000.00	1/03/28	4.561% Qtr.
Cornbelt Power #565	4/18	$2,073,000.00	1/03/28	4.561% Qtr.
Cornbelt Power #565	4/18	$5,900,000.00	1/03/28	4.561% Qtr.
Cornbelt Power #2054	4/18	$3,628,000.00	1/03/33	4.505% Qtr.
Tipmont Rural Electric #2150	4/18	$1,000,000.00	1/03/39	4.595% Qtr.
Tri-County Electric #876	4/21	$621,000.00	12/31/36	4.525% Qtr.
Scott County Telephone #2175	4/22	$1,413,000.00	12/31/20	4.321% Qtr.
Volunteer Electric Coop. #803	4/25	$5,000,000.00	12/31/30	4.515% Qtr.
Buggs Island Telephone #2040	4/26	$400,000.00	12/31/19	4.222% Qtr.
Mountain View Electric #2110	4/26	$4,950,000.00	12/31/37	4.510% Qtr.
Shelby Energy Coop. #758	4/29	$1,398,000.00	12/31/35	4.463% 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	April 30, 2005	March 31, 2005	Monthly Net Change 4/1/05-4/30/05	Fiscal Year Net Change 10/1/04-4/30/05
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	$20.0	$85.0	-$65.0	-$180.0
FmHA-RHIF	$230.0	$230.0	$0.0	-$450.0
Rural Utilities Service-CBO	$4,270.2	$4,270.2	$0.0	$0.0
Subtotal*	$4,520.2	$4,585.2	-$65.0	-$630.0
Government-Guaranteed Lending:				
DOD-Foreign Military Sales	$1,352.0	$1,354.7	-$2.7	-$112.9
DoEd-HBCU+	$119.3	$119.5	-$0.2	$1.3
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+	$2,141.3	$2,139.4	$1.9	$0.0
DOI-Virgin Islands	$6.1	$6.1	$0.0	-$1.5
DON-Ship Lease Financing	$487.7	$487.7	$0.0	-$10.9
Rural Utilities Service	$17,823.8	$17,693.0	$130.7	$862.8
SBA-State/Local Development Cos.	$45.5	$47.1	-$1.5	-$11.0
DOT-Section 511	$2.8	$2.8	$0.0	-$0.1
Subtotal*	$22,950.7	$22,822.5	$128.2	$644.6
Grand total*	$27,471.0	$27,407.7	$63.2	-$1,785.4

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

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

May 17, 2005
JS-2447

Testimony of Robert Werner, Director
Office of Foreign Assets Control
U.S. Department of the Treasury
Before The Permanent Subcommittee on Investigations
Committee on Homeland Security and Governmental Affairs

Chairman Coleman, Ranking Member Levin and other distinguished members of the Subcommittee, I appreciate the opportunity to discuss the responsibilities of the Office of Foreign Assets Control, or OFAC, as these pertain to the United Nations "Oil-for-Food" program and the Iraqi sanctions.

My testimony today will center on the Committee's interest in OFAC's role regarding the administration, compliance and oversight of U.S. persons authorized to participate in the "Oil-for-Food" program as well as those who obtained licenses to engage in transactions related to travel to, and within, Iraq.

Before turning to a discussion of these responsibilities and processes, however, I would like to provide you with a general overview of OFAC's mission and jurisdictional authorities.

Mission and Jurisdiction

Since becoming Director of OFAC in October of 2004, I have learned first hand that it is an exceptional agency of experienced, knowledgeable professionals dedicated to carrying out the complex mission of administering and enforcing economic sanctions programs based on U.S. foreign policy and national security goals with a workforce of 140 authorized full-time staff.

OFAC currently administers 29 economic sanctions programs against foreign governments, entities and individuals. Though eight of these 29 programs have been terminated, they still require residual administrative and enforcement activities.

OFAC's authority to impose controls on transactions and to freeze foreign assets is derived from the President's constitutional and statutory wartime, and national emergency powers. In performing its mission, OFAC relies principally on delegations of authority made pursuant to the President's broad powers under the *Trading with the Enemy Act* ("TWEA"), International *Emergency Economic Powers Act* ("IEEPA"), and the *United Nations Participation Act* ("UNPA") to prohibit or regulate commercial or financial transactions involving specific foreign countries, entities, or individuals. In administering and enforcing economic sanctions programs, OFAC maintains a close working relationship with other federal departments and agencies to ensure that these programs are implemented properly and enforced effectively. OFAC works directly with the Department of State ("State"); the Department of Commerce ("Commerce"); the Department of Justice, the Federal Bureau of Investigation (FBI), the Department of Homeland Security's U.S. Customs and Border Protection (CBP) and U.S. Immigration and Customs Enforcement (ICE); bank regulatory agencies; and other law enforcement agencies to fulfill our mission.

I would also note, Mr. Chairman, that all of the programs we administer require that we work closely with the broad range of industries potentially affected by these programs. We are expanding and improving our communication with our diverse constituencies ranging from the financial and services sectors to manufacturing and agricultural industries. The cooperation we receive from U.S. corporations in complying with sanctions is generally exceptional.

UN/Iraq Sanctions Overview and Implementation

Following the Iraq invasion of Kuwait on August 2, 1990, the UN Security Council issued UNSC Resolution 661 on August 6, 1990, imposing sweeping economic sanctions against Iraq and providing protective measures with respect to Kuwait. Resolution 661 also established a committee consisting of all members of the UN Security Council to monitor and supervise implementation of the sanctions (the "661 Committee"). Following the invasion of Kuwait, the President also issued Executive Order 12722, on August 2, 1990, which froze the assets of the Government of Iraq in the United States or under the control of U.S. persons and imposed a comprehensive trade embargo against Iraq. Following the adoption of UNSC Resolution 661, the President issued Executive Order 12724 on August 9, 1990, broadening the sanctions previously imposed. These sanctions were implemented by OFAC through the Iraqi Sanctions Regulations, 31 C.F.R. Part 575 (the "Regulations").

Section 575.205 of the Regulations prohibited any goods, technology or services from being exported from the U.S. to Iraq, except for donated articles intended to relieve human suffering that were authorized by OFAC on a case-by-case basis. Under sections 575.520 and 575.521 of the Regulations, U.S. persons could apply to OFAC for authorization to export to Iraq donated food and donated supplies intended strictly for medical purposes.

Except as otherwise authorized, section 575.207 of the Regulations prohibited U.S. persons from engaging in transactions relating to travel to Iraq by any U.S. citizen or permanent resident alien, or to activities by any U.S. citizen or permanent resident alien within Iraq. This prohibition included payments by U.S. persons for their own travel or living expenses while in Iraq. The Regulations did not prohibit travel transactions related to travel to Iraq or to activities within Iraq that were: (1) necessary to effect the departure of a U.S. citizen or permanent resident alien from Kuwait or Iraq; (2) relating to travel and activities for the conduct of the official business of the United States Government or the United Nations; or (3) by persons regularly employed in journalistic activity by recognized newsgathering organizations.

OFAC referred travel applications to the Department of State for foreign policy guidance in appropriate cases, such as when an applicant claimed a compelling humanitarian consideration (e.g., a critical illness of an immediate family member in Iraq), or where circumstances indicated that a national interest was at stake. In these instances, licensing determinations were made on a case-by-case basis in consultation with the Department of State. In addition, U.S. persons planning to travel to Iraq under a U.S. passport were required by the Department of State to have their passports validated for travel to Iraq by the Office of Passport Services.

In April of 1995, the Security Council adopted UNSC Resolution 986 (Oil-for-Food) as a temporary measure to provide for the humanitarian needs of the Iraqi people. In May of 1996, the Government of Iraq signed a Memorandum of Understanding setting out detailed arrangements for the implementation of Resolution 986. Under Oil-for-Food, the Government of Iraq was permitted to sell and to export from Iraq petroleum and petroleum products as well as purchase and import humanitarian materials and supplies to meet the essential needs of the civilian population in Iraq. The proceeds from sales of Iraqi-origin petroleum and petroleum products were to be deposited into a special escrow account at the New York branch of Banque Nationale de Paris ("BNP New York") where they would be used to fund purchases made by the Government of Iraq.

The Secretary-General established a panel of independent experts in the international oil trade to oversee oil-purchase contracts and ensure that they

complied with requirements provided for in Resolution 986. The panel was responsible for assessing the pricing mechanisms for petroleum purchases in order to determine whether they reflected fair market value The panel was also responsible for providing analysis and recommendations to the 661 Committee.

With respect to purchases of humanitarian materials and supplies, the Government of Iraq was required to prepare a categorized list of humanitarian goods and supplies it intended to purchase and import pursuant to Resolution 986 and submit it to the Secretary-General. The Secretary-General would then forward the distribution list to the 661 Committee. Individual contracts for purchases of humanitarian goods and supplies were submitted to the 661 Committee through the relevant UN mission of the exporting state. Committee members could disapprove any contract. Payment from the Iraq escrow account at BNP New York would only be approved for items included in the distribution list, unless the 661 Committee decided otherwise on a case-by-case basis. Experts in the UN Secretariat were to examine each contract, especially regarding quality and quantity of the goods and supplies in order to determine whether a fair price and value were reflected in the document.

Effective December 10, 1996, OFAC amended the Regulations to provide statements of licensing policy with respect to Oil-for-Food, which appeared in the December 11, 1996, edition of the Federal Register. Section 575.522 of the Regulations authorized U.S. persons to enter into executory contracts with the Government of Iraq for the purchase of Iraqi-origin petroleum and petroleum products, and to trade in oilfield parts and equipment and civilian goods, including medicines, health supplies and foodstuffs. U.S. persons were also authorized to enter into executory contracts with third parties outside OFAC's jurisdiction that were incidental to permissible executory contracts with the Government of Iraq. U.S. persons were not authorized to engage in transactions related to travel to, or within, Iraq for the purpose of negotiating and signing executory contracts. However, U.S. persons could enlist and pay the expenses of non-U.S. nationals to travel to Iraq on their behalf for the purpose of negotiating and signing executory contracts.

OFAC required U.S. persons, who had entered into executory contracts with the Government of Iraq for the sale of humanitarian materials and supplies or oilfield parts and equipment, to submit an application to OFAC for a case-by-case review and approval prior to performance of each contract. OFAC referred each application to the Department of State and if appropriate the Commerce Department for guidance on whether to authorize performance of the contract. State was then responsible for submitting the contract to the UN 661 Committee for review concerning whether to authorize release of funds from the Iraq account at BNP New York to pay for the goods upon their delivery to Iraq. OFAC issued a license determination after it received from State a copy of the 661 Committee approval of payment and a separate memorandum from State recommending that a specific license be issued to the applicant.

OFAC issued approximately 1050 specific licenses to U.S. persons for various aspects of the Oil-for-Food program, primarily under three provisions of the Regulations. Sales to the Government of Iraq of oilfield parts and equipment and humanitarian aid were subject to licensing under, respectively, sections 575.524 and 575.525 of the Regulations. Three U.S. companies were authorized under section 575.524 to sell oilfield parts and equipment directly to the Government of Iraq, and 23 U.S. companies were authorized under section 575.525 to make direct sales to the GOI of humanitarian aid. A total of 48 licenses were issued to these 26 U.S. companies authorizing performance of sales contracts entered into with the Government of Iraq.

Section 575.523 of the Regulations authorized the performance of contracts approved by the UN 661 Committee for the purchase of Iraqi-origin petroleum or petroleum products directly from the GOI. Nine U.S. companies were each issued a license under this section.

Most U.S. persons licensed by OFAC under this program were authorized to engage in trade transactions with third country entities who were contractors or

subcontractors with the Government of Iraq. In other words, these remaining approximately 1000 specific licenses either authorized U.S. persons to engage in transactions with third parties related to sales to the GOI, or else authorized non-U.S. persons to engage in transactions involving U.S.-origin goods or components being supplied to the Government of Iraq. For example, under 575.523, OFAC issued thirteen specific licenses to seven U.S. persons for activities that facilitated the purchase of Iraqi oil by third parties.

Finally, the general license in section 575.526 of the Regulations authorized U.S. persons to import into the United States, and otherwise deal in, Iraqi-origin petroleum and petroleum products provided that the goods in question had been approved for purchase and export from Iraq by the 661 Committee.

Outreach

Because of the complexity of the Oil-for-Food program, OFAC engaged in an outreach program to assist licensees in understanding their obligations. OFAC provided guidance about the Program's requirements in hundreds of sanctions workshops. It also published information on Iraqi sanctions in numerous plain-language brochures, including *Iraq: What You Need to Know About U.S. Sanctions*, and *Foreign Assets Control Regulatons for the Financial Community, ... for Exporters and Importers, ... for the Insurance Industry*, and *... for the Securities Industry*. Further, it referenced the program in articles published in industry magazines for bankers, for shippers, and for the international trade community.

In addition to engaging in this general guidance, in January of 1997, OFAC issued a memorandum to the attention of the U.S. Customs Service recommending that Customs require importers of Iraqi petroleum or petroleum products to provide a copy of the 661 Committee approval for which the petroleum or petroleum products in question comprised all or a part of the original purchase. In addition, OFAC suggested that Customs might wish to request from the importer a brief statement describing the type and amount of the imported Iraqi products and affirming that, to the best of the importer's knowledge and belief, the imported Iraqi petroleum or petroleum products comprised all or a portion of the purchase covered in the accompanying UN document. In a memorandum to OFAC dated March 6, 1997, Customs confirmed that it had issued instructions to Customs field offices pursuant to the guidance contained in OFAC's memorandum.

In December of 2000, OFAC also published explicit information about authorized and unauthorized payments under the Oil-for-Food program. This document, entitled "Guidance on Payments for Iraqi Origin Petroleum," was prepared in response to media reports that the Government of Iraq had attempted to force its oil customers to violate UN Security Counsel Resolutions by demanding that they pay premiums in the form of surcharges, port fees or other payments into an Iraqi controlled account. The guidance specifically stated that no transfer of funds or other financial or economic resources to or for the benefit of Iraq or a person in Iraq could be made except for transfers to the 986 Escrow Account. The document mirrored a December 15, 2000, communication from the 661 Committee with the following explicit points:

> 1.) The Sanctions Committee did not approve a surcharge of any kind on Iraqi Oil.
>
> 2.) Payments for purchasing Iraqi crude oil could not be made to a non-UN account.
>
> 3.) Therefore, buyers of Iraqi oil should not pay any kind of surcharge to Iraq.

Designation Authority

Under the Iraq sanctions program, OFAC had the authority to specially designate -- that is, to identify publicly and to block assets of any person, whether an individual

or a business, that was directly or indirectly owned or controlled by the Government of Iraq, or that purported to act for or on behalf of that government. As an essential element of the Iraq sanctions, OFAC began an initiative to identify front companies and agents used to acquire technology, equipment, and resources for Iraq or to otherwise act for or on behalf of the Government of Iraq. Iraq Specially Designated Nationals (SDN) included Iraqi governmental bodies, representatives, agents, intermediaries or fronts, and could be either overt or covert entities of the government. The designations not only exposed these persons and blocked their assets but also cut them off from participation in the U.S. financial and economic systems. .Ultimately, OFAC named approximately 300 separate entities or individuals as Iraq SDNs.

Enforcement

OFAC also worked closely with federal law enforcement agencies to enforce sanctions against Iraq. For example, CBP has responsibility to interdict goods destined to or from OFAC-sanctioned countries or groups. CBP inspectors contact OFAC's Enforcement Division when suspect goods are detained to determine if OFAC has issued licenses for these goods. OFAC's outreach training to CBP inspectors at the Federal Law Enforcement Training Center and at CBP Ports of Entry throughout the country included information about sanctions against Iraq.

Moreover, OFAC has completed over 300 investigations and audits against U.S. financial institutions, corporations and individuals involving violations of the Iraq sanctions program. The violations investigated ranged from unauthorized attempts to export goods to Iraq by U.S. companies to the operation of brokerage accounts for Specially Designated Nationals of Iraq by brokerage firms. In addition, audits of banking transactions conducted by OFAC have revealed other cases involving funds transfers destined for Iraq transmitted by U.S. banks. OFAC's action against violators included the issuance of warning letters, the imposition of civil monetary penalties and, where no violation was found, no further agency action depending on the nature, circumstances and scope of the violation.

Finally, OFAC criminal investigations are conducted by ICE, the Commerce Department's Office of Export Enforcement ("OEE"), and the FBI. OFAC plays a coordinating and advisory role in such cases, and works closely with agents and Assistant U.S. Attorneys. OFAC often provides an expert witness at trial. Criminal charges of IEEPA violations have been brought in at least 13 cases since August 1990, for unlicensed transactions with Iraq. These cases have involved illegal exports, money remittances and dealings in Iraqi oil.

OFAC is also working with agents in a number of on-going criminal investigations, including investigations by the Department of Justice of potential violations of the Oil-for-Food program. In one case, dealing with the purchase of Iraqi oil in excess of the amount authorized by the U.N. under Oil-for-Food, OFAC ordered a U.S. company to place in excess of several million dollars into a blocked account at a U.S. financial institution. In another case, OFAC provided information from an Oil-for-Food license file to a U.S. Attorney's Office.

Conclusion

I thank the Committee for the opportunity to discuss OFAC's role in implementing economic sanctions against Iraq, including its role in the Oil-for-Food program. I look forward to taking your questions.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 17, 2005
2005-5-17-12-35-43-26679

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 $78,410 million as of the end of that week, compared to $79,512 million as of the end of the prior week.

I. Official U.S. Reserve Assets *(in US millions)*						
	May 6, 2005			May 13, 2005		
TOTAL	79,512			78,410		
1. Foreign Currency Reserves [1]	Euro	Yen	TOTAL	Euro	Yen	TOTAL
a. Securities	11,863	14,991	26,854	11,706	14,682	26,388
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	11,579	3,013	14,592	11,414	2,951	14,365
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]			15,418			15,184
3. Special Drawing Rights (SDRs) [2]			11,607			11,431
4. Gold Stock [3]			11,041			11,041
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets						
	May 6, 2005			May 13, 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		
	May 6, 2005	May 13, 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.

FROM THE OFFICE OF PUBLIC AFFAIRS

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May 17, 2005
JS-2448

Report to Congress International Economic and Exchange
May 2005

LINKS

- Statement of Secretary John W. Snow on the FOREX Report JS - 2449

REPORTS

- Report to Congress on International Economic and Exchange Rate Policies

Report to Congress on
International Economic and Exchange Rate Policies
May 2005

This report reviews developments in international economic policy, including exchange rate policy, focusing on the second half of 2004. The report is required under the Omnibus Trade and Competitiveness Act of 1988, which states, among other things, that: "The Secretary of the Treasury shall analyze on an annual basis the exchange rate policies of foreign countries, in consultation with the International Monetary Fund, and consider whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade."

This report reviews the effects that significant international economic developments have had on the United States and foreign economies and evaluates the factors that underlie those developments. For the specific purpose of assessing whether an economy is manipulating the rate of exchange between its currency and the U.S. dollar according to the terms of the Act, Treasury has traditionally undertaken a careful review of the trading partner's exchange rates, external balances, foreign exchange reserve accumulation, macroeconomic trends, monetary and financial developments, institutional development, and financial and exchange restrictions among other things. Attention is given to both the changes and the interactions of significant variables. Isolated developments in any one area do not typically provide sufficient grounds to conclude that exchange rates are being manipulated under the terms of the Act. A combination of factors, on the other hand, can and has in the past led Treasury to find that certain countries had satisfied the terms of the Act[1].

After reviewing developments in the United States, the report examines exchange rate policies in major economies across five regions of the world: (1) the Western Hemisphere, (2) Europe and Eurasia, (3) Sub-Saharan Africa, (4) the Middle East and North Africa and (5) South and East Asia.

To summarize, the report finds that:

- Economies around the world continue to follow a variety of exchange rate policies, ranging from a flexible exchange rate with little or no intervention to currency unions and full dollarization. For example, Canada follows a flexible exchange rate regime with no intervention, twelve countries are members of the European Monetary Union, and El Salvador, Ecuador and Panama use the U.S. dollar as their "domestic" currency.

- The report finds that no major trading partner of the United States met the technical requirements for designation under the Omnibus Trade and Competitiveness Act of 1988 during the second half of 2004. A number of economies continue to use pegged

[1] These issues are discussed more completely in Treasury's March 11, 2005, Report To The Committees On Appropriations on Clarification Of Statutory Provisions Addressing Currency Manipulation.

exchange rates and/or intervene in foreign exchange markets. A peg or intervention, though, does not in and of itself satisfy the statutory test. Treasury has consulted with the IMF management and staff, as required by the statute, and they concur with these conclusions.

- Nevertheless, Treasury has engaged, and will continue to engage, with several economies, including some in Asia, to promote the adoption of market-based exchange policies and regimes. Most notable among these is China. Current Chinese policies are highly distortionary and pose a risk to China's economy, its trading partners, and global economic growth. Concerns of competitiveness with China also constrain neighboring economies in their adoption of more flexible exchange policies. If current trends continue without substantial alteration, China's policies will likely meet the statute's technical requirements for designation.

- While China's ten-year-long pegged currency regime may have at times contributed to stability, it no longer does so. The peg blocks the transmission of critical price signals, impedes needed adjustment of international imbalances, attracts speculative capital flows and is a large and increasing risk to the Chinese economy. Indeed, Chinese officials have publicly acknowledged the need to move to a more flexible system, have repeatedly vowed to do so and have undertaken the necessary and appropriate preparations. It is widely accepted that China is now ready and should move without delay in a manner and magnitude that is sufficiently reflective of underlying market conditions. Treasury will continue to engage with China and closely monitor changes in its foreign exchange policy over the coming weeks and months.

- Treasury is continuing to engage actively with economies to encourage, in both bilateral and multilateral discussions, flexible market-based exchange rate regimes combined with a clear price stability goal and a transparent system for adjusting policy instruments. In this light, the communiqués of the G-7 Finance Ministers and Central Bank Governors in October of 2004 and February and April of 2005 stated: "...that more flexibility in exchange rates is desirable for major countries or economic areas that lack such flexibility to promote smooth and widespread adjustments in the international financial system, based on market mechanisms."

The United States International Accounts[2]

The current account deficit is conceptually equal to the gap between domestic investment and domestic saving, as a matter of international accounting. When investment in the United States is higher than domestic saving, foreigners make up the difference, and the United States has a

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[2] The IMF annually reviews U.S. economic performance and policies through the so-called IMF Article IV surveillance process. The last Article IV surveillance review took place in July 2004. The IMF staff paper and the results of the IMF Executive Board's discussion of the U.S. Article IV review can be found at http://www.imf.org/external/pubs/ft/scr/2004/cr04230.pdf. In addition, the IMF discusses U.S. economic policies and performance in the context of its twice yearly World Economic Outlook reports. These can be found at http://www.imf.org/external/pubs/ft/weo/weorepts.htm.

current account deficit. In contrast, if saving exceeds investment in a country, then that country has a current account surplus as its people invest abroad.

The growth of the U.S. current account deficit over more than a decade has been linked to high levels of domestic U.S. capital formation compared to domestic U.S. saving. Perceived high rates of return on U.S. assets, based on sustained strong productivity growth relative to the rest of the world, sound U.S. economic performance and the attractiveness of the U.S. investment climate, attract foreign investment. Sustained external demand for United States assets has both supported the dollar in the foreign exchange markets over the years and allowed the United States to achieve levels of capital formation that would have otherwise not been possible. Robust growth in investment is critical to the non-inflationary growth of production and employment.

In the second half of 2004, for example, the U.S. current account deficit was $679 billion (at a seasonally adjusted annual rate and on a national income and product accounting, or NIPA, basis) or 5.7 percent of GDP. This $679 billion deficit equaled the gap between $2,369 billion in investment and $1,690 billion in saving[3]. That is, U.S. domestic investment was $679 billion more than domestic saving with net foreign investment making up the difference.

The U.S. economy performed well over the second half of 2004. Real GDP increased at an average annual rate of 3.9 percent in the final two quarters, led by rapid gains in both business fixed investment and personal consumption. Improved labor markets (with almost one million new payroll jobs added during July-December and a decline in the unemployment rate to an average of 5.4 percent), as well as a rise in household net worth, contributed to increased consumer spending and favorable balance sheets despite low saving. Public saving is expected to improve, as solid economic growth and tight controls imposed by fiscal policies are expected to cut the Federal budget deficit by more than half, from 3.6 percent of GDP in FY 2004 to 1.5 percent by FY 2009.

The U.S. current account was $708 billion in deficit (at a seasonally adjusted annual rate and on a balance of payments basis[4]) in the second half of 2004. A major item financing the current account deficit has been net private foreign purchases of U.S. securities, which reached an annualized $552 billion in the second half of 2004. (Included in these were net private foreign purchases of U.S. Treasury securities amounting to $26 billion.) In addition, foreign official institutions increased their U.S. assets by $308 billion.

Viewed over a longer period, the U.S. current account balance declined, as a percent of GDP, from a one percent surplus in the first quarter of 1991 to a four percent deficit in the fourth quarter of 2000, to a six percent deficit in the second half of 2004.

Due to the current account deficit the net investment position of the United States (with direct investment valued at the current stock market value of owners' equity) fell to a negative $2.7

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[3] Including the (relatively small) statistical discrepancy.

[4] Although the current account measures are conceptually the same, balance of payments statistics are compiled on a slightly different basis from national income statistics. Saving includes the statistical discrepancy between the income and product accounts.

trillion as of December 31, 2003, the latest date for which data are available, from a negative $2.6 trillion at the end of 2002. A $398 billion valuation adjustment due to exchange rate changes offset much of 2003's financial outflow. Despite a large negative position, U.S. residents earned $30 billion more on their foreign investments in 2004 than foreigners earned on their U.S. investments. These positive net income receipts are the result of large net inflows of income from direct investment offsetting net outflows of income on portfolio investment.

The U.S. current account deficit is the counterpart of the aggregate surplus of other economies in the world. The policies of all countries affect the global pattern of current account balances. It is important that policies that the United States follows keep the United States and the world economy strong. The adjustment of global imbalances is a shared responsibility. First, in the United States, policies aimed at increasing saving of the public sector and the private sector should contribute to global adjustment and reinforce the continuing stability of the international financial system. Second, in Europe and Japan, policies for further structural reforms are needed to boost sustainable growth. Third, greater flexibility of exchange rates is needed, particularly in emerging Asia economies that lack such flexibility.

The U.S. Dollar

The Federal Reserve Board's "broad" nominal dollar index decreased 6.7 percent during the second half of 2004. The dollar depreciated 8.9 percent against the "major" foreign currencies (seven other industrialized economy currencies) and 3.8 percent against the currencies of "other important trading partners" of the United States (largely currencies of emerging market economies). The broad index declined 16.9 percent from February 27, 2002, when it reached its recent peak, through December 31, 2004. Over this latter period the dollar depreciated 29.5 percent against the major currencies while appreciating 1.8 percent against the currencies of other important trading partners.

The consumer price index (CPI) rose 2.0 percent annualized rate from July through December and in the final month of the year was 3.3 percent higher than a year earlier. Excluding food and energy, the core CPI rose 2.2 percent during the 12 months ending in December 2004. With the economy expanding and underlying inflation modest, the Federal Reserve continued to remove monetary accommodation, increasing its federal funds target rate four times, by a total of 100 basis points, in the second half of the year to reach to 2.25 percent on December 14. The yield on 10-year Treasury notes fluctuated during the latter half of the year, but finished the year at about 4.2 percent in December, essentially unchanged from the end of 2003 and 50 basis points lower than in June despite the rise in short term interest rates.

As discussed below, the currencies of different economies showed varying degrees of flexibility relative to the dollar, as some monetary authorities sought to dampen or prevent movements of their exchange rates against the dollar while others did not intervene at all. The United States did not intervene in foreign exchange markets during the second half of 2004.

Western Hemisphere

Nominal exchange rates in the region on average appreciated against the U.S. dollar in the second half of the year, as Latin America posted nearly 6 percent real GDP growth in 2004, the highest regional growth rate in a quarter-century. Interest rate spreads between the Latin American Emerging Market Bond Index (EMBI+) and U.S. Treasury securities decreased from 569 basis points in end-June to 434 basis points by end-December 2004.

Argentina

Argentina has had a flexible exchange rate since the end of 2001 when it abandoned its convertibility law, which pegged the peso one-to-one to the U.S. dollar. Argentina's currency remained relatively steady in the second half of 2004, depreciating 0.5 percent from 2.96 pesos per dollar to 2.97 pesos per dollar. Argentina's trade surplus was $6.2 billion in the second half of 2004, with exports rising 20 percent and imports rising 53 percent compared to the same period the previous year. The seasonally adjusted current account fell from 2.2 percent of GDP in the first half of 2004 to 1.9 percent of GDP in the second. The U.S. trade deficit with Argentina was $334 million in the second half of 2004.

Argentina's gross foreign exchange reserves grew by $2.2 billion during the second half of the year to $19.6 billion at the end of December 2004 as Argentina's central bank accumulated international reserves during periods of peso strengthening. The economic recovery continued after the severe contraction in the first half of 2002, with real GDP growing 14.0 percent at a seasonally adjusted annualized rate in the third quarter of 2004 and 11.4 percent in the fourth quarter. Consumer prices accelerated, with a net increase of 5.2 percent in seasonally adjusted terms from June 2004 to December 2004.

Brazil

Brazil has a flexible exchange rate regime and relies on inflation targeting to guide monetary policy. The *real* appreciated 16.9 percent against the dollar during the second half of 2004 from BRL3.11/US$ to BRL2.66/US$. Brazil's sovereign risk spread stood at 383 basis points over U.S. Treasuries at end-2004 versus 646 basis points at the end of June. Year-on-year inflation stood at 7.6 percent in December, above the central bank's 5.5 percent target for 2004 but within the target band. Brazil had a $6.3 billion, or 2.0 percent of GDP, current account surplus in the second half of 2004 compared to $5.4 billion, or 1.9 percent of GDP, in the first half. The United States had a trade deficit with Brazil of $4.9 billion in the second half of 2004 compared to a $3.4 billion deficit in the second half of 2003. Foreign direct investment increased to $14.1 billion in the second half of 2004 compared with $4.0 billion in the first half. The central bank increased net international reserves to $27.5 billion by end-December 2004 compared to $24.9 billion at end-June, as the central bank purchased international reserves at the end of the year. Real GDP (saar) increased 4.4 percent and 1.7 percent in the third and fourth quarters respectively. For the full-year 2004, GDP posted a 5.2 percent increase—the highest growth rate in ten years.

Canada

Canada has a flexible exchange rate regime. It has not intervened in the foreign exchange market since 1998, except to make a small contribution to the brief G-7 intervention in support of the euro in September 2000. Its central bank targets an inflation rate of 2 percent with a +/- 1 percent band. During the second half of 2004, the Canadian dollar appreciated against the U.S. dollar by 11.4 percent, from 1.34 C$/US$ to 1.20 C$/US$. The J.P. Morgan broad real trade-weighted index for the Canadian dollar appreciated by 8.3 percent while the J.P. Morgan narrow nominal trade-weighted index for the Canadian dollar appreciated by 9.5 percent. Canada's current account surpluses during the third and fourth quarters of 2004 were $6.4 billion, or 2.6 percent of GDP, and $5.2 billion, or 1.9 percent of GDP, respectively. The merchandise trade surplus with the U.S. during the period was $33.6 billion. Canada's international reserves declined in second half of 2004 to $34.5 billion from $35.4 billion in the first half. Year-on-year headline inflation in December 2004 was 2.1 percent. The economy expanded in the second half of 2004, with annualized real GDP growth of 3.4 percent and 3.0 percent in the third and fourth quarters, respectively.

Mexico

Mexico has a flexible exchange rate regime. Its central bank targets an inflation rate of 3 percent with a +/-1 percent band. The Bank of Mexico also follows a transparent rule for selling foreign reserves accumulated by state enterprises. During the second half of 2004 the Mexican peso appreciated by 3.5 percent against the dollar, from 11.54 pesos/dollar to 11.15 pesos/dollar. The J.P. Morgan narrow nominal trade-weighted index for the peso depreciated by 0.4 percent, while the J.P Morgan broad real trade-weighted index for the peso appreciated by 0.4 percent. Mexico's current account deficits during the third and fourth quarters of 2004 were $2.3 billion, or 1.4 percent of GDP, and $2.9 billion, or 1.7 percent of GDP, respectively. Mexico's merchandise trade surplus with the U.S. during the period was $22.8 billion. Foreign direct investment in the second half of 2004 was $5.4 billion, versus $11.2 billion in the first half of the year. International reserves grew by $2.4 billion during the second half of the year, reaching $61.5 billion by the end of December. Year-on-year headline inflation was 5.1 percent in December. The economy grew robustly in the second six months of 2004, with real seasonally adjusted GDP increasing at annual rates of 3.8 percent and 5.6 percent during the third and fourth quarters, respectively.

Europe and Eurasia

The Euro-zone

During the second half of 2004, the euro remained relatively stable through mid-October, but appreciated sharply thereafter, gaining 9 percent from mid-October, or 11.2 percent from end-June, to year-end. The index of the real effective exchange rate of the European Central Bank (ECB) appreciated 4.9 percent over the second half of the year. The ECB did not intervene in foreign exchange markets during 2004.

The countries in the Euro-zone taken together had a current account surplus during the second half of 2004 equal to $11.3 billion (sa), or 0.2 percent of GDP, down from $38.4 billion, or 0.8 percent of GDP, in the first half of the year. Goods exports increased 8.4 percent while goods imports increased 12.9 percent in the second half of 2004 over the same period in 2003. The trade surplus of the Euro-zone vis-à-vis the U.S. was $44.2 billion in the second half of 2004 compared to $39.7 billion in the second half of 2003.

Euro-zone growth was an estimated 0.8 percent (annualized) in the second half of 2004. Germany and Italy have held back Euro-zone growth while France had annualized growth of 1.5 percent in the second half led by strong domestic demand. For the region, final consumption expenditure rose 1.0 percent in the second half of 2004 while investment increased 2.5 percent. Core inflation was 1.9 percent yr/yr in December 2004 compared to 2.0 percent yr/yr in June 2004. Headline inflation – which includes energy and other volatile prices excluded in the core index – was 2.4 percent yr/yr at the end of the second half of 2004, the same rate as at the end of the first half.

Central Europe & Ukraine

The currencies of the major central European economics appreciated sharply against the dollar during the second half of 2004. This partly reflected the dollar's depreciation against the euro during the period, but each of the currencies also strengthened against the euro, their main reference currency, supported by attractive domestic interest rates.

In Hungary, short term yields of 10.0 percent helped the forint appreciate 2.1 percent against the euro (14.0 percent against the dollar), despite continued concern about large fiscal and current account deficits. The National Bank of Hungary's index of the real value of the forint rose by slightly less, 1.8 percent, as inflation slowed.

In Poland, the zloty rose 10.5 percent against the euro during the second half of 2004 (an appreciation of 23.4 percent against the dollar). Zloty appreciation reflected the differential between domestic interest rates and Euro-zone yields, as well as increased political stability and improved macroeconomic performance. The National Bank of Poland's index of the zloty in real terms rose 8.1 percent.

In Ukraine, the hryvnia rose 0.3 percent against the dollar during the second half as the central bank continued to manage the bilateral exchange rate against the dollar heavily.

Russia

The large net inflows resulting from high oil prices continued during the second half of 2004. Russia's current account surplus in the second half of 2004 was $33.8 billion (nsa), or 10.5 percent of GDP, compared to $15.8 billion, or 6.6 percent of GDP, in the second half of 2003. The ruble appreciated 4.9 percent against the U.S. dollar in the second half of 2004 compared to 0.6 percent in the first half. However, because of the relative strength of the euro, J.P. Morgan's Broad Real Effective Exchange Rate Index appreciated just 0.6 percent in the second half of 2004 compared to 5.1 percent in the first half. Russian monetary authorities continued to

intervene to moderate the appreciation of the ruble against the dollar, and official reserve assets increased $36.3 billion to a record high of $124.5 billion. Consumer prices rose 11.9 percent in the year through December 2004 compared to 10.2 percent in the year through June 2004.

Sub-Saharan Africa

Overall, Sub-Saharan African's current account deficit narrowed to an estimated 1.6 percent of GDP in 2004 from 2.4 percent in 2003. An improvement in the current account balances of the region's main oil exporters drove the overall change. The growth in the U.S. trade deficit to $27 billion, from $19 billion in 2003 with sub-Saharan Africa reflects higher U.S. oil imports, which accounted for 73 percent of all U.S. imports from the region.

Roughly half of sub-Saharan African countries officially peg their currencies to other currencies, primary the Euro. Most sub-Saharan African currencies appreciated in nominal terms against the U.S. dollar in the second half of 2004. The South African Rand, which floats relatively freely appreciated about 10 percent against the U.S. dollar during the second half of 2004, benefiting from higher prices of South Africa's commodity exports. However, the value of the currencies of six countries with managed or independently floating exchange rate regimes changed little against the U.S. dollar over the six month period, most notably the Nigerian Naira, despite significant increases in oil receipts. Of the countries for which reliable data is available, the Democratic Republic of the Congo's currency depreciated the most in nominal terms (11 percent).

Middle East and North Africa

Strong economic growth continued across the Middle East and North Africa, supported by high oil prices. GDP growth in the oil-exporting countries of the Gulf Cooperation Council countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the UAE) remained robust. Mainly due to higher oil prices, current accounts across the Gulf remained largely in balance or surplus, having increased significantly, along with holdings of official reserves. Oil-exporting GCC countries tie their currencies directly to the U.S. dollar.

Many other countries in the region, such as Jordan and countries in North Africa, also maintain pegged exchange rate regimes. Changes in current account balances largely reflected changes in terms of trade, with balances rising in large oil exporters like Algeria and falling in importers like Morocco. In Egypt, exchange rate flexibility increased considerably following the launch of an interbank foreign exchange market in December 2004. The current account surplus rose due to higher oil prices and increased receipts from tourism and the Suez Canal (reflecting robust global trade). This, along with a small but growing net increase in capital inflows due to tighter monetary policy, growing investor confidence in the reform-oriented economic team, and an expected surge in privatizations, led to upward pressures on the pound and virtually eliminated the spread between official and parallel markets. In the six months ending December 2004, the pound appreciated 1.9 percent in nominal terms against the dollar, and the current account registered a $2.9 billion surplus, a $900 million increase over the same period in 2003. Net international reserves increased from $14.8 billion end-June 2004 to $15.4 billion end-December 2004.

Turkey maintained its floating exchange rate regime. Overall, the Turkish lira appreciated by 10.4 percent in nominal terms against the U.S. dollar in the second half of 2004, as capital inflows increased in anticipation of a European Union decision to begin accession negotiations and high real interest rates. However, during this period, the central bank's index of the real trade-weighted lira rose 4.1 percent, reflecting 1.7 percent nominal depreciation against the euro. Inflation fell from 12.7 percent in 2003 to 9.4 percent in 2004, its lowest level in decades. The current account deficit widened in 2004 to 5.1 percent of GNP ($15.4 billion), from 3.4 percent in 2003, on the back of strong domestic demand, as GNP grew 9.9 percent over the first three quarters of 2004, compared to the same period in 2003. Imports and exports increased 39.1 percent and 30.8 percent, respectively, compared with 2003, driving the trade deficit to $23.8 billion, up 70 percent from $14.0 billion in 2003. Reserves stood at $37.6 billion at end-2004, up from $35.2 billion at end-2003, still only 75 percent of short-term external debt.

In Israel, which also maintains a floating exchange rate, the shekel appreciated 4.4 percent in nominal terms against the dollar during the second half of 2004, while remaining constant in real trade-weighted terms due to significant trade weights of the euro and sterling. Capital inflows surged in 2004 as the decline in foreign direct investment in 2004 was more than offset by strong portfolio investment throughout the year (reversing the general trend of positive FDI and negative portfolio investment). While posting a small deficit in the second half of 2004 as private consumption rose, the current account registered a slight surplus for the year (0.4 percent of GDP) due to strong growth in goods and services exports. GDP growth increased in 2004 to 4.3 percent for the year, up from 1.3 percent in 2003, with an acceleration in the second half of 2004. Foreign exchange reserves rose 3.6 percent in the second half of 2004, reaching $26.6 billion at end-December, after remaining unchanged in the first half of 2004.

South and East Asia

South and East Asia contributed to the global economy's strong growth in 2004. Developing East Asia grew at 7.3 percent in 2004. Japan grew at 2.7 percent, its highest rate since 1996. Strong external demand, particularly in the United States, and the revival of the global IT industry supported growth in the region. But a revival of domestic investment in economies of the region also underpinned economic growth. The growth of domestic demand in China, in particular, is contributing significantly to the global growth. Although imports into the region grew rapidly with improving economic performance, export growth was also strong and current account surpluses increased in most major economies of the region.

Within the year, growth was strongest in the first quarter. By the third and fourth quarter growth rates had dropped significantly in a number of East Asian countries – Japan in particular. This was in part due to excessive inventory buildups in the IT sector, but also reflected a moderate slowing of U.S. growth and rising oil prices. Solid growth within the region and rising oil prices also marked the end of concerns about deflation in a number of countries outside Japan, and the beginning of a shift in monetary policy to avoid inflation. In some cases, notably Korea, exchange rate appreciation was viewed as a way of containing imported inflation.

Capital flows into the region went through two broad cycles. After slowing significantly in the second quarter of 2004, capital inflows picked up sharply in the last half of the year, and were especially strong in the fourth quarter. As a result, private capital flows into the region rose for the fourth straight year in 2004 and may be nearing pre-Asian Crisis levels. Net inward foreign direct investment increased by more than 30 percent to an estimated $72 billion. Net portfolio and other capital inflows increased as well. Monetary authorities faced growing foreign demand for domestic currency assets and upward pressures on their currencies over the year as a whole, particularly in the second half.

Trade flows among East Asian economies have increased sharply in recent years, reflecting increased integration of economies in the region. But increased intra-regional trade also reflects the increasing diffusion of component production among economies in the region, often for products that are exported outside East Asia. As a result, monetary authorities of economies with more flexible exchange rates appear to be increasingly concerned about the effect of currency appreciation on their competitiveness relative to other economies in East Asia. While noting these concerns, the Administration has encouraged increased exchange rate flexibility for East Asian economies generally, both in bilateral discussions and in regional fora such as APEC. APEC Finance Ministers made a significant move in this direction in their statement of September 3, welcoming steps taken by member economies to facilitate the move to greater exchange rate flexibility.

India

Faced with strong financial inflows and rising inflation, the central bank allowed greater flexibility in the managed floating exchange rate regime and liberalized controls on capital outflows. The Indian rupee appreciated against the U.S. dollar by 6.3 percent during the second half of 2004. Foreign institutional investors poured $5 billion into Indian equity markets in the second half of 2004 compared with $3.5 billion in the first half, as investor concerns that the newly elected government would slow market oriented reforms receded. Income from remittances also remained strong. The U.S. bilateral merchandise trade deficit with India was steady at $4.7 billion in the second half of 2004, compared to $4.8 billion for the first half. Despite increases in exports of services, a sharp rise in commodity imports due to higher prices pushed the current account into a deficit of 0.1 percent of GDP in 2004, from a surplus of 1.3 percent of GDP in 2003. Foreign exchange reserves increased to $125 billion at year end from $114 billion at the end of June.

Japan

Japan's economic recovery, which began in the second quarter of 2002, stalled in the second half of 2004. Japan's economy contracted slightly in the second and third quarters of the year and grew marginally in the fourth quarter. Japan also appeared to lose some ground in its long fight to eliminate deflation, as core consumer prices (the Japanese CPI less fresh foods) fell by 0.2 percent year-on-year during the second half of 2004, after falling 0.1 percent on a year-on-year basis in the first half of the year. However, other price measures, such as the deflators for private consumption and GDP, showed continued progress toward price stability.

Japan has had a persistent current account surplus and capital outflows to the rest of the world, a consequence of a surplus of Japanese savings over domestic investment. Rates of return on domestic investment have been generally low, although the Prime Minister's program of structural reform and deregulation and the recent acceleration of corporate restructuring and mergers and acquisition activity hold out the prospect of higher returns. Japan's global current account surplus remained steady at about 3.5 percent of GDP (or $83.1 billion) in the second half of 2004. Japan's bilateral merchandise trade surplus with the United States totaled $39 billion in the second half of 2004, up from $36.2 billion in the first half. Capital continued to flow out of Japan in the second half of 2004 reportedly in response to changing expectations of U.S. growth relative to Japanese growth and higher U.S. interest rates.

During the June 30 to December 31, 2004 reporting period, the yen appreciated 5.6 percent against the dollar, reaching a level of 103.8 at year-end. At the same time that the Japanese economy appeared to weaken, economic releases from the United States showed continued strength. This differential was reflected in currency values during the first three months of this year. The yen hit a peak value of 101.9 to the dollar on January 17, 2005, but by March 31 was trading at 107.0 to the dollar, a depreciation of 3.1 percent from its end-year level. Over a more extended period, since early February 2002 through the end of March 2005, the dollar has depreciated by 20 percent against the yen, less than its 29.5 percent depreciation against the major currency component of the Federal Reserve Board's Broad Nominal Index of the dollar over the same period.

Japanese authorities have not intervened in the foreign exchange market since March 16, 2004.[5] Japanese foreign exchange reserves rose by $25.7 billion in the second half of 2004 to $824.3 billion, due to interest earnings and a depreciation of the dollar against other currencies held as Japanese reserves. This contrasts with an increase in Japanese foreign exchange reserves of $145.8 billion in the first half of 2004, a period in which the authorities did intervene.

China

China kept its fixed exchange rate of 8.28 to the U.S. dollar throughout the reporting period, a rate it has maintained since 1995, through periods of both upward and downward pressures on the exchange rate. While the benefits of China's ten-year-long pegged currency regime may have at times served well the Chinese economy, this is no longer the case for the large, increasingly market-based economy that China has become. China's fixed exchange rate is now an impediment to the transmission of price signals and international adjustment, and imposes a risk to its economy, China's trading partners, and global economic growth. China has clearly stated that it intends to move to a market-based flexible exchange rate, and has undertaken the necessary and appropriate preparations. It is now widely accepted that China is now ready and should move without delay in a manner and magnitude that is sufficiently reflective of underlying market conditions.

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[5] The Japanese Ministry of Finance announces its total foreign exchange intervention at the end of each month, and publishes the dates and amounts of intervention at the end of each quarter. See http://www.mof.go.jp/english/e1c021.htm

To maintain the fixed exchange rate the Chinese authorities supplied renminbi for net inflows of foreign exchange, accumulating foreign exchange reserves in the process. This accumulation of foreign reserves accelerated in second half of 2004. China's official foreign exchange reserves grew by a net $139 billion to $610 billion during the second half of 2004, with over two-thirds of the increase taking place in fourth quarter.

China's fixed exchange rate regime and the large amount of renminbi the monetary authorities supply in maintaining the fixed exchange rate made effective macroeconomic policy management more difficult during the second half of 2004 and into 2005. To soak up ("sterilize") the additional renminbi created by purchasing foreign exchange, China's central bank sells bonds to domestic banks. Net issuance of central bank sterilization bonds has risen sharply since September 2004. Chinese policymakers also took a series of administrative measures over the last year to curb lending, and raised domestic interest rates slightly in October 2004 in order to constrain investment and contain consumer prices.

These macroeconomic policy measures had some effect in cooling off the economy during the second half of 2004. However, economic growth remained quite strong in the fourth quarter of last year, and 2005 data suggest that China's growth rate and inflation risks are rebounding. In the first quarter of 2005, real GDP, driven by trade and investment, grew by 9.5 percent. Industrial output and investment growth also remained brisk. China's exports grew rapidly on sharp increases in textile and apparel exports following the end of quotas and increased electronics shipments. After a 3.9 percent year-over-year increase in consumer prices in March, inflation moderated in April, but still remains higher than at the end of 2004. Real interest rates fell as a result, countering the authorities' efforts to contain the increase in bank lending.

China's experience over the reporting period illustrates some of the difficulties of maintaining the fixed exchange rate. Rapid growth in exports, increased liquidity, and low real interest rates continue to support China's economic growth, and concerns remain about overinvestment and inflationary pressures. In this regard, China needs to rely more on domestic demand growth, particularly consumption growth. The central bank has had to work hard to counteract the growth in domestic liquidity from foreign exchange intervention. It is also very limited in its ability to raise interest rates since this would spur greater capital inflows. The rapid growth of credit and very high rate of investment in turn risk undermining the progress China has made in reforming its banking system by creating new flows of non-performing loans.

China's global trade surplus increased in the second half of 2004 to a (seasonally unadjusted) total of $40 billion (4.2 percent of GDP), up from a $21 billion surplus (2.6 percent of GDP) in the same period in 2003. The trade surplus in the second half of 2004 offset a deficit during the first half, bringing China's reported trade surplus to $32 billion for all of 2004.[6] The increase in

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[6] These trade figures are on an FOB-CIF basis. Several studies have noted that China's global trade surplus (one component of its current account surplus) as reported in aggregate by China's trading partners differs markedly from what is reported by Chinese official statistics. One difficulty that arises is that much trade to and from China travels via Hong Kong. Importing countries usually accurately determine the source of their imports though certificates of origin. But exporters (both Chinese and partner country exporters) often record the destination of their exports as Hong Kong, even though the goods go on to other markets. This explains a significant part of the discrepancy between Chinese and partner country trade estimates of China's trade surplus, since a significant part of the trade between China and partner countries is recorded as trade with Hong Kong.

China's global trade surplus is partly due to recovery in the global IT market and the increase in Chinese shipments of components. But there are also reports that trade transactions are also being used to move capital into China for domestic investment or in anticipation of a revaluation of the renminbi. This could occur either through accelerating the collection of payments due for Chinese exports while delaying payment for imports, or by over-invoicing exports and under-invoicing imports. Both responses are common in countries with capital controls. China's bilateral surplus on trade in goods with the United States also expanded in the second half of 2004 to $93.5 billion compared to $70.2 billion for the last half of 2003. U.S. trade in both directions continued to expand at a faster rate than total U.S. trade. While total U.S. exports to all destinations grew by 13 percent in 2004, U.S. exports to China grew 22 percent during the same period.

China's balance of payments surplus amounted to $206 billion in 2004, up 76 percent from 2003 (China's balance of payments data are available only on an annual basis). China's current account surplus increased sharply in 2004 to $68.7 billion, or 4.2 percent of GDP. This surplus has increased in recent years from $17.4 billion in 2001 (1.5 percent of GDP), to $45.9 billion (3.1 percent of GDP) in 2003[7]. China's capital and financial account saw a net inflow of $111 billion in 2004 (compared to $53 billion in 2003). Reserve accumulation figures suggest that private financial inflows surged in the second half of 2004, as speculation on an appreciation of the renminbi increased and as property markets in major urban areas heated up. Despite recent liberalization, China maintains greater controls on capital outflows than inflows, which contributes to upward pressure on reserves and the balance of payments.

In the context of an economy with large and dependable capital inflows, large prospects for productivity gains, and unsustainably high rates of investment, China's current account surplus is large.

China has committed to push ahead firmly and steadily to a market-based flexible exchange rate, and is taking concrete steps to bring about exchange rate flexibility. Chinese Premier Wen said on March 14, 2005 that China would "create a market-based, managed and floating exchange rate." Chinese Central Bank Governor Zhou has said recently that "rigid exchange rates present huge risks."

Since September 2003, when the Treasury began its intensive engagement with China to hasten its move to a more flexible exchange rate, the Chinese Government has taken important steps to establish the necessary financial environment and infrastructure to support exchange rate flexibility.

First, China has undertaken measures to increase the volume of foreign exchange trading, an important step in aiding market development and reducing the volatility of exchange rates. China has reduced restrictions on capital flows and allowed its firms and citizens greater scope to engage in market transactions. In February, China eliminated the foreign exchange surrender requirements for many commercial firms, which can now exchange their export earnings with

[7] In addition to the trade balance, a widening surplus on transfers and a narrowing deficit on investment income are significant factors increasing the current account surplus. At this time, trade statistics are the only current account items available for 2004.

authorized banks rather than the central bank. Domestic Chinese insurance companies and China's national social security fund are authorized to invest in overseas capital markets, thereby increasing the volume of renminbi foreign exchange transactions. Recently, China increased the amount of foreign currency that business travelers can take out of the country, permitted Chinese emigrants to transfer assets overseas, and allowed Chinese students to take more money abroad to pay for living expenses. As a result, the volume of foreign exchange market transactions in renminbi has expanded rapidly in the past few years. China needs to continue to liberalize its exchange regime by increasing the scope for foreign investment in China and allowing its residents greater access to foreign exchange.

Second, China has also taken steps to develop foreign exchange market instruments and to increase its financial institutions' experience in dealing with fluctuating currencies. China has introduced, or will introduce soon, financial instruments and systems for trading currencies and managing currency risk through hedging. Foreign exchange forward contracts can now be offered in China, and foreign exchange futures trading systems and instruments are being developed. Domestic and foreign banks can trade non-reminbi currency pairs (such as US dollar-yen), and certain Chinese banks will act as market-makers for this foreign currency trading. The Treasury and U.S. financial regulators provided substantial technical assistance to China in these efforts, through the Technical Cooperation Program (TCP) established with the People's Bank of China.

Finally, China has taken steps to strengthen its financial sector and its financial regulation, making the financial sector more resilient to foreign exchange rate fluctuations. In addition to raising one-year deposit and lending rates late last year, China's central bank eliminated a ceiling on interest rates on bank loans, giving banks greater scope to price risk. Further market oriented reforms in this area are needed. China's banking regulator tightened loan accounting standards by introducing a risk-based loan classification system to track non-performing loans (NPLs) more effectively. It also tightened loan supervision by increasing the number and scope of bank audits and on-site bank examinations, and by setting more aggressive targets for reducing NPLs and increasing capital. The larger banks have upgraded their credit risk management systems, centralized and standardized credit extension procedures, and improved corporate governance practices following regulatory measures to allow foreign interests to take strategic stakes, to define clearly responsibilities for Boards, management and shareholders, and to raise disclosure requirements. China needs to continue this progress and to take further steps to allow foreign investment in the major commercial banks, show that its tightened NPL classification system is yielding results, and strengthen the functioning of its securities markets. To assist the Chinese authorities, Treasury provided technical guidance last year on banking supervision, credit analysis, international accounting standards, and resolution of non-performing loans.

In summary, the fixed exchange rate that China now maintains is a substantial distortion to world markets, blocking the price mechanism and impeding adjustment of international imbalances. It is also a source of large and increasing risk to the Chinese economy. China has completed significant preparations over the last two years for adoption of a more flexible, market-oriented exchange rate. China is now ready to move to a more flexible exchange rate and should move now. Treasury will monitor progress on China's foreign exchange market developments very closely over the next six months in advance of preparation of the fall report.

Korea

In contrast to strong growth in other parts of emerging East Asia, Korean growth in 2004 was held back by the continuing effects of a credit card boom and bust. With household spending depressed, Korean economic growth during the year was largely driven by increased exports. The growth rate decelerated in the second half of 2004 to 3.2 percent (annualized), from 4.7 percent growth in the first half, largely due to a continued decline in private consumption.

Export growth slowed in the second half of 2004, but exports were still up 25 percent year-on-year, after growing at 37 percent year-on-year in the first half. Export growth to China was particularly strong, up 42 percent for 2004. Total import growth did not keep pace, but still rose by 26 percent for the year. The difference in import and export growth rates was reflected in Korean external balances. The U.S. bilateral trade deficit with Korea totaled $19.8 billion for the full year 2004. For the second half of 2004 the trade deficit totaled $10.8 billion, up 44 percent from the same period a year earlier, as U.S. imports from Korea grew by 23 percent and exports to Korea by 10 percent. Korea's current account surplus was 4.0 percent of GDP for the second half of 2004, compared to 4.1 percent for the first half of the year.

Total capital and financial flows, exclusive of reserve accumulation, registered a net surplus (inflow) of $7.5 billion (n.s.a.) for the second half of 2004, an increase over the small ($0.8 billion) inflow for the first half. The financial inflows resulted from Korean residents' increasing their foreign borrowings. The Korean authorities continued to intervene in the second half, as official foreign reserves increased by $32 billion to $199 billion, equivalent to 112 percent of the total external debt of Korea.

Despite this intervention, the won appreciated 14.8 percent versus the dollar over the course of 2004; during the fourth quarter alone the won appreciated 10 percent. Citing a slowdown in the pace of economic recovery, particularly in domestic demand, the Korean central bank reduced its benchmark call rate a quarter-point again in November following on a similar cut in August. The effect of the won appreciation in the fourth quarter was to reduce inflation pressures, particularly those due to oil price increases. This, in turn, allowed the Central Bank of Korea to pursue its more accommodative monetary stance despite inflation coming in at the upper end of the 2.5-3.5 percent target range.

Taiwan

Taiwan's GDP growth moderated to 3.8 percent saar in the second half of 2004 relative to the first half of the year. GDP growth in the second half of 2003 reached 9.4 percent due to a sharp recovery of domestic demand (in particular business investment) and strong export growth (particularly to China). The 2004 slowdown was the result of both a decline in investment and a modest slowdown in government consumption.

Accommodative monetary policy, accompanied by higher oil and commodity prices, halted three years of deflation in 2004 with headline consumer price index growing at a rate of 2.9 percent in the third quarter and 1.9 percent in the fourth. In the third quarter of 2004, the central bank

raised interest rates for the first time in four years on concerns of inflation, particularly related to rising oil prices. It has continued to raise rates in the fourth quarter and first quarter of this year.

Taiwan's exports increased by 16.5 percent year-on-year in the second half of 2004, while imports expanded by 28.8 percent, resulting in a trade surplus of $2.5 billion in the third quarter and a trade deficit in the fourth quarter of $0.2 billion. Taiwan's bilateral trade surplus with the United States increased slightly from $6.8 billion in the second half of 2003 to $7.1 billion in the second half of 2004.

The current account surplus in the second half of 2004 was 4.8 percent of GDP ($7.5 billion), down from a surplus of nearly 7.7 percent of GDP in the first half. The 2004 current account surplus of $19.0 billion, 6.2 percent of GDP, was the smallest annual figure in three years. Taiwan continued to experience portfolio capital inflows in the second half of 2004, primarily due to increased investment in equities. This was more than offset by portfolio outflows during that same period; resulting in a net outflow in the capital and financial account.

Taiwan's foreign exchange reserve accumulation slowed significantly in the second half of 2004, with foreign exchange reserves increasing by $12 billion, compared to a $23 billion in the first half of 2004. By year end, total foreign exchange reserves had reached just over $242 billion, or 79.2 percent of GDP and about four times short-term external debt.

The New Taiwan (NT) dollar has been on an appreciating trend since the third quarter of 2004, increasing 6.0 percent against the dollar in the second half of 2004. Since then the NT dollar continued its appreciating trend reaching a peak of NTD30.79/USD in early March. While Taiwan's central bank maintains that "the NT dollar exchange rate is determined by market forces," the Central Bank Governor has also recently stated that it may "enter the foreign-exchange market to make adjustments" to maintain stability as the currency strengthens.

Malaysia

Although Malaysia's economic growth slowed a bit in the second half of 2004, to a 4.4 percent annual rate, due in part to moderation in global growth, growth for 2004 as a whole – 7.1 percent – was the highest in four years. Private consumption and exports were the primary drivers of growth. Fiscal consolidation continued, as public spending on infrastructure was cut and total public sector spending grew moderately. Investment grew modestly, but still remained well below its levels in the early 1990s.

The current account surplus was $7.8 billion, or 12.7 percent of GDP, in the second half of 2004, up from 11.5 percent in the second half of 2003. Large current account surpluses are a striking feature of the Malaysian economy in the last few years. After running substantial external deficits prior to the Asian Financial Crisis in 1997, Malaysia has had significant and growing trade and current account surpluses. The trade surplus in 2004 was $25.2 billion (21.4 percent of GDP), up from $21.8 billion (21.0 percent of GDP) in 2003. The current account surplus in 2004 was $14.9 billion. Malaysia's current account surplus is in large part the counterpart to a sharp fall in domestic investment that took place in the aftermath of the Asian Financial Crisis. After rising to over 40 percent of GDP in 1995-97, total investment dropped sharply in 1998, and

has not recovered. Over the last few years, investment as a percent of GDP has declined gradually, reaching 20.5 percent in 2004. The decline in private investment has been even more striking, falling from over 30 percent of GDP in 1997 to below 8 percent in 2003.

The trade balance is the predominant component of Malaysia's current account surplus, and was $11.4 billion for the second half of 2004, up from $10.6 billion in the latter half of 2003. Malaysia's bilateral trade surplus with the United States totaled $9.8 billion in the second half of 2004, compared with $7.9 billion in the second half of 2003.

Malaysia has maintained a fixed peg to the dollar (3.80 ringgit to a dollar) since September 1998, when it also expanded capital controls. Most of the controls on capital flows have since been relaxed. Further liberalization took effect April 1, 2005, to allow: increased investment abroad; maintenance of currency export proceeds with licensed banks onshore; and hedging in any committed or anticipatory current account transaction or on any committed capital account payments. Offshore trading of the ringgit remains, however, prohibited, and foreign portfolio investment by residents continues to be limited.

Malaysia experienced net financial account inflows of $1.73 billion in the last half of 2004, versus a net outflow of $0.55 billion in the second half of 2003, reportedly due in part to speculation on an upward revaluation of the currency. At the end of 2004, total foreign exchange reserves stood at $61.7 billion, almost six times short-term external debt and up from $49.0 billion at end-June 2004.

Malaysian authorities remain publicly committed to the fixed exchange rate system, and have declared that that the peg is supported by strong fundamentals. But the low level of private domestic investment and the growing current account suggest opportunities for domestic-led growth that Malaysia is not taking advantage of. Although a small open economy such as Malaysia can benefit from a pegged exchange rate, increasing imbalances in the economy may warrant closer scrutiny and monitoring of the exchange rate regime going forward.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 17, 2005
js-2449

Statement of Secretary John W. Snow on the FOREX Report

Addressing imbalances in the global economy is a shared responsibility among the major economic regions of the world. While imbalances occur as the patterns of trade and investment flows shift between economic regions, uneven rates of growth in the major economies and inefficient or distortionary policies restrict adjustments and put stress on the global financial systems. Economic policymakers must address these imbalances now; waiting increases the risk that adjustments will occur abruptly.

We know that the international economy performs best when large economies embrace free trade, the free flow of capital, and flexible currencies. Obstacles in any of these areas prevent smooth adjustments. At best, such obstacles result in less than maximum growth; at worst, they create distortions and increase risks.

The United States is doing its part to address imbalances by aggressively tackling our fiscal deficit and our long-term liabilities. Because of strong growth and appropriate fiscal policy, the U.S. budget deficit in 2004 was well below projections, and with recent data, I expect improvement in our fiscal deficit position this year as well. [Some private forecasters predict that our fiscal deficit will be below 3% of GDP this year if we continue to hold the line on spending.] We are also working to put in place innovative policies to increase the savings rate. But our actions alone will not be sufficient.

I expect strong economic growth in the United States to continue. This is in the U.S. interest, and the world's. It is an essential component of our deficit reduction strategy as strong growth results in rising government receipts, as we have been seeing. But it is important to recognize that there is also no one-to-one correspondence between reductions in our fiscal and current account deficits. We do not, and will not, have a current account target. The best contribution the United States can make to our own people and the global economy is to keep our economic house in order and ensure continued strong growth.

Our actions alone will not be sufficient to unwind global imbalances. Simply put, large imbalances will continue if growth in our major trading partners continues to lag. European and Japanese GDP together exceeds that in the United States. Some European countries, such as Ireland and Spain, continue to perform well. But on the continent, notable weaknesses persist, and Japanese growth, while turning upward, remains modest. These economies must continue to adopt and implement vigorous and necessary structural reforms to establish robust rates of growth – both for the good of their own citizens and to contribute to reduction in the imbalances in the global economy.

Today I have sent to Congress a report outlining the currency practices of America's major trading partners. The report addresses the third -- and most immediately pressing -- element of the effort to address global imbalances: the imperative of exchange rate flexibility, especially in emerging Asian economies.

The report finds that no major trading partner of the United States met the technical requirements of the statute for designation during the period covered, which is the second half of 2004. However, it would be a mistake to interpret this conclusion as

acquiescence with the foreign exchange policies of many of America's trading partners. In fact Treasury is actively engaged with several economies to promote the adoption of flexible, market-based exchange policies and to help facilitate broader adjustment. Most notable among these is China.

China's rigid currency regime has become highly distortionary. It poses risks to the health of the Chinese economy, such as sowing the seeds for excess liquidity creation, asset price inflation, large speculative capital flows, and over-investment. It also poses risks to its neighbors, since their ability to follow more independent and anti-inflationary monetary policies is constrained by competitiveness considerations relative to China. Sustained, non-inflationary growth in China is important for maintaining strong global growth and a more flexible and market-based renminbi exchange rate would help the Chinese achieve this goal.

A more flexible system will also support economic stability, which we understand is of paramount concern to Chinese leadership. China's ten-year-long pegged currency regime may have contributed to stability in the past, but that is no longer the case today, as China has grown to be a more significant participant in global trade and financial flows. Currently, China relies largely on administrative controls to manage its economy – controls that are cumbersome and increasingly ineffective. An independent monetary policy will allow China to more easily and effectively pursue price stability, stabilize growth, and respond to economic shocks. China has a history of significant swings in credit-fueled investment and inflationary pressures and these have often ended in "hard landings." Such swings are disruptive to the Chinese economy and may prove more disruptive in the future – not only to China but also to the global economy.

A more flexible system will allow for a more efficient allocation of resources and higher productivity. The current system is fueling over-investment and excessive reliance on export-led growth while under-emphasizing domestic consumption. Moreover, much of the investment and capital flows into these favored sectors and projects may not prove profitable under market-determined prices, which could lead to another investment hard landing, more non-performing loans and a weakened banking sector.

And a more flexible system would also quell speculative capital inflows that are costly to China's government and increasingly likely to prove disruptive. China's ability to sterilize capital inflows is increasingly limited and harmful to its banking sector.

Finally, recent history has taught us that it's better to move from a fixed to a flexible currency system during from a position of strength, and not when economic weakness compels reform.

Chinese officials have publicly acknowledged the need to move to a more flexible system, have repeatedly vowed to do so, and have undertaken the necessary and appropriate steps to prepare for such a move.

Unfortunately, the debate on China's currency regime is clouded by a number of misconceptions of U.S. policy. Allow me to address a couple of these. First, we are not calling for an immediate full float with fully liberalized capital markets. This would be a mistake at this time – China's banking sector is not prepared. What we are calling for is an intermediate step that reflects underlying market conditions and allows for a smooth transition – when appropriate – to a full float.

Second, we recognize that a more flexible system in China, in and of itself, will not solve global imbalances – as I have said, this is a shared responsibility. However, greater flexibility in China and other Asian economies is a necessary component.

Third, some argue that a more flexible system will prove deflationary and increase Chinese unemployment. In fact, a flexible system will provide China with a more sophisticated array of policy tools – namely an independent monetary policy – that will prove much move effective in achieving price stability and the ability to adjust to shocks.

Our engagement with China over the past two years, including fruitful accomplishments associated with Treasury's joint Technical Cooperation Program, leaves me with little doubt that China is now prepared to begin reform of the currency regime.

In fact, I believe that the risks associated with delay far outweigh any concerns with immediate reform. The current system poses a risk to China's economy, its trading partners, and global economic growth. Concerns of competitiveness with China also constrain neighboring economies in their adoption of more flexible exchange policies.

As Treasury's report states, if current trends continue without substantial alteration, China's policies will likely meet the technical requirements of the statute for designation. China is now ready and should move without delay in a manner and magnitude that is sufficiently reflective of underlying market conditions.

As the need for adjustment is global, multilateral organizations are addressing the need for flexibility. Group of 7 finance ministers and central bank governors have adopted a policy, stated in its communiqués, that "...more flexibility in exchange rates is desirable for major countries or economic areas that lack such flexibility to promote smooth and widespread adjustments in the international financial system, based on market mechanisms." The Asian Development Bank and the Asia-Pacific Economic Cooperation (APEC) have also publicly stressed the importance of flexible currency regimes.

The chief officers of the International Monetary Fund and the Asian Development Bank have also stressed the need for currency flexibility. I also call on the International Monetary Fund (IMF), as part of its strengthening of multilateral and regional surveillance, to report on the potential contribution of emerging Asia to unwinding global imbalances, including an analysis of the regional impact of the Chinese foreign exchange system. As policy-makers, we have a responsibility to fully understand these important forces that are shaping the global economy. As the central international institution for global monetary cooperation, with a wealth of technical expertise, the IMF is best placed to undertake this work, and indeed has the responsibility for doing so.

It is critical that we address the issues of imbalances aggressively and in a cooperative spirit with the goal of raising global growth. Nothing would do more damage to the prospects of increasing living standards throughout the world than efforts to inhibit the flow of trade. However, it is incumbent on China to address concerns before mounting pressures worldwide to restrict trade harm the openness of the international trading system.

LINKS

- Report to Congress International Economic and Exchange

FROM THE OFFICE OF PUBLIC AFFAIRS

May 16, 2005
JS-2450

Deputy Assistant Secretary Iannicola Leads Financial Education Roundtable in El Paso

Treasury's Deputy Assistant Secretary for Financial Education Dan Iannicola, Jr. today led a financial education roundtable along with the El Paso Affordable Housing Credit Union Service Organization in El Paso, Texas. Iannicola spoke to representatives from eight credit unions and other community leaders about the Department of the Treasury and the Financial Literacy and Education Commission's role in improving financial literacy in partnership with various community-based organizations across the country.

Iannicola commended the roundtable participants for their work in financial literacy. "This group shows a strong commitment to the idea that financial education can make a real difference in people's lives," said Iannicola. "The organizations here today help a variety of people with a variety of issues. They help recent immigrants, members of the military, Native Americans and others with matters such as getting an account with a financial institution, managing credit and purchasing a first home. The people of El Paso are well served by these strong community leaders."

The CUSO is a non-profit organization formed by the following eight local credit unions: El Paso Area Teachers Federal Credit Union; El Paso Employees Federal Credit Union; Ft. Bliss Federal Credit Union; GECU; Golden Key Federal Credit Union; Mountain Star Federal Credit Union; One Source Federal Credit Union; and the West Texas Credit Union. It focuses on promoting financial education and savings, and providing access to capital. The CUSO has held approximately 200 financial education and homeownership workshops over the last 2 ½ years enrolling over 3,500 participants.

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.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 18, 2005
js-2451

Assistant Secretary of the Office of Economic Policy
Mark J. Warshawsky
The Urgent Need for Social Security Reform
National Press Foundation
Washington, D.C.

Thank you for the kind introduction. I am honored to be here today.

I want to thank the organizers of this conference at the National Press Foundation. This is a great opportunity to discuss topical issues, like social security, in an open forum.

President Bush said in his February State of the Union address that he wanted to engender a national dialogue about Social Security. Regardless of where you stand on the solution to address the looming Social Security insolvency, one thing is for sure, the national dialogue has been raised. Now, people are talking about it, not only in the halls of Congress – but it is the topic at lunch counters and kitchen tables, college dining halls and office water coolers all over the country.

SOCIAL SECURITY REFORM

President Bush has made Social Security reform a major priority of his second term. Today I'll explain why it is so important that responsible Social Security reform occur now, why one element of a successful reform plan must be personal retirement accounts that give individuals more control over their financial futures, and why progressive indexing is a good approach to improving the solvency of the system.

The Size of Social Security's Financial Shortfall

How big is Social Security's current funding gap? The most widely cited measure of that gap is the 75-year actuarial imbalance, which is now estimated at $4.3 trillion or 1.92 percent of taxable payroll. This measure suggests that immediately raising the payroll tax rate by 1.92 percentage points, to 14.32 percent, would permanently fix Social Security. But as many of you are aware, that is not true. With each passing year, the Trustees would report an ever larger financial imbalance as the 75-year scoring window is moved forward to include years with ever larger gaps between expected system costs and income.

As this example makes clear, estimates made over a 75 year horizon do not fully capture the financial status of the Social Security program. In fact, no finite forecast period completely embodies the financial status of the program because people pay taxes in advance of receiving benefits: at any finite cutoff date, people will have accrued benefits that have not yet been paid.

In order to get a complete picture of Social Security's permanent financial problem, the time horizon for calculating income and costs must be extended to the indefinite future. Such a calculation is provided in the 2005 Trustees Report; it is estimated there that for the entire past and future of the program, the present value of scheduled benefits exceeds the present value of scheduled tax income by $11.1

trillion. To put this in perspective, eliminating the permanent deficit could be accomplished with an immediate and permanent 3.5 percentage point increase in the payroll tax rate (to 15.9 percent), or with a 22 percent reduction in all current and future benefits. In both cases, it would be worth noting, there would be massive near-term Trust Fund accumulations.

Intergenerational Equity: Why Social Security Must be Reformed Now

It is clear that the Social Security system is not financially viable and must be fixed. How to close the permanent financing gap raises difficult questions over how the net benefits of Social Security should be shared across generations. In this context, it is important to recognize that the large unfunded obligations in the system are primarily the consequence of the past system generosity to generations that are now either dead or retired. Of course, those early generations are beyond reform's reach, so the entitlement reforms needed to close the financing gap must fall entirely on later generations.

Viewing Social Security from the perspective of how it affects generations and individuals explains why it is imperative that Social Security be reformed now. Delaying reform only reduces the options for fairly distributing the benefits of Social Security across generations. Most people agree that it would not be fair to alter Social Security's promises to retirees and near retirees. The longer reform is delayed, the fewer generations that are left to participate in a reformed entitlement system so as to close Social Security's funding gap, and the more severe those reforms will be.

To make this point more concretely, consider a policy of closing Social Security's permanent financing gap by immediately increasing the payroll tax rate by 3.5 percentage points. If the tax increase were instead delayed until 2041 when the trust fund is depleted, the requisite tax increase would be 6.3 percentage points. Clearly, I do not advocate any of these policies. My point is that there is no doubt that fairness to future generations requires that action be taken now.

I would also point out that purely pay-as-you go financing of Social Security would be grossly unfair to future generations. For example, one way to make Social Security solvent would be to leave benefits unchanged and to raise payroll taxes year by year beginning when the Trust Fund is exhausted. According to current projections, the payroll tax rate under that policy would steadily rise beginning in 2041 and reach 19 percent at the end of the 75-year projection period and would continue to rise thereafter. No reasonable person would view that as a fair policy. I conclude that any reform that is fair across generations would avoid pay-as-you go financing and therefore would at least partially pre-fund Social Security benefits.

Fixing the System

Fortunately, the current untenable situation of Social Security 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 has issued guiding principles for reforming Social Security.

One very important principle is that the benefits of seniors at or near retirement should be protected, and that payroll tax rates should not be increased.

Another principle is that personal retirement accounts (PRAs) should be made available for younger workers to build a nest egg for retirement that they own and control, and which they can pass on to their children and grandchildren.

Additionally, we must pursue the goal of a permanently sustainable system, eschewing halfway measures that would necessitate further reforms in the future.

Personal Retirement Accounts

I would like to focus on the advantages of PRAs. PRAs provide individual control, ownership, and offer individuals the opportunity to partake in the benefits of investing in private-sector markets. Individual control and ownership means that people would be free to pass the value of accounts to their heirs (bequests).

Personal retirement accounts will be voluntary. At any time a worker can "opt in" by making a one-time election to put a portion of his or her payroll taxes into a personal retirement account. A worker who chooses not to opt in will receive traditional Social Security benefits, reformed so as to make the system permanently solvent.

Perhaps most importantly, the retirement security of our current young and future workers depends on PRAs. PRAs allow individuals to save now to help fund their retirement incomes. In principle, that could be done with reforms that save tax revenues in the Social Security Trust Fund. But such "saving" would almost certainly be undone by political pressures to increase government spending and hence produce larger deficits outside of Social Security. The only way to truly save for our retirement and give our children and grandchildren a fair deal is with personal accounts. Personal accounts serve as private and therefore effective "lock boxes". When pre-funding is done using a personal account, there is no pressure to increase government spending, because this pre-funding belongs to individuals and does not appear on the government balance sheet as budget surpluses.

Progressive Indexing

Recently, in a primetime news conference, President Bush outlined his proposals to permanently strengthen Social Security. The President believes that future generations should receive benefits equal to or greater than today's seniors - and that the safety net should be strengthened for those who need it most. Middle- and low-income Americans are among those with the most to gain from these reforms.

Common sense dictates that the highest earning seniors in the future do not need benefits dramatically higher than the highest earners receive today -- especially when the cost of paying such benefits would mean crippling tax increases. To protect the neediest Americans, President Bush is proposing a progressive indexing approach which would offer greater benefits for most Americans than the current system can afford to pay. For middle- and low-income seniors, benefits would continue to grow faster than inflation. For the highest-earning seniors, however, benefits would grow no faster than the rate of inflation.

Progressive indexing would mean real income security for millions of middle class Americans who would otherwise face certain benefit cuts. Under the President's proposal, all future seniors would receive benefits at least as high as today's seniors, even after adjusting for inflation and some – those most in need – will do much better. Today's middle-income 20-year-old would get $17,300 per year in benefits, which is $1,800 more than the current system can pay and $2,500 more than today's middle-income retiree receives. Expected benefits for those workers who invest in personal accounts would be even higher.

A responsible, reasonable and sustainable rate of benefit growth for wealthier seniors would also eliminate poverty among future seniors. Today, roughly two million retirees who paid into Social Security their whole lives are collecting benefits that leave them below the poverty line. By 2041, this number would double. A sliding-scale benefit formula would eventually be able to ensure that no American who works a full lifetime need retire in distress.

President Bush is proposing a reformed system that can afford to keep the promises it makes. Progressive indexing would create benefits which middle class Americans can rely on, rather than the empty promises of the current system. The Administration wants to see Social Security strengthened for those Americans who need it most and President Bush is leading the way towards a permanent solution.

CONCLUSION

To conclude, let me say that I am encouraged that Social Security reform is finally being earnestly debated, and that all parties are motivated to make Social Security fair and permanently solvent. Today, my small contribution to this debate consists of five major points:

1. Social Security as currently designed cannot be sustained. We know with absolute certainty that Social Security will ultimately be reformed. The only question is when and how.
2. Social Security reform is urgent. The longer reform is delayed, the more unfair reform will be to future generations, and the more difficult it will be for individuals to plan their financial futures.
3. Social Security reform must make Social Security permanently solvent. Half measures ensure that further reforms will be necessary, and amount to a delay of reform that would be unfair to future generations.
4. Making Social Security permanently solvent requires that retirement incomes be pre-funded in PRAs rather than the Social Security Trust Fund. Any attempt to pre-fund retirement incomes in the Trust Fund would be undone by excessive government spending outside of Social Security.
5. Progressive indexing would solve most but not all of Social Security's financing shortfalls. The President is committed to working with Congress to find the best way to resolve the remaining shortfall.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 18, 2005
JS-2452

The Honorable John W. Snow
Prepared Remarks to the American Iron and Steel Institute
2005 General Meeting
Washington, DC

Good afternoon; thanks for having me here today. I hope you're having a terrific meeting.

I appreciate how close you are to the pulse of markets and current events. And I know that few, if any, can match you in the steel industry for your grasp of commodities markets and materials markets, as well as a sense of long term production and capacity trends.

That's why I would like to talk today about a topic that I know is foremost in your minds... one that wasn't on our radar screens a few years ago, but is now central to world economic events: the Chinese economy and Chinese economic policy.

The three decades since the Chinese took a decisive step toward the creation of a market economy have seen a remarkable transformation of the Chinese economy.

Since 1987, Chinese growth has averaged over nine percent per year, catapulting that country from a minor player to the seventh largest economy in the world. Per capita income has more than tripled in that period and hundreds of millions of people have been lifted from poverty. Even more remarkable has been their transformation in terms of trading with other countries. China has gone from being almost cut off from the outside world to now being the 3rd largest trading country after the United States and Germany. Over the past four years China, along with the United States, has been a key growth engine for the entire world economy.

Today, as you well know, what takes place in China affects the entire world economy. That means that turbulence in China's growth – periods of acceleration and overheating of production and investment, followed by hard-landings – now have a big effect on the global economy, as well as on markets for commodities and basic materials.

There can be no doubt that much of China's growth performance is the result of the policy choices that it has made – especially its embrace of the market over central planning. But this remarkable transformation could not have taken place without access to the world market, the open-trading system, and foreign investment.

China benefits greatly from the world trading and financial system. But with that role comes responsibility, which is truly the issue of the day.

First, China must live up to its WTO commitments, including: opening markets; protecting intellectual property and respecting the rules of the international trading system.

Second, China must also play its part in promoting sustained world economic growth and the adjustment to international imbalances. This is where China's exchange rate policy is key.

China has kept its exchange rate fixed to the dollar for the last ten years. And while a fixed exchange rate may have had benefits for China originally, that is not true today.

China's fixed exchange rate impedes the transmission of international price signals and international adjustment. It also skews incentives within the Chinese economy toward production for export and away from production for domestic demand.

Of great concern to you, I know, and to me and the President: China's fixed rate is inappropriate for the world economy. It is also inappropriate for the Chinese economy. It has widened regional imbalances and income disparities. It has also led to huge capital inflows that have fueled overinvestment and speculation in the property market, as well as the creation of a new generation of bad loans. The fixed exchange rate coupled with large capital flows deprives China of the ability to run its own monetary policy or alter domestic interest rates – greatly diminishing the ability of economic policy makers to avoid the cycle of boom and bust that has occurred in the past. And finally, a fixed exchange rate allows imbalances to build up and speculators to identify what becomes an increasingly sure bet. The result is that adjustments, when they take place, are all the more disruptive.

What China needs is a more market-based, flexible exchange rate – one that responds to international price signals and facilitates international and domestic adjustment. The Chinese leadership recognizes this, and they have made a commitment to move to a market based flexible exchange rate.

This Administration has worked closely and intensively with the Chinese authorities over the past 2 years -- both at the senior policy level and at the technical level – to prepare for a more flexible exchange rate. We have also been joined by China's major trading partners and the international institutions, making clear that this is not simply a US issue.

China has taken major steps as well. It has deepened markets for foreign exchange by liberalizing controls on transactions and surrender of foreign exchange, and by loosening controls on capital flows. China has also introduced financial instruments and trading systems to support a flexible exchange rate.

A major step actually took place today in Shanghai. The Chinese Foreign Exchange Trading System and Reuters began operation of a new trading system that, among others things, expands the number of currencies that can be traded and allows banks to act as market makers.

Finally, China has strengthened its financial system, including the regulation of foreign exchange exposure and trading.

As a result of these efforts, China is now ready to introduce a more market-based, flexible exchange rate regime... and the time to do so is now. Further delay would not only postpone adjustment in the Chinese and global economies, it would also add to the risks that are now building up.

Yesterday I released Treasury's annual Foreign Exchange Report. The report contained a very careful evaluation of the foreign exchange practices of China and other economies. While we did not find that China met the technical requirements for designation under the terms of the 1988 Trade Act, the report made it very clear that China must act soon to avoid designation in the future.

A flexible exchange rate would give China greater ability to ensure stable growth, avoid inflation and bad loan problems, and address internal income disparities. It would also facilitate smooth and rapid adjustments to imbalances, both in the Chinese economy and the global economy.

Greater exchange rate flexibility by China in particular, and by a number of large economies in Asia in general, is an important part of bringing down the US trade and current account imbalances while maintaining robust global growth.

That said, we should recognize that Chinese exchange rate flexibility is not a panacea. The reduction of global imbalances is a shared responsibility, and each of the major economies has its part to play. The United States must cut the fiscal deficit and increase domestic savings. We know this, and the President has made a clear commitment to cut the federal deficit in half as a share of GDP by 2009. The Administration is also committed to increasing the U.S. savings rate... and as you know President Bush would like to see reforms of the Social Security System that give Americans more control over their retirement income.

Global imbalances are also widened by economies that are not growing as fast as they could. The economic engines in Europe and Japan, for example, have been in neutral for too long. The European Union and Japan need to address the structural problems that limit domestic growth, so that incomes there can grow at full potential, and so that they can drive global growth forward. Faster growth in Europe and Japan is critical to shrinking the U.S. current account deficit without shackling the global economy.

The third component is greater exchange rate flexibility in China, along with other emerging Asian economies.

Adjustment of international imbalances and the maintenance of sustained global growth is a shared responsibility involving macroeconomic policy, structural policy, and exchange rate policy. The International Monetary Fund has a unique role in mobilizing policy responses to international imbalances, and a unique role in considerations of exchange rate policy. Yesterday I called on the IMF to undertake a comprehensive review of current imbalances and report on its findings.

A more flexible exchange rate for China is not a panacea. It will not eliminate the US trade deficit. But Chinese flexibility is part of the solution – along with flexibility of other currencies, stronger domestic-led growth in Europe and Japan, and bringing down the deficit and raising savings in the United States.

A market-based flexible exchange rate is now the next step in China's move to a market economy. It recognizes the role that China now plays in the world economy, as well as the need for effective market economy policy tools. It's a good step for China, and it's a good step for the rest of the world.

I'd be happy to take your questions now.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 18, 2005
JS-2453

Key Note Address of Under Secretary Stuart Levey
California & Florida Bankers Associations' Business Leaders Luncheon

I would like to thank Janet Lampkin (CBA CEO) and the California Bankers Association and Alex Sanchez (FBA CEO) and the Florida Bankers Association for the opportunity to speak with you today.

Your organizations are vitally important to this nation's efforts to combat terrorist financing and financial crime, and it is a pleasure for me to be speaking before you.

I have the honor of serving as the first ever Under Secretary for Terrorism and Financial Intelligence at the Department of the Treasury. My job is to marshal Treasury's resources to combat national security threats, such as proliferation and terrorism, and to safeguard our financial system from terrorist financing and money laundering. Many facets of my role, I am sure, are important to your institutions – that is, oversight of both the Financial Crimes Enforcement Network (FinCEN), which administers the Bank Secrecy Act, and the Office of Foreign Assets Control (OFAC), which administers U.S. sanctions imposed upon terrorists, drug kingpins and rogue countries.

Before I begin my remarks today, I would like to take a moment on behalf of both Secretary Snow and myself to thank you for the terrific support you and your institutions have provided us in our efforts. Before I came to Treasury, I worked at the Justice Department for the Deputy Attorney General. I knew then of the assistance financial institutions all over the country were giving to help make our country safer. Since I have come to Treasury, I have seen many more examples. I want you to know that we appreciate your assistance and great corporate citizenship very much. The partnership between the government and the financial industry established after September 11th must continue to grow as we make our country safer.

In some ways, our partnership has been codified in the USA PATRIOT Act in which the Congress recognized a new national security paradigm brought about by 9/11: information is key to the security of the nation. There are many critical provisions in the PATRIOT Act, but perhaps the most important ones deal with information sharing. The PATRIOT Act broke down walls that prevented the sharing of information between law enforcement and the intelligence community. Significantly for those of us here today, the PATRIOT Act provided us new tools to share information both between the government and financial institutions and among financial institutions themselves. These tools – when used effectively – can add immeasurably to our national security for one key reason: financial information, unlike some other types of intelligence, is highly reliable and valuable to identifying, locating and disrupting terrorist networks and others that mean to do us harm.

I am often asked how we are doing in the fight against terrorist financing. It is a difficult question, because, frankly al Qaida and other terrorist groups do not publish financial statements. Instead, we must rely on various proxies to give us a sense of our progress. In my mind, the most useful of these proxies is the intelligence information we receive. While I am limited in what I can say about it, I can tell you that the information we have been receiving lately is encouraging. We have seen intelligence suggesting that terrorists are having trouble raising, moving and storing

money. We are also seeing terrorist groups avoiding formal financing channels, and instead resorting to riskier and more cumbersome financial conduits like bulk cash smuggling. Because of aggressive action by the Departments of Treasury and Justice and other agencies to shut down corrupt charities and to hold individuals who fund terrorism personally accountable as terrorists – just like terrorist operatives – we are seeing that once willing donors are being deterred from sending money to terrorist groups.

We have also used financial information to identify and disrupt terrorist networks and operations. Most importantly, we have indications that terrorist groups like al Qaida and Hamas are feeling the pressure and are hurting for money. During this same time period, we have also made our financial system's infrastructure more resilient. In short, through our partnership, we have made a difference.

I am keenly aware that this partnership has meant significant investment on your part. The Bank Secrecy Act and the burden that it places on financial institutions have gotten a great deal of attention recently. I think that attention is healthy and appropriate. Those of us charged with responsibilities in this area realize there are problems that must be resolved. We want to do a better job defining your obligations and helping you meet them, and we need to hear your ideas about the implementation of the Act for us to do this correctly. We have no desire to impose unnecessary burdens on industry and we certainly do not have all of the answers in Washington.

In the spirit of that candid dialogue, I would like to make a couple of points to keep in mind as we discuss the compliance burdens being placed upon you.

First, the threat against us continues to be real. The enemy we face is motivated, patient and ruthless. Our terrorist enemies do still want to attack us and they are very focused on our economy and financial systems in particular. We know that al Qaida targeted our nation's financial sector on September 11th with the attack on the World Trade Center, and the financial sector continues to be a favored target. We are reminded of this on a regular basis. Just last month, indictments were handed down in New York charging Issa al-Hindi and two others with conspiring to use weapons of mass destruction and providing material support to terrorists. According to the indictment, they conducted surveillance of the International Monetary Fund (IMF) and World Bank (WB) headquarters in Washington, the Prudential Financial headquarters in New Jersey, and the New York Stock Exchange Building and Citigroup Centre in New York. I am sure that you find this as chilling as I do. I am sure you will recall the heightened threat level in August of 2004 in response in part to these matters. The further we get from September 11, 2001, the harder it may be to keep our sense of urgency, but we must never let our guard down.

It is not just terrorism that we have to guard against. Many national security threats have a sophisticated financial underpinning that we can work together to degrade, proliferation of weapons of mass destruction for example. We must stay vigilant and continue to improve our capabilities to identify and act on financial information.

The second item I would like to address is the assertion made by some that the BSA reports you file are useless or at the very least unused. This is, quite frankly, a myth. To the contrary, the importance of these reports cannot be overstated. I had lunch last week with the terrorist financing section of the FBI, and they were shocked when I mentioned this assertion was being made. They were able to show me statistics suggesting that BSA data is by far the most valuable source of leads in terrorism investigations and in other sophisticated investigations being conducted by the Bureau.

I am constantly receiving examples of criminal investigations initiated by BSA reporting. Each of the federal law enforcement agencies routinely reviews suspicious activity reports, often with dedicated SAR review teams. Recently, the Drug Enforcement Administration, conducting a routine SAR review by zip codes, followed leads that uncovered a violent street gang using a money remitter to move drug proceeds both domestically and internationally. Also recently, the FBI, using

SAR analysis, initiated an investigation that resulted in federal felony charges filed against seven people associated with an organization that purported to be a charity raising money for needy people in the Middle East. Four people have already pled guilty and are cooperating with the ongoing investigation.

The list of such cases is virtually endless. I hope you are as pleased as I am that the SARs and CTRs your institutions have been filing are so valuable, and understand that we take them very seriously.

We are also well aware that we need to do better on our end of the partnership, and you should know we are committed to doing that. I believe that Bill Fox, FinCEN's director, has demonstrated that he is committed to meeting you halfway in this partnership and to engage in the open dialogue I mentioned before. Let me just say a few words about how we are trying to do better.

First, we have recognized that there is a need for a single, clear voice about what is expected from the industry. We have heard the complaints about conflicting and mixed messages from various agencies, and we are taking steps to do something about it. We are now acting to coordinate the bureaucracies with responsibilities under the Bank Secrecy Act to ensure that we are implementing the BSA in a reasonable and consistent way that achieves the Act's policy goals. FinCEN is doing an outstanding job in endeavoring to direct and harmonize the government's guidance on BSA compliance. As the administrator of the Bank Secrecy Act, FinCEN must ensure that when one of the delegated examiners takes action, it is consistent with the policy goals of the BSA. Also, FinCEN must ensure that policy set in Washington translates into action by the line examiners. The federal banking regulators have shown great commitment and cooperation in working with FinCEN to bring coherence to the enforcement of the BSA. We are starting to see a change already.

I have also begun a dialogue with the Department of Justice to see what can be done to improve coordination with respect to prosecutorial decisions to seek, or even to threaten, criminal charges under the Bank Secrecy Act. I know this is something the industry is very concerned about, and I think we will be seeing significant improvements in the very near future.

Finally, we are making it a high priority to improve the flow of information to the private sector. Section 314 of the USA PATRIOT Act envisioned a robust flow of sensitive information to the private sector – a flow that we are working to create. In the past few weeks FinCEN has finalized a secure web site that can be used for this purpose, and we will now endeavor to make that real. This is a critical step because it will enable us to help you help us in identifying the types of suspicious activity that pose real dangers.

We are also working hard to ensure that your counterparts all over the world are being asked to do their part in this fight. International cooperation in combating money laundering and terrorist financing is more important than ever. As this audience well knows, the U.S. financial system does not exist as an island, which is why I spend a great deal of my time reaching out globally, working with multinational organization and regional bodies, and bilaterally with other countries to encourage the adoption of fundamental anti-money laundering and counter terrorist financing policies and procedures.

One of the most significant advances we have seen in recent weeks is foreign banks adopting OFAC's Specially Designated Nationals, or SDN, list even for transactions that do not touch the U.S. This is a momentous event in terms of multiplying the effects of our domestic sanctions authorities. In countries that lack the infrastructure to establish sanctioning bodies like OFAC, we are working directly with the private sector at the invitation of national governments and central banks. Our goal is to engage the private sector as our partners against money laundering and the financing of terrorism just as we are doing here at home.

Our continued success requires building bridges across governmental departments, between the regulatory agencies and to you, the private sector. It is a big project

and it is ongoing. We are keenly aware of the mixed messages you have received and the growing pains we have all endured. However, I want to leave you with the thought that our efforts against terrorist financing and to protect our national security are a shared responsibility.

The old paradigm of governments defending their citizenry from outside threats vanished on 9/11. The threats to our security are no longer purely external, but can come from within, and require that we all think about the threat differently. In short, the government cannot do it alone. We need your help. We will work tirelessly to fulfill our obligations in this partnership. Working together, we have made great progress, and only by working together can we build upon that success.

Thank You.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 18, 2005
JS-2454

Remarks of Greg Zerzan
Acting Assistant Secretary for Financial Institutions
before the Exchequer Club
Washington, DC

Thank you very much for inviting me to appear before you today. I am honored to be speaking before a group dedicated to discussing the important economic and financial policy questions of the day--a field which is always the source of lively debate, but rarely more so than today.

Back in 2003 I had been in my newly appointed position at Treasury for less than a month when I was tasked with going out on the road to discuss the President's tax cuts. It's something I was eager to do; long a believer in the power of keeping money in the hands of those who earned it, I looked forward to spreading the good news about the President's plan.

And in fact I did hear a tremendous amount of support; so much so that we were able to pass the legislation despite some vehement Congressional opposition. But what surprised me more was the fact that I heard any opposition at all. Yet there I was, in the middle of southern New Jersey, accosted by a group of men and women complaining that the budget for a government program they supported had been so curtailed that they were not able to get a grant for their local theater hall. How could the President being proposing tax cuts, they asked, when they couldn't even put on a performance of "Death of a Salesman"?

So here, staring me in the face, was the problem that afflicts all policy makers: for every program there is a constituency; for every jot and title of the law there is a group that feels dearly invested.

But the President proposed his successive rounds of tax cuts because he believed in something even more fundamental: leaving capital in the hands of private citizens to spend and invest as they see fit is more productive than having government redistribute it for them. It amazes that this idea remains controversial, but even now we face the looming prospect of further fights in Congress over whether to make the tax cuts permanent, and over what types of reforms to expect when the President's tax panel comes out with its recommendations later this summer. But let's look at the record in light of the President's tax cuts: for the first seven months of the current fiscal year, receipts total $1.217 trillion, up 14% from the same period in 2004. The government recorded a $57.71 billion budget surplus in April, up sharply from the $17.58 billion budget surplus in April 2004. Since May of 2003 over 3 million new jobs have been created. Simply put, the tax cuts have done exactly what they were designed to do: they have promoted economic growth and job creation, and played a large part in lifting our economy out of recession while at the same time helping to reduce deficits. As we move forward in the coming years let us hope that the lesson of the President's leadership in this area is not forgotten-tax cuts work.

Of course, tax issues are not the only dilemma which we are confronting. As you know, the President has called for fixing the broken Social Security system to ensure that the promises made to future generations will be kept. Currently, the Social Security trust fund is heading towards insolvency: by 2017 the system will begin to pay out more in benefits than it receives in contributions. By 2041, the trust

fund will be broke.

Reforming Social Security is not a Republican or a Democrat issue; it is an American problem. Unfortunately, some seem willing to deny a problem even exists in the hope that they can score political points. The problem with this approach is self evident- eventually they will have to explain to the American people why the Social Security checks they were promised are not arriving in the mail. Some have claimed that voters have short memories, but that has not been my experience.

In order to fix a broken system the President has stated that one way to fix the system is for benefits to grow faster in the future for low-income workers than for those who are better off. Under a reform proposal, low-income workers should receive benefits that grow faster than inflation. In order to return the system to solvency, the benefit increases for wealthier seniors would grow no faster than the rate of inflation.

Additionally, younger workers should be allowed to have a nest-egg through personal accounts, and one option for such an account should be investing in Treasury securities.

In any event, workers 55 years and older will see no changes to the benefits they have been promised. The President wants to save Social Security in a responsible way that ensures the program exists for future generations. We could not avoid this upcoming debate about Social Security reform even if we wanted to- demographics and basic economics tell us the system is on the road to collapse. By acting now the President has sounded the clarion call to Congress, and those who would seek short term political advantage on this issue are doing a disservice to our children and grandchildren.

We are of course also in the midst of an historic debate about the role and regulation of the housing government sponsored enterprises. It is worth noting at the outset what a tremendous success our housing market has been- currently homeownership is at 69%, an all-time high, and housing starts continue to rise at a record pace. This Administration supports homeownership not only because of the important role the housing industry plays in our economy, but also because homeownership benefits society. Home owners tend to be involved in their communities, involved in the civic life where they live, and are both literally and figuratively invested in their neighborhoods, schools and towns.

And it is because homeownership is so highly regarded that the Administration has proposed comprehensive reform of the regulatory structure for the housing GSEs. The Administration has called for the creation of a single regulator for Fannie Mae, Freddie Mac and the Federal Home Loan Banks, one equipped with all the powers, tool and stature of our other financial regulators. This means that the new regulator should have the power to set the minimum and risk-based capital levels of the GSEs, approve the types of businesses a GSE can enter into, including those newly proposed and those which already exist, and the power to place an entity in receivership should that prove necessary.

These powers also include the ability to place limits on the retained portfolios of the GSEs. Retaining enormous portfolios of mortgages does little to further the mission of creating a liquid secondary market in mortgaged backed securities, but does present significant systemic risk. Any regulatory reform legislation passed by Congress should give the GSE regulator the power to limit retained portfolio holdings, and should provide the regulator with clear and explicit direction to do so.

These issues which I have shared with you today are of course not the only topics which occupy our time here in Washington, but certainly they are among the most pressing. In the weeks and months ahead we have the opportunity to promote change that can provide a firm foundation for the continued success and prosperity of our country. I thank you for allowing me to appear before you to advance these ideas, and I look forward to your continued participation in the public discussion of them.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 18, 2005
JS-2455

MEDIA ADVISORY
The U.S. Department of Treasury to Host Economic Roundtable,
"The Need to Strengthen Social Security"

Secretary John W. Snow will host a roundtable event, "The Need to Strengthen Social Security," at the Treasury Department on Thursday, May 19th, from 9 a.m. to 12 p.m.

The event will bring together some of the nation's leading economists for a conversation on the problems facing Social Security and the best way to structure a permanent solution. The program will include a panel discussion, "Yesterday's Promises + Tomorrow's Demographics = Today's Challenge," followed by remarks from some of the leading voices in the Social Security debate.

Roundtable participants will include Harvey S. Rosen, Chairman of the President's Council of Economic Advisers; Robert C. Pozen, Chairman, MFS Investment Management; Benjamin J. Stein, renowned author, economist, lawyer, and entertainer; Mark J. Warshawsky, Treasury Assistant Secretary for Economic Policy; Carolyn L. Weaver, former Director of Social Security & Pension Studies at the American Enterprise Institute; Sylvester J. Schieber, Vice President and Director of U.S. Benefits Consulting at Watson Wyatt Worldwide; Dr. June O'Neill, former Director of the Congressional Budget Office; and Charles P. Blahous, Special Assistant to the President for Economic Policy.

"President Bush has laid out goals for reform – to ensure that future generations receive benefits equal to or greater than today's seniors; to protect those who depend on Social Security the most; and to replace the empty promises being made to younger workers with real money," said Secretary Snow. "The Department of the Treasury and the Council of Economic Advisers share the President's vision for bipartisan Social Security reform and Thursday's roundtable will move the policy discussion forward."

The following event is open to credentialed media with photo identification (credentials must be visible at all times). Full agenda follows below.

Thursday, May 19th

"The Need to Strengthen Social Security"
U.S. Department of the Treasury
Cash Room
1500 Pennsylvania Avenue, NW
Washington, D.C.
9:00 a.m. to 12:00 p.m. EDT
**** Media without Treasury credentials must send their name, organization, date of birth and Social Security number to Frances Anderson at** frances.anderson@do.treas.gov **or (202) 528-9086 by 5pm today.**

AGENDA

The Need to Strengthen Social Security:
A Roundtable by the U.S. Department of the Treasury

Schedule of Proceedings

9:00 am
Welcome:
The Honorable John W. Snow
Secretary of the Treasury

9:15 am
Speaker: Ben Stein
Renowned author, economist, lawyer, and entertainer

9:30 am
Panel: "Yesterday's Promises + Tomorrow's Demographics = Today's Challenge"

Moderator:
The Honorable Mark J. Warshawsky
Assistant Secretary for Economic Policy
U.S. Department of the Treasury

Panelist:
Carolyn L. Weaver, Ph.D
Former Director of Social Security & Pension Studies,
American Enterprise Institute
"Yesterday's Promises"

Panelist:
Sylvester J. Schieber, Ph.D.
Vice President, Watson Wyatt Worldwide
"Tomorrow's Demographics"

Panelist:
The Honorable June O'Neill
Former Director, Congressional Budget Office
"Today's Challenge"

10:30 am Scheduled Break

10:45 am
Speaker: Robert C. Pozen
Chairman, MFS Investment Management
"On Progressive Indexing"

11:15 am
Speaker:The Honorable Harvey S. Rosen
Chairman, Council of Economic Advisers
"The Case for Personal Retirement Accounts"

11:30 am
Speaker: The Honorable Charles P. Blahous
Special Assistant to the President for Economic Policy,
National Economic Council
"Tying It All Together"

FROM THE OFFICE OF PUBLIC AFFAIRS

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May 18, 2005
JS-2456

Treasury and IRS to Provide More Time to Spend FSA Funds

WASHINGTON, DC -- Today the Treasury Department and the IRS issued Notice 2005-42 which will allow employers to modify Flexible Spending Arrangements (FSAs) to extend the deadline for reimbursement of health and dependent care expenses up to 2½ months after the end of the plan year. Previously, employees were required to "use-or-lose" FSA funds by the end of the year. Under the old rules, any unspent funds at year's end would be forfeited.

"The new rule will give workers with FSAs more time to pay for medical and dependent care expenses and will ease the year-end spending rush prompted by the prior rule," stated Treasury Secretary John Snow. "Putting people back in charge of their own care is one of the most important things we can do to strengthen our health care system. That's why President Bush has made it a priority to make it easier to access and pay for care through FSAs and to encourage consumer driven health care initiatives such as Health Savings Accounts."

FSAs allow employees to pays for uncovered or unreimbursed medical costs with pre-tax funds. FSAs are different than Health Savings Accounts (HSAs), which allow individuals and families with high-deductible health care plans to set pre-tax money aside for health expenses. Unlike an FSA, which must be spent within a certain period of time, HSAs can be rolled over from one year to the next.

REPORTS

- The text of Notice 2005-42

Section 125 – Cafeteria Plans -- Modification of Application of Rule Prohibiting Deferred Compensation Under a Cafeteria Plan

Part III - Administrative, Procedural, and Miscellaneous

Notice 2005-42

PURPOSE

The purpose of this notice is to modify the application of the rule prohibiting deferred compensation under a § 125 cafeteria plan. This notice permits a grace period immediately following the end of each plan year during which unused benefits or contributions remaining at the end of the plan year may be paid or reimbursed to plan participants for qualified benefit expenses incurred during the grace period.

BACKGROUND

In general, no amount is included in the gross income of a participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits of the plan. Section 125(a). A cafeteria plan is defined in § 125(d)(1) as a written plan maintained by an employer under which all participants are employees, and the participants may choose among two or more benefits consisting of cash and qualified benefits. Section 125(f) defines a "qualified benefit" as any benefit which, with the application of § 125(a), is not includable in the gross income of the employee by reason of an express provision of Chapter I of the Internal Revenue Code (other than §§ 106(b), 117, 127 or l32). Qualified benefits include employer-provided accident and health plans excludable from gross income under §§ 106 and 105(b), group-term life insurance excludable under § 79, dependent care assistance programs excludable under § 129 and adoption assistance programs excludable under § 137. Elections under a cafeteria plan, once made, can be changed or revoked only as provided in Treas. Reg. § 1.125-4. A cafeteria plan must have a plan year specified in the written plan document. Prop. Treas. Reg. § 1.125-1, Q&A-3.

Section 125(d)(2)(A) states that the term "cafeteria plan"' does not include any plan which provides for deferred compensation. The statutory prohibition on deferred compensation in a cafeteria plan is addressed in Prop. Treas. Reg. §§ 1.125-1 and 1.125-2. Prop. Treas. Reg. § 1.125-2, Q&A-5 states that:

> A cafeteria plan may not include any plan that offers a benefit that defers the receipt of compensation. In addition, a cafeteria plan may not operate in a manner that enables employees to defer compensation. For example, a plan that permits employees to carry over unused elective contributions or plan benefits (e.g., accident or health plan coverage) from one plan year to another operates to defer compensation. This is the case

> regardless of how the contributions or benefits are used by the employee in the subsequent plan year (e.g., whether they are automatically or electively converted into another taxable or nontaxable benefit in the subsequent plan year or used to provide additional benefits of the same type). Similarly, a cafeteria plan operates to permit the deferral of compensation if the plan permits participants to use contributions for one plan year to purchase a benefit that will be provided in a subsequent plan year … .

See also Prop. Treas. Reg. § 1.125-1, Q&A-7.

Thus, a cafeteria plan does not include any plan that defers the receipt of compensation or operates in a manner that enables participants to defer compensation by, for example, permitting participants to use contributions for one plan year to purchase a benefit that will be provided in a subsequent plan year. This rule is commonly referred to as the "use-it-or-lose-it" rule, requiring that unused contributions or benefits remaining at the end of the plan year be "forfeited."

However, other areas of tax law provide that for a short, limited period, compensation for services paid in the year following the year in which the services that are being compensated were performed is not treated as "deferred compensation." For example, Treas. Reg. § 1.404(b)-1T, Q&A-2(a) provides that for purposes of the deduction rules in § 404(a), (b) and (d), a plan, or method or arrangement defers the receipt of compensation or benefits to the extent it is one under which an employee receives compensation or benefits more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed. Under Treas. Reg. § 1.404(b)-1T, Q&A-2(c), a plan, or method or arrangement shall not be considered as deferring the receipt of compensation or benefits for more than a brief period of time after the end of the employer's taxable year to the extent that compensation or benefits are received by the employee on or before the fifteenth day of the third calendar month after the end of the employer's taxable year in which the services are rendered. See also Weaver v. Commissioner, 121 T.C. 273 (2003); Rev. Rul. 88-68, 1988-2 C.B. 117. Cf. H. R. Conf. Rep. No. 755, 108th Cong., 2d Sess. at 735 (2004) (§ 409A "does not apply to annual bonuses or other annual compensation amounts paid within 2 and 1/2 months after the close of the taxable year in which the relevant services required for payment have been performed"). Consistent with these other areas of tax law, Treasury and the IRS believe it is appropriate to modify the current prohibition on deferred compensation in the proposed regulations under § 125 to permit a grace period after the end of the plan year during which unused benefits or contributions may be used.

MODIFICATION OF APPLICATION OF RULE PROHIBITING DEFERRED COMPENSATION UNDER A § 125 CAFETERIA PLAN

The rule that a cafeteria plan may not defer the receipt of compensation as set out in Prop. Treas. Reg. §§ 1.125-1 and 1.125-2 is modified as follows: A cafeteria plan document may, at the employer's option, be amended to provide for a grace period immediately following the end of each plan year. The grace period must apply to all participants in the cafeteria plan. Expenses for qualified benefits incurred during the grace period may be paid or reimbursed from benefits or contributions remaining unused at the end of the immediately preceding plan year. The grace period must not extend beyond the fifteenth day of the third calendar month after the end of the immediately preceding plan year to which it relates (i.e., "the 2 and 1/2 month rule"). If a cafeteria plan document is amended to include a grace period, a participant who has unused benefits or contributions relating to a particular qualified benefit from the immediately preceding plan year, and who incurs expenses for that same qualified benefit during the grace period, may be paid or reimbursed for those expenses from the unused benefits or contributions as if the expenses had been incurred in the immediately preceding plan year. The effect of the grace period is that the participant may have as long as 14 months and 15 days (the 12 months in the current cafeteria plan year plus the grace period) to use the benefits or contributions for a plan year before those amounts are "forfeited" under the "use-it-or-lose-it" rule.

During the grace period, a cafeteria plan may not permit unused benefits or contributions to be cashed-out or converted to any other taxable or nontaxable benefit. Unused benefits or contributions relating to a particular qualified benefit may only be used to pay or reimburse expenses incurred with respect to that particular qualified benefit. For example, unused amounts elected to pay or reimburse medical expenses in a health flexible spending arrangement (FSA) may not be used to pay or reimburse dependent care or other expenses incurred during the grace period. To the extent any unused benefits or contributions from the immediately preceding plan year exceed the expenses for the qualified benefit incurred during the grace period, those remaining unused benefits or contributions may not be carried forward to any subsequent period (including any subsequent plan year) and are "forfeited" under the "use-it-or-lose-it" rule. As under current practice, employers may continue to provide a "run-out" period after the end of the grace period, during which expenses for qualified benefits incurred during the cafeteria plan year and the grace period may be paid or reimbursed.

An employer may adopt a grace period as authorized in this notice for the current cafeteria plan year (and subsequent cafeteria plan years) by amending the cafeteria plan document before the end of the current plan year.

The rules of this notice are illustrated by the following examples:

Example (1). Employer with a cafeteria plan year ending on December 31, 2005, amended the plan document before the end of the plan year to permit a grace period which allows all participants to apply unused benefits or contributions remaining at the end of the plan year to qualified benefits incurred during the grace period immediately following that plan year. The grace period adopted by the employer ends on the fifteenth day of the third calendar month after the end of the plan year (March 15, 2006 for the plan year ending December 31, 2005). Employee X timely elected salary reduction of $1,000 for a health FSA for the plan year ending December 31, 2005. As of December 31, 2005, X has $200 remaining unused in his health FSA. X timely elected salary reduction for a health FSA of $1,500 for the plan year ending December 31, 2006. During the grace period from January 1 through March 15, 2006, X incurs $300 of unreimbursed medical expenses (as defined in § 213(d)). The unused $200 from the plan year ending December 31, 2005 is applied to pay or reimburse $200 of X's $300 of medical expenses incurred during the grace period. Therefore, as of March 16, 2006, X has no unused benefits or contributions remaining for the plan year ending December 31, 2005. The remaining $100 of medical expenses incurred between January 1 and March 15, 2006 is paid or reimbursed from X's health FSA for the plan year ending December 31, 2006. As of March 16, 2006, X has $1,400 remaining in the health FSA for the plan year ending December 31, 2006.

Example (2). Same facts as Example (1), except that X incurs $150 of § 213(d) medical expenses during the grace period (January 1 through March 15, 2006). As of March 16, 2006, X has $50 of unused benefits or contributions remaining for the plan year ending December 31, 2005. The unused $50 cannot be cashed-out, converted to any other taxable or nontaxable benefit, or used in any other plan year (including the plan year ending December 31, 2006). The unused $50 is subject to the "use-it-or-lose-it" rule and is "forfeited." As of March 16, 2006, X has the entire $1,500 elected in the health FSA for the plan year ending December 31, 2006.

EFFECT ON OTHER DOCUMENTS

Future guidance will modify Prop. Treas. Reg. §§ 1.125-1 and 1.125-2 to reflect the provisions in this notice.

DRAFTING INFORMATION

The principal author of this notice is Elizabeth Purcell of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice contact Ms. Purcell on (202) 622-6080 (not a toll-free call).

FROM THE OFFICE OF PUBLIC AFFAIRS

May 17, 2005
JS-2457

Deputy Assistant Secretary Iannicola Teaches Personal Finance to Girl Scouts and Helps Launch Financial Literacy Initiative in San Antonio, Texas

Treasury's Deputy Assistant Secretary for Financial Education, Dan Iannicola, Jr. today taught a personal finance lesson to more than fifty Girl Scouts in San Antonio, Texas. Iannicola helped kick off a financial literacy initiative sponsored by the Girl Scouts called CentsAbility. Iannicola taught the Scouts how to set realistic financial goals, how to plan for those goals, how to establish a savings plan and to create a realistic budget based on current income and expenses.

"Knowing how to manage one's money is an essential life skill. Today we're empowering these Girl Scouts with the knowledge to someday function as independent adults," said Iannicola. "I commend the Girl Scout Council of San Antonio for making financial literacy a priority through its use of the CentsAbility financial education program," he continued.

The participants were started on a savings plan and given their own new piggy bank as a reminder of what they had learned during today's lesson. The Girl Scouts is a worldwide organization dedicated to helping girls build character and skills for success in the real world. In partnership with committed adults, the organization focuses on helping girls develop qualities that will serve them throughout their lives. The CentsAbility program, was developed to help girls ages 9-11 develop and flex their financial literacy muscles. The projects and activities included in the CentsAbility kit offer opportunities for volunteers to help girls learn, and put into action key concepts and skills related to personal money management.

The Department of the Treasury is a leader in promoting financial education. Treasury established the Office of Financial Education ("Office") in May 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.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 19, 2005
js-2458

Secretary Snow's Remarks at Treasury's Social Security Economic Roundtable

Treasury Department Hosts Economic Roundtable, "The Need to Strengthen Social Security" Leading Economists Gather To Discuss The Need For A Permanent Solution

Secretary John W. Snow today welcomed leading economists and policy experts to the Treasury Department for a roundtable event, "The Need to Strengthen Social Security."

The roundtable, which took place this morning in Treasury's historic Cash Room, was a productive discussion of the problems facing Social Security and the best way to structure a permanent solution. The program featured a panel, "Yesterday's Promises + Tomorrow's Demographics = Today's Challenge," followed by remarks from some of the leading voices in the Social Security debate.

Roundtable participants included Harvey S. Rosen, Chairman of the President's Council of Economic Advisers; Robert C. Pozen, Chairman, MFS Investment Management; Ben Stein, renowned author, economist, lawyer, and entertainer; Mark J. Warshawsky, Treasury Assistant Secretary for Economic Policy; Carolyn L. Weaver, former Director of Social Security & Pension Studies at the American Enterprise Institute; Sylvester J. Schieber, Vice President and Director of U.S. Benefits Consulting at Watson Wyatt Worldwide; Dr. June O'Neill, former Director of the Congressional Budget Office; and Charles P. Blahous, Special Assistant to the President for Economic Policy.

Secretary Snow's Remarks:

The Honorable John W. Snow
Prepared Remarks: Economic Roundtable on Social Security Reform
Treasury Department Cash Room

Good morning; thank you all for coming. It is always a pleasure to welcome guests to this stunning and historic room in the Treasury.

I believe that our speakers, and our program today, will do this impressive room justice. Some of the sharpest economic minds in the country are here to discuss the most pressing and exciting economic issue of the day: saving and strengthening our nation's Social Security system.

The system is financial unsustainable, and America knows it. The question is no longer whether to fix Social Security... the question today is how are we going to fix it.

The Social Security trustees report, after all, cannot be denied. The work of non-partisan actuaries shows that Social Security cash flows peak in 2008 and turn negative in 2017. The trust fund itself will be exhausted in 2041. The unfunded obligation is a staggering $11.1 trillion on a permanent basis, and $4.0 trillion over the next 75 years.

No one knows these facts, this reality, better than today's speakers and panelists. Today's discussion will therefore be a significant part of the terrific national dialogue that has been in full-swing since the President talked about saving Social Security in his State of the Union Address. I've traveled all over the country to engage Americans in a conversation about the issue, and it's been wonderful to see the discussions that are taking place, from lunch counters to kitchen tables, from college dining halls to the halls of Congress – where specific proposals and ideas are emerging, and the President and I are delighted to see that progression.

As all of you know, the President is leading the national dialogue on this issue by voicing his commitment to some key principles – his is not an overly prescriptive approach – and by maintaining openness to ideas and solutions from everyone who comes forward with them.

One of the most important things that the President talks about is the need for any solution to be a permanent one. We need to make the system solvent on a permanent basis. Too many times now Social Security has been patched up with tax increases and other band-aids that get us through a few more years, but don't offer a lasting answer. Waiting to act would invite the next band-aid solution... for without action, younger workers face massive, economically damaging tax increases (payroll taxes would have to be raised immediately by 3.5 percentage points – that's about a 30 percent increase – to make the system whole on a permanent basis) or steep benefit cuts to keep the program solvent.

Because of our changing demographics, the structure of the program simply isn't going to work for future generations the way it did for retirees of the 20th century. It is time to modernize the program, and the sooner we do so, the better. The future of our children and grandchildren, and future of our great economy, absolutely depend on it.

Let me be clear that the promises of the system do not have to change. We can keep the promises – more accurately, we can improve the system to deliver on the promises – but to do so we must thoughtfully re-configure how they are delivered.

For example, the President has proposed a form of progressive indexing of benefits. By slowing the rate of growth of benefits for wealthier Americans, we can protect the future benefit levels for lower income people. Under this approach, those most in need will retire with benefits which are greater than the current system can deliver while higher income people will see their benefits rise over current levels, but at a slower rate.

The President's indexing proposal is an approach that is socially just while also being financially responsible, bringing the program about 70 percent of the way toward solvency. I know he is looking forward to working with Congress to bring the program all the way to 100 percent, permanent solvency.

I'm looking forward to hearing the excellent discussion of ideas on solvency, personal accounts, permanent solutions and more today at this roundtable, so I won't delay us any longer; let's get started. Thank you.

-30-

FROM THE OFFICE OF PUBLIC AFFAIRS

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May 19, 2005
JS-2459

Treasury Secretary Snow Appoints Olin L. Wethington as Special Envoy on China

Treasury Secretary John Snow today announced that he is appointing Olin L Wethington as his Special Envoy on China. Mr. Wethington will be responsible for direct engagement with China on issues related to exchange rate and financial market reform.

"I'm very pleased that Olin Wethington has agreed to take on this assignment," said Secretary John Snow. "His appointment comes at a time when continuation of certain policies constrains adjustment of international imbalances and poses risk to global economic growth. His appointment seeks to continue and intensify a constructive dialogue with China on these issues. This is a critical time for China to implement necessary economic reforms – most notably, reform of its currency regime and the adoption of market-based exchange policies. Olin Wethington brings extensive experience and talent to this position. I have enormous confidence in his ability to do this job."

Secretary Snow directed Mr. Wethington, in carrying out his responsibilities, to consult with other governments as necessary, particularly in Asia and among the G-7, and with international financial institutions, most importantly the International Monetary Fund.

His responsibilities will also include the China portfolio of Ambassador Paul Speltz, who will continue his full-time position as U.S. Executive Director at the Asian Development Bank in Manilla, Philippines. Secretary Snow praised the work of Ambassador Speltz: "Ambassador Speltz did an outstanding job over the past year and has achieved so much, particularly with our Technical Cooperation Program with China. There is no greater testament to Paul's accomplishments than the fact that China today is now ready to introduce currency flexibility. I greatly appreciate the job he has done and I am very pleased that he will continue to represent the United States at the Asian Development Bank."

"It is a great honor to take this assignment, as it is an important priority for the Bush Administration that China implements sound economic policies. I look forward to working with the Chinese government, as well as other governments in the region, and our partners in the G7 to encourage China to reform its currency policy. Such a reform is in China's best interest and it is in the best interest of the global economy," Wethington said.

Mr. Wethington has a successful track record in international financial diplomacy and deep experience in dealing with foreign governments on matters of financial market reform. In 1991-92, he served as Assistant Secretary for International Affairs at the U.S. Treasury. In that capacity, he led a number of important financial market initiatives, particularly in Asia, including the U.S./Japan Structural Impediments Initiative, and was a key participant in the dollar/yen talks. He also chaired the U.S./Korea financial services talks and led, on behalf of the Treasury, discussions during that period with China on exchange rate matters. He served as chief negotiator of the financial services components of the NAFTA, including

banking, securities and insurance. In 1990-91, Mr. Wethington served as Executive Secretary, Economic Policy Council, at the White House. In the private sector, as a senior partner with Steptoe & Johnson LLP, he advised over the past several decades numerous major American companies on international financial and trade matters, including with respect to China.

More recently, Mr. Wethington served as Director, Economic Policy, with the Coalition Provisional Authority in Baghdad, where for close to eight months he was the senior Treasury official on banking, finance and economic matters, including the effort to build the capacity of the Central Bank and Finance Ministry of Iraq. Upon his return from Baghdad, he was named Counselor to the Secretary of the Treasury and played a central role in the international effort to reduce substantially Iraq's $125 billion external debt. He led the on-ground negotiations for the United States within the Paris Club that produced international agreement to eliminate 80% of Iraq's external debt--the largest debt write-down by sovereign creditors in the fifty-year history of the Paris Club.

Mr. Wethington will continue to serve in his capacity as Counselor to the Treasury Secretary.

He is a graduate of the University of Pennsylvania, where he majored in Oriental Studies, including Chinese history and language, and of the Harvard Law School.

REPORTS

- Snow Letter
- Speltz Letter

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

May 19, 2005

Ambassador Paul W. Speltz
Emissary of the U.S. Secretary of the Treasury
To the People's Republic of China
c/o U.S. Embassy Manila
1201 Roxas Blvd.
Ermita, Manila
Philippines 1000

Dear Paul:

I want to express my heartfelt thanks for your impressive efforts over the past year as my Special Emissary to the Chinese Government, while at the same time serving admirably in your post as U.S. Executive Director to the Asian Development Bank.

In large part due to your efforts, we have established numerous and effective channels of communication to the Chinese authorities, and China has completed the preparations necessary to now move to a more market-based flexible exchange rate. You should be very proud of that accomplishment. As we have made clear, it is strongly in the interest of China to now adopt a more flexible exchange rate.

Our efforts will intensify over the coming months as we work with China, and increasingly with other Asian economies, to bring about a move to greater exchange rate flexibility.

As we enter this new stage, you have my full support as you now devote your entire energies to the critical job of U.S. Executive Director to the Asian Development Bank. I know that the demands on your time at the Asian Development Bank are significant– for relief of the tsunami-affected countries and for a range of other issues.

I want to thank you again for your extraordinary efforts in bringing us to this new stage in U.S.-China relations. I will continue to seek your counsel on issues relating to China's economic reform efforts. Please know how much I appreciate being able to count on your continued work for the Administration at the Asian Development Bank.

Sincerely,

John W. Snow

Emissary of the U.S. Secretary of Treasury to the
People's Republic of China

American Embassy
Manila, Philippines

May 18, 2005

The Honorable John W. Snow
Secretary of the Treasury
U.S. Department of The Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220
U.S.A.

Dear Mr. Secretary,

Thank you for giving me the opportunity to serve as your Economic and Financial Emissary to China over the past thirteen months. As China has made sufficient reforms to now begin to introduce flexibility in its currency regime, this is an appropriate time for me to return to my full-time service as U.S. Executive Director at the Asian Development Bank.

Over the last year, we have made significant progress with China on economic and banking reforms. It is important to note that in addition to the progress on our chief goal of persuading China to move to a flexible exchange rate regime, we have also achieved a number of other noteworthy objectives related to that goal. Clearly, the most important accomplishment of the past year was to achieve the understanding from China's economic leadership that adopting a flexible currency system is in China's own best interests to help it effectively manage its economy. Today there is no doubt that China is prepared to introduce greater flexibility in its exchange rate regime.

The reforms undertaken by the Chinese during this period are substantial and critical to China's progress, specifically in the financial sector; meeting WTO compliance; and building the financial infrastructure for sustainable economic growth with a flexible currency regime.

In support of China's preparations for exchange rate reform, we have engaged with the People's Bank of China in the bilateral Technical Cooperation Program (TCP) that you established during your September 2003 visit. As part of this cooperation, we have actively worked with the State Administration of Foreign Exchange (SAFE) to encourage further capital account liberalization and develop the foreign exchange markets. The Chicago Mercantile Exchange has already established a close working relationship with

SAFE's China Foreign Exchange Trading System (CFETS) that will soon allow China to trade foreign exchange derivatives products. Reflecting China's new capabilities in foreign exchange trading, CFETS began trading an additional eight currency pairs in China on May 18.

We also provided valuable assistance in the area of banking reform to assist in China's resolution of non-performing loans (NPLs) in its banking system. Our efforts have been so well-received that the People's Bank of China has asked for follow-up efforts to continue progress in this area. Separately, Treasury and the Federal Deposit Insurance Corporation (FDIC) are also teaming up to provide a seminar on bank deposit insurance.

In the area of expanding market access in China's securities industry, our ongoing discussions with the China Securities Regulatory Commission (CSRC) have also helped persuade the Chinese authorities that allowing more foreign investment in Chinese securities firms will be helpful in strengthening China's troubled securities sector. A number of deals are currently in progress that will allow foreign firms to acquire an effective controlling interest in local securities firms.

These are just a few of the more notable results of the strengthened U.S.-China relationship on financial issues. This cooperative relationship is clearly helping China to manage its transition as it moves into a flexible exchange rate regime.

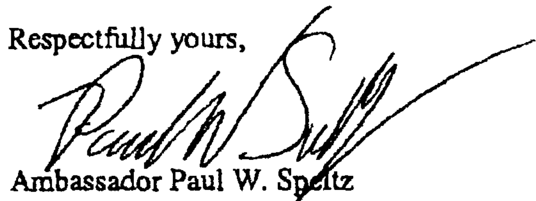
As you know, I have been honored to serve you as your Financial Emissary in China. I have done this job in addition to continuing to serve as United States Executive Director for the Asian Development Bank (ADB). Balancing these two full-time responsibilities while commuting between the Philippines, China and the many other Asian member countries of the ADB, has been an effective arrangement. However, this extensive travel in Asia makes it difficult for me to come to Washington enough to confer directly with senior administration officials and to be responsive to Congress' need for ongoing updates. I have found that my many meetings with members of Congress have proved helpful to all sides in providing a clear understanding of the Administration's overall U.S. - China economic engagement and specifically on the difficulties regarding the Chinese action on currency reform.

I would ask that my remaining time in the Philippines be focused on my responsibilities in representing President Bush at the ADB. The United States, as a major shareholder at the ADB, plays a critical role in advancing the adoption of sound economic policies, generating economic growth, and raising living standards of poor people in Asia. During the last two years, we have made positive and significant steps in reforming this multilateral development bank, specifically in the areas of combating corruption, promoting management reform, and good governance. Externally, my work and frequent travel to Afghanistan, Pakistan, Indonesia, and other countries in the region, have all been carefully coordinated with the various U.S. Government agencies to further our bilateral and international development objectives. This is very important and we need to continue

to actively drive this initiative forward. Our ongoing work in assisting with the Tsunami disaster is another critical program that we are focusing on.

I remain at your service to provide any advice and counsel as you and your team at Treasury continues the effort to ensure that China adopts sound economic policies.

Respectfully yours,



Ambassador Paul W. Speltz

FROM THE OFFICE OF PUBLIC AFFAIRS

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May 19, 2005
JS-2460

Treasury and IRS Announce Proposed Regulations Regarding Dual Consolidated Losses

WASHINGTON, DC -- The Treasury Department and the Internal Revenue Service today announced proposed regulations regarding dual consolidated losses under section 1503(d) of the Internal Revenue Code. The existing regulations, as modified by the new proposed rules, are generally intended to prohibit a U.S. corporation from taking a deduction for a loss from its operations for U.S. tax purposes if that same loss may be used to offset income in a foreign country. The new proposed regulations update the existing regulations to take into account changes in the laws and regulations of both the United States and other countries since the existing regulations were issued, as well as to reflect the U.S. experience with administering the existing regulations.

The most significant changes provided by the proposed regulations address three concerns that arise under the current regulations. First, the scope of the proposed regulations minimizes the over- and under-inclusive application of the current regulations. Second, the proposed regulations modernize the regime to take into account updated U.S. entity classification regulations and related issues so that the rules can be applied with greater certainty. Finally, the proposed regulations reduce administrative burdens imposed on taxpayers and the IRS.

The regulations are proposed to be effective for dual consolidated losses that are incurred in taxable years beginning after the date upcoming final regulations are issued.

REPORTS

- Dual Consolidated loss Regulations

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

REG-102144-04

RIN 1545-BD10

Dual Consolidated Loss Regulations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rule making and notice of public hearing.

SUMMARY: This document contains proposed regulations under section 1503(d) of the Internal Revenue Code (Code) regarding dual consolidated losses. Section 1503(d) generally provides that a dual consolidated loss of a dual resident corporation cannot reduce the taxable income of any other member of the affiliated group unless, to the extent provided in regulations, such loss does not offset the income of any foreign corporation. Similar rules apply to losses of separate units of domestic corporations. The proposed regulations address various dual consolidated loss issues, including exceptions to the general prohibition against using a dual consolidated loss to reduce the taxable income of any other member of the affiliated group.

DATES: Written and electronic comments and outlines of topics to be discussed at the public hearing scheduled for September 7, 2005, at 10:00 a.m., must be received by August 22, 2005.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-102144-04), room 5203, Internal Revenue Service, P.O. Box 7604, Washington, DC 20044. Submissions may

FROM THE OFFICE OF PUBLIC AFFAIRS

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May 20, 2005
JS-2461

Treasury and IRS Announce Proposed Regulations on Equity Partnerships

WASHINGTON, DC -- Today the Treasury Department and the Internal Revenue Service issued proposed regulations describing the tax consequences of transferring partnership interests in exchange for services.

The proposed regulations provide that the amount includible in income by the transferee of the partnership interest, and the amount of the corresponding compensation deduction to the partnership, generally is equal to the fair market value of the transferred interest.

Because partnership interests can be difficult to value, and to help partnerships maintain capital accounts properly, the proposed regulations allow a partnership and its partners to elect a safe harbor under which the fair market value of a partnership interest is treated as equal to the liquidation value of the interest. The proposed regulations generally provide that a partnership that transfers a partnership interest in exchange for services recognizes no gain or loss on the transfer.

In addition, the Internal Revenue Service issued Notice 2005-43, which includes a draft revenue procedure describing additional rules and conditions relating to the safe harbor election.

REPORTS

- Proposed Revenue Procedure Regarding Partnership Interests Transferred in Connection with the Performance of Services
- Partnership Equity for Services

Part III – Administrative, Procedural, and Miscellaneous

Proposed Revenue Procedure Regarding Partnership Interests Transferred in Connection with the Performance of Services

Notice 2005-43

Purpose

This notice addresses the taxation of a transfer of a partnership interest in connection with the performance of services. In conjunction with this notice, the Treasury Department and the Internal Revenue Service are proposing regulations under § 83 of the Internal Revenue Code. The proposed regulations grant the Commissioner authority to issue guidance of general applicability related to the taxation of the transfer of a partnership interest in connection with the performance of services. This notice includes a proposed revenue procedure under that authority. The proposed revenue procedure provides additional rules for the elective safe harbor under proposed § 1.83-3(l) for a partnership's transfers of interests in the partnership in connection with the performance of services for that partnership. The safe harbor is intended to simplify the application of § 83 to partnership interests and to coordinate the provisions of § 83 with the principles of partnership taxation. Upon the finalization of the proposed revenue procedure, Rev. Proc. 93-27, 1993-2 C.B. 343, and Rev. Proc. 2001-43, 2001-2 C.B. 191, (described below) will be obsoleted. Until that occurs,

taxpayers may not rely upon the safe harbor set forth in the proposed revenue procedure, but taxpayers may continue to rely upon current law, including Rev. Proc. 93-27, 1993-2 C.B. 343, and Rev. Proc. 2001-43, 2001-2 C.B. 191.

Effective Date

The Treasury Department and the Service intend for the revenue procedure proposed in this notice to be finalized and made effective in conjunction with the finalization of the related proposed regulations under § 83 and subchapter K of chapter 1 of the Internal Revenue Code (subchapter K).

Request for Comments

Comments are requested on the proposed revenue procedure in this notice. Although the Treasury Department and the Service request comments on all aspects of the proposed revenue procedure, comments are requested specifically on the following:

1. Whether additional guidance is needed to address the transfer of an interest in a partnership to a person who is not rendering services directly to such partnership (for example, an upper-tier partnership transfers an interest in a lower-tier partnership to a person for services rendered to the upper-tier partnership).

2. Whether election of the safe harbor described in proposed § 1.83-3(l) and the proposed revenue procedure should be permitted on Form 1065, U.S. Return of Partnership Income, and whether continued use

of the safe harbor should be reported annually on Form 1065 and Schedule K-1, Partner's Share of Income, Credits, Deduction, etc.

Comments may be submitted on or before August 22, 2005 to Internal Revenue Service, PO Box 7604, Washington, DC 20044, Attn: CC:PA:LPD:PR (Notice 2005-43), Room 5203. 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:PR (Notice 2005-43), 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 2005-43) in the subject line.

Drafting Information

The principal authors of this notice are Stephen Tackney of the Office of Associate Chief Counsel (Tax Exempt and Government Entities); and Audrey Ellis and Demetri Yatrakis of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice and the application of § 83, contact Stephen Tackney on (202) 622-6030 (not a toll-free call). For further information regarding this notice and the application of the rules contained in subchapter K, contact Audrey Ellis or Demetri Yatrakis on (202) 622-3060 (not a toll-free call).

PROPOSED REVENUE PROCEDURE

SECTION 1. PURPOSE

Proposed § 1.83-3(l) of the Income Tax Regulations allows taxpayers to elect to apply special rules (the Safe Harbor) to a partnership's transfers of interests in the partnership in connection with the performance of services for the partnership. The Treasury Department and the Internal Revenue Service intend for the Safe Harbor to simplify the application of § 83 of the Internal Revenue Code to partnership interests transferred in connection with the performance of services and to coordinate the principles of § 83 with the principles of partnership taxation. This revenue procedure sets forth additional rules for the elective safe harbor under proposed § 1.83-3(l) for a partnership's transfer of interests in the partnership in connection with the performance of services for that partnership.

SECTION 2. LAW AND DISCUSSION

Section 83(a) provides that if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of (1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over (2) the amount (if any) paid for such property, is included in the gross income of the person who performed such services in the first taxable year in which the rights of the person

having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable.

Section 1.83-3(e) provides that, for purposes of § 83 and the regulations thereunder, the term property includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future. For these purposes, under proposed § 1.83-3(e) property includes a partnership interest. Generally, a mere right to allocations or distributions described in § 707(a)(2)(A) is not a partnership interest. Proposed § 1.83-3(e) also provides that, in the case of a transfer of a partnership interest in connection with the performance of services, the Commissioner may prescribe generally applicable administrative rules to address the application of § 83 to the transfer.

Section 83(b) provides that a service provider may elect to include in his or her gross income, for the taxable year in which substantially nonvested property is transferred, the excess of (1) the fair market value of the property at the time of the transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse), over (2) the amount (if any) paid for the property. If such an election is made, § 83(a) does not apply with respect to the transfer of the property upon vesting and, if the property is subsequently forfeited, no deduction is allowed to the service provider in respect of the forfeiture.

Section 1.83-2(b) provides that an election under § 83(b) must be filed not later than 30 days after the date the property was transferred and may be filed prior to the date of the transfer. Section 1.83-2(c) provides that the election is

made by filing one copy of a written statement with the Internal Revenue Service Center with which the service provider files his or her return. In addition, one copy of such statement must be submitted with the service provider's income tax return for the taxable year in which the property was transferred.

Section 1.83-1(a) provides that, unless an election under § 83(b) is made, the transferor is regarded as the owner of substantially nonvested property transferred in connection with the performance of services until such property becomes substantially vested, and any income from such property received by the service provider (or beneficiary thereof), or the right to the use of such property by the service provider, constitutes additional compensation and is included in the gross income of the service provider for the taxable year in which the income is received or the use is made available. Under this rule, a partnership must treat as unissued any substantially nonvested partnership interest transferred in connection with the performance of services for which an election under § 83(b) has not been made. If the service provider who holds such an interest receives distributions from the partnership with respect to that interest while the interest is substantially nonvested, the distributions are treated as compensation in the capacity in which the service provider performed the services. For example, if a service provider that is not a pre-existing partner holds a substantially nonvested partnership interest that the service provider received in connection with the performance of services and the service provider did not make an election under § 83(b) with respect to that interest, then any distributions made to the service provider on account of such interest are treated

as additional compensation and not partnership distributions. If, instead, the service provider who receives a substantially nonvested partnership interest in connection with the performance of services makes a valid election under § 83(b), then the service provider is treated as the owner of the property. See Rev. Rul. 83-22, 1983-1 C.B. 17. The service provider is treated as a partner with respect to such an interest, and the partnership must allocate partnership items to the service provider as if the partnership interest were substantially vested.

Section 1.83-3(b) provides that property is substantially nonvested for § 83 purposes when it is subject to a substantial risk of forfeiture and is nontransferable. Property is substantially vested for § 83 purposes when it is either transferable or not subject to a substantial risk of forfeiture.

Section 1.83-3(c) provides that, for § 83 purposes, whether a risk of forfeiture is substantial or not depends upon the facts and circumstances. A substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied.

Section 1.83-3(d) provides that, for § 83 purposes, the rights of a person in property are transferable if such person can transfer any interest in the property to any person other than the transferor of the property, but only if the

rights in such property of such transferee are not subject to a substantial risk of forfeiture.

Proposed § 1.83-3(l) provides that, subject to such additional conditions, rules, and procedures that the Commissioner may prescribe in regulations, revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin, a partnership and all of its partners may elect a safe harbor under which the fair market value of a partnership interest that is transferred in connection with the performance of services is treated as being equal to the liquidation value of that interest for transfers on or after the date final regulations are published in the Federal Register if the following conditions are satisfied: (1) the partnership must prepare a document, executed by a partner who has responsibility for federal income tax reporting by the partnership, stating that the partnership is electing, on behalf of the partnership and each of its partners, to have the safe harbor apply irrevocably as of the stated effective date with respect to all partnership interests transferred in connection with the performance of services while the safe harbor election remains in effect and attach the document to the tax return for the partnership for the taxable year that includes the effective date of the election; (2) except as provided below, the partnership agreement must contain provisions that are legally binding on all of the partners stating that (a) the partnership is authorized and directed to elect the safe harbor, and (b) the partnership and each of its partners (including any person to whom a partnership interest is transferred in connection with the performance of services) agrees to comply with all requirements of the safe harbor with respect to all partnership

interests transferred in connection with the performance of services while the election remains effective; and (3) if the partnership agreement does not contain the provisions described in clause (2) of this sentence, or the provisions are not legally binding on all of the partners of the partnership, then each partner in a partnership that transfers a partnership interest in connection with the performance of services must execute a document containing provisions that are legally binding on that partner stating that (a) the partnership is authorized and directed to elect the safe harbor, and (b) the partner agrees to comply with all requirements of the safe harbor with respect to all partnership interests transferred in connection with the performance of services while the election remains effective. The specified effective date of the safe harbor election may not be prior to the date that the safe harbor election is executed. Proposed § 1.83-3(l) provides that the partnership must retain such records as may be necessary to indicate that an effective election has been made and remains in effect, including a copy of the partnership's election statement under this paragraph (l), and, if applicable, the original of each document submitted to the partnership by a partner under this paragraph (l). If the partnership is unable to produce a record of a particular document, the election will be treated as not made, generally resulting in termination of the election. The safe harbor election also may be terminated by the partnership preparing a document, executed by a partner who has responsibility for federal income tax reporting by the partnership, which states that the partnership, on behalf of the partnership and each of its partners, is revoking the safe harbor election on the stated effective date, and

attaching the document to the tax return for the partnership for the taxable year that includes the effective date of the revocation.

Section 83(h) provides that, in the case of a transfer of property in connection with the performance of services or a cancellation of a restriction described in § 83(d), there is allowed as a deduction under § 162, to the person for whom the services were performed (the service recipient), an amount equal to the amount included under § 83(a), (b), or (d)(2) in the gross income of the service provider. The deduction is allowed for the taxable year of the service recipient in which or with which ends the taxable year in which such amount is included in the gross income of the service provider. Under § 1.83-6(a)(3), if property is substantially vested upon the transfer, the deduction is allowed to the service recipient in accordance with its method of accounting (in conformity with §§ 446 and 461).

Section 1.83-6(c) provides that if, under § 83(h) and § 1.83-6(a), a deduction, an increase in basis, or a reduction of gross income was allowable (disregarding the reasonableness of the amount of compensation) in respect of a transfer of property and such property is subsequently forfeited, the amount of such deduction, increase in basis, or reduction of gross income shall be includible in the gross income of the person to whom it was allowable for the taxable year of the forfeiture. The basis of such property in the hands of the person to whom it is forfeited shall include any such amount includible in the gross income of such person, as well as any amount such person pays upon forfeiture.

Section 704(b) requires that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) be determined in accordance with the partner's interest in the partnership, determined by taking into account all facts and circumstances, if (1) the partnership agreement does not provide otherwise as to the partner's distributive share, or (2) the allocation to a partner under the agreement does not have substantial economic effect.

Proposed § 1.704-1(b)(2)(iv)(b)(1) provides that a partner's capital account includes the amount contributed by that partner to the partnership, and, in the case of a compensatory partnership interest that is transferred on or after the date final regulations are published in the **Federal Register**, the amount included on or after that date as the partner's compensation income under § 83(a), (b), or (d)(2). For these purposes, a compensatory partnership interest is an interest in the transferring partnership that is transferred in connection with the performance of services for that partnership (either before or after the formation of the partnership), including an interest that is transferred on the exercise of a compensatory partnership option. A compensatory partnership option is an option to acquire an interest in the issuing partnership that is granted in connection with the performance of services for that partnership (either before or after the formation of the partnership). See proposed § 1.721-1(b)(4).

Proposed § 1.704-1(b)(4)(xii)(a) provides that if a § 83(b) election has been made with respect to a substantially nonvested interest, allocations of partnership items while the interest is substantially nonvested cannot have economic effect.

Proposed § 1.704-1(b)(4)(xii)(b) provides that allocations of partnership items to a holder of a nonvested interest for which a § 83(b) election has been made will be deemed to be in accordance with the partners' interests in the partnership if the partnership agreement requires that: (1) in the event that the interest for which the § 83(b) election is made is later forfeited, the partnership shall make forfeiture allocations in the year of the forfeiture; and (2) all material allocations and capital account adjustments under the partnership agreement not pertaining to substantially nonvested partnership interests for which a § 83(b) election has been made are recognized under § 704(b). Proposed § 1.704-1(b)(4)(xii)(e) provides that proposed § 1.704-1(b)(4)(xii)(b) does not apply to allocations of partnership items made with respect to a substantially nonvested interest for which the holder has made a § 83(b) election if, at the time of the § 83(b) election, there is a plan that the interest will be forfeited. In determining whether there is a plan that the interest will be forfeited, the Commissioner will consider all of the facts and circumstances (including the tax status of the holder of the forfeitable compensatory partnership interest).

Proposed § 1.704-1(b)(4)(xii)(c) defines forfeiture allocations as allocations to the service provider (consisting of a pro rata portion of each item) of gross income and gain or gross deduction and loss (to the extent such items are available) for the taxable year of the forfeiture in a positive or negative amount equal to (1) the excess (not less than zero) of (a) the amount of the distributions (including deemed distributions under § 752(b) and the adjusted tax basis of any property so distributed) to the partner with respect to the forfeited

partnership interest (to the extent such distributions are not taxable under § 731), over (b) the amounts paid for the interest and the adjusted tax basis of property contributed by the partner (including deemed contributions under § 752(a)) to the partnership with respect to the forfeited partnership interest, minus (2) the cumulative net income (or loss) allocated to the partner with respect to the forfeited partnership interest. Proposed § 1.704-1(b)(4)(xii)(d) provides that for purposes of proposed § 1.704-1(b)(4)(xii)(c), items of income and gain are reflected as positive amounts, and items of deduction and loss are reflected as negative amounts.

Section 721(a) provides that no gain or loss is recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

Proposed § 1.721-1(b)(1) provides that § 721 generally does not apply to the transfer of a partnership interest in connection with the performance of services. Such a transfer constitutes a transfer of property to which § 83 and the regulations thereunder apply. However, under proposed § 1.721-1(b)(2), except as provided in § 83(h) or § 1.83-6(c), no gain or loss is recognized by a partnership upon: (i) the transfer or substantial vesting of a compensatory partnership interest, or (ii) the forfeiture of a compensatory partnership interest.

Proposed § 1.761-1(b) provides that if a partnership interest is transferred in connection with the performance of services, and that partnership interest is substantially nonvested (within the meaning of § 1.83-3(b)), then the holder of the partnership interest is not treated as a partner solely by reason of holding the

interest, unless the holder makes an election with respect to the interest under § 83(b).

Rev. Proc. 93-27, 1993-2 C.B. 343, provides generally that if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of becoming a partner, the Service will not treat the receipt of such an interest as a taxable event for the partner or the partnership. The revenue procedure does not apply if (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) within two years of receipt, the partner disposes of the profits interest; or (3) the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of § 7704(b).

Rev. Proc. 2001-43, 2001-2 C.B. 191, clarifies Rev. Proc. 93-27 and provides that, for purposes of Rev. Proc. 93-27, if a partnership grants a substantially nonvested profits interest in the partnership to a service provider, the service provider will be treated as receiving the interest on the date of its grant, provided that: (1) the partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest; (2) upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of

the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest; and (3) all other conditions of Rev. Proc. 93-27 are satisfied.

SECTION 3. SCOPE

.01 In General. The Safe Harbor in section 4 of this revenue procedure applies to any Safe Harbor Partnership Interest transferred by a partnership if the transfer is made during the period in which the Safe Harbor Election is in effect (whether or not the Safe Harbor Partnership Interest is substantially vested on the date of transfer). Thus, for example, sections 4.02 through 4.04 of this revenue procedure apply to a Safe Harbor Partnership Interest that is transferred during the period in which the Safe Harbor Election is in effect, even if that Safe Harbor Partnership Interest does not become substantially vested until after the Safe Harbor Election is terminated, a § 83(b) election is made after the Safe Harbor Election is terminated, or that Safe Harbor Partnership Interest is forfeited after the Safe Harbor Election is terminated. Further, a Safe Harbor Election is binding on the partnership, all of its partners, and the service provider. The Safe Harbor includes all of the rules set forth in section 4 of this revenue procedure, and a partnership, its partners, and the service provider may not choose to apply only certain of the rules in section 4 of this revenue procedure or to apply the Safe Harbor only to certain partners, service providers, or partnership interests.

.02 Safe Harbor Partnership Interest. (1) Except as otherwise provided in section 3.02(2) of this revenue procedure, a Safe Harbor Partnership Interest is any interest in a partnership that is transferred to a service provider by such

partnership in connection with services provided to the partnership (either before or after the formation of the partnership), provided that the interest is not (a) related to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease, (b) transferred in anticipation of a subsequent disposition, or (c) an interest in a publicly traded partnership within the meaning of § 7704(b). Unless it is established by clear and convincing evidence that the partnership interest was not transferred in anticipation of a subsequent disposition, a partnership interest is presumed to be transferred in anticipation of a subsequent disposition for purposes of the preceding clause (b) if the partnership interest is sold or disposed of within two years of the date of receipt of the partnership interest (other than a sale or disposition by reason of death or disability of the service provider) or is the subject, at any time within two years of the date of receipt, of a right to buy or sell regardless of when the right is exercisable (other than a right to buy or sell arising by reason of the death or disability of the service provider). For the purposes of this revenue procedure, "disability" means a condition which causes a service provider to be unable to engage in any substantial gainful activity by reason of a medically determinable physical or mental impairment expected to result in death or to last for a continuous period of not less than 12 months.

(2) An interest in a partnership is not a Safe Harbor Partnership Interest unless at the date of transfer the requirements of section 3.03 of this revenue procedure are satisfied and a Safe Harbor Election has not terminated

pursuant to section 3.04 of this revenue procedure. For the first taxable year that a partnership is subject to a Safe Harbor Election, a partnership interest may be a Safe Harbor Partnership Interest if a Safe Harbor Election is attached to the partnership tax return for the taxable year including the date of transfer, provided that the other requirements of section 3.03 of this revenue procedure are satisfied on or before the date of such transfer.

.03 Required Conditions for Safe Harbor Election. In order to effect and maintain a valid Safe Harbor Election the following conditions must be satisfied:

(1) The partnership must prepare a document, executed by a partner who has responsibility for federal income tax reporting by the partnership, stating that the partnership is electing, on behalf of the partnership and each of its partners, to have the Safe Harbor described in Rev. Proc. 200X-XX apply irrevocably with respect to all partnership interests transferred in connection with the performance of services while the Safe Harbor Election remains in effect. The Safe Harbor Election must specify the effective date of the Safe Harbor Election, and the effective date for the Safe Harbor Election may not be prior to the date that the Safe Harbor Election is executed. The Safe Harbor Election must be attached to the tax return for the partnership for the taxable year that includes the effective date of the Safe Harbor Election.

(2) Except as provided in section 3.03(3) of this revenue procedure, the partnership agreement must contain provisions that are legally binding on all of the partners stating that (a) the partnership is authorized and directed to elect the Safe Harbor described in this revenue procedure, and (b) the partnership and

each of its partners (including any person to whom a partnership interest is transferred in connection with the performance of services) agrees to comply with all requirements of the Safe Harbor described in this revenue procedure with respect to all partnership interests transferred in connection with the performance of services while the election remains effective. If a partner that is bound by these provisions transfers a partnership interest to another person, the requirement that each partner be bound by these provisions is satisfied only if the person to whom the interest is transferred assumes the transferring partner's obligations under the partnership agreement. If an amendment to the partnership agreement is required, the amendment must be effective before the date on which a transfer occurs for the Safe Harbor to be applied to such transfer.

(3) If the partnership agreement does not contain the provisions described in section 3.03(2) of this revenue procedure, or the provisions are not legally binding on all of the partners of the partnership, then each partner in a partnership that transfers a partnership interest in connection with the performance of services must execute a document containing provisions that are legally binding on each partner stating that (a) the partnership is authorized and directed to elect the Safe Harbor described in this revenue procedure, and (b) the partner agrees to comply with all requirements of the Safe Harbor described in this revenue procedure with respect to all partnership interests transferred in connection with the performance of services while the election remains effective. Each person classified as a partner must execute the document required by this

paragraph (3), and the document must be effective, before the date on which a transfer occurs, for the Safe Harbor to be applied to such transfer. If a partner who has submitted the required document transfers a partnership interest to another person, the condition that each partner submit the necessary document is satisfied only if the person to whom the interest is transferred either submits the required document or assumes the transferring partner's obligations under a document required by this paragraph that was previously submitted with respect to the transferred interest.

.04 Termination of Safe Harbor Election. A Safe Harbor Election continues in effect until terminated. A Safe Harbor Election terminates automatically on the date that a partnership fails to satisfy the conditions and requirements described in sections 3.02 and 3.03 of this revenue procedure. A Safe Harbor Election also terminates automatically in the event that the partnership, a partner, or service provider reports income tax effects of a Safe Harbor Partnership Interest in a manner inconsistent with the requirements of this revenue procedure, including a failure to provide appropriate information returns. A partnership may affirmatively terminate a Safe Harbor Election by preparing a document, executed by a partner who has responsibility for federal income tax reporting by the partnership, indicating that the partnership, on behalf of the partnership and each of its partners, is revoking its Safe Harbor Election under Rev. Proc. 200X-XX and the effective date of the revocation, provided that the effective date may not be prior to the date the election to terminate is executed. Such termination election must be attached to the tax return for the partnership

for the taxable year that includes the effective date of the election. The rules of the Safe Harbor in section 4 of this revenue procedure do not apply to any partnership interests transferred on or after the date of a termination of the Safe Harbor Election under this paragraph but continue to apply to any Safe Harbor Partnership Interests transferred while the Safe Harbor Election was in effect.

.05 Election After Termination. If a partnership has made a Safe Harbor Election and if such Safe Harbor Election has been terminated under section 3.04 of this revenue procedure, then, absent the consent of the Commissioner, the partnership (and any successor partnerships) are not eligible to make a Safe Harbor Election for any taxable year that begins before the fifth calendar year after the calendar year during which such termination occurs. For purposes of this paragraph, a successor partnership is any partnership that (1) on the date of termination, is related (within the meaning of § 267(b) or § 707(b)) to the partnership whose Safe Harbor Election has terminated (or, if the partnership whose Safe Harbor Election has terminated does not exist on the date of termination would be related if it existed on such date), and (2) acquires (either directly or indirectly) a substantial portion of the assets of the partnership whose Safe Harbor Election has terminated.

.06 Recordkeeping Requirement. Under proposed § 1.83-3(l), the partnership is required to keep as records: (1) a copy of the Safe Harbor Election submitted by the partnership to the Service under section 3.03(1) of this revenue procedure, and (2) if applicable, the original of each document submitted to the partnership by a partner under section 3.03(3) of this revenue procedure.

If the partnership is unable to produce a record of a particular document, the election will be treated as not made, generally resulting in termination of the Safe Harbor Election under section 3.04 of this revenue procedure.

SECTION 4. SAFE HARBOR

.01 Safe Harbor. For purposes of § 83, the rules in sections 4.02 through 4.04 of this revenue procedure apply to any Safe Harbor Partnership Interest for which a Safe Harbor Election is in effect.

.02 Liquidation Value. Under the Safe Harbor, the fair market value of a Safe Harbor Partnership Interest is treated as being equal to the liquidation value of that interest. For this purpose, liquidation value is determined without regard to any lapse restriction (as defined at § 1.83-3(i)) and means the amount of cash that the recipient of the Safe Harbor Partnership Interest would receive if, immediately after the transfer, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to the fair market value of those assets and then liquidated.

.03 Vesting. Under the Safe Harbor, a Safe Harbor Partnership Interest is treated as substantially vested if the right to the associated capital account balance equivalent is not subject to a substantial risk of forfeiture or the interest is transferable. A Safe Harbor Partnership Interest is treated as substantially nonvested only if, under the terms of the interest at the time of the transfer, the interest terminates and the holder may be required to forfeit the capital account balance equivalent credited to the holder under conditions that would constitute a

substantial risk of forfeiture, and the interest is not transferable. For these purposes, the capital account balance equivalent is the amount of cash that the recipient of the Safe Harbor Partnership Interest would receive if, immediately prior to the forfeiture, the interest vested and the partnership sold all of its assets (including goodwill, going concern value, or any other intangibles associated with the partnership's operations) for cash equal to the fair market value of those assets and then liquidated. Notwithstanding the previous sentence, a Safe Harbor Partnership Interest will not be considered substantially nonvested if the sole portion of the capital account balance equivalent forfeited is the excess of the capital account balance equivalent at the date of termination of services over the capital account balance equivalent at the end of the prior partnership tax year or any later date before the date of termination of services.

.04 Forfeiture Subsequent to § 83(b) Election. If a Safe Harbor Partnership Interest with respect to which a § 83(b) election has been made is forfeited, the service provider must include as ordinary income in the taxable year of the forfeiture an amount equal to the excess, if any, of (1) the amount of income or gain that the partnership would be required to allocate to the service provider under proposed § 1.704-1(b)(4)(xii) if the partnership had unlimited items of gross income and gain, over (2) the amount of income or gain that the partnership actually allocated to the service provider under proposed §1.704-1(b)(4)(xii).

SECTION 5. APPLICATION OF SAFE HARBOR TO SERVICE PROVIDER AND SERVICE RECIPIENT

.01 Application of Safe Harbor to the Service Provider. Under the Safe Harbor, the service provider recognizes compensation income upon the transfer of a substantially vested Safe Harbor Partnership Interest in an amount equal to the liquidation value of the interest, less any amount paid for the interest. If the service provider receives a Safe Harbor Partnership Interest that is substantially nonvested, does not make an election under § 83(b), and holds the interest until it substantially vests, the service provider recognizes compensation income in an amount equal to the liquidation value of the interest on the date the interest substantially vests, less any amount paid for the interest. If the service provider receives a Safe Harbor Partnership Interest that is substantially nonvested and makes an election under § 83(b), the service provider recognizes compensation income on the date of transfer equal to the liquidation value of the interest, determined as if the interest were substantially vested, pursuant to the rules of § 83(b) and § 1.83-2, less any amount paid for the interest.

.02 Application of Safe Harbor to the Service Recipient. Under § 83(h), the service recipient generally is entitled to a deduction equal to the amount included as compensation in the gross income of the service provider under § 83(a), (b), or (d)(2), but only to the extent the amount meets the requirements of § 162 or § 212. Under the Safe Harbor, the amount included in the service provider's gross income in accordance with section 4.02 of this revenue procedure is considered the amount included as compensation in the gross income of the service provider under § 83(a) or (b) for purposes of § 83(h). The deduction generally is allowed for the taxable year of the partnership in which or

with which ends the taxable year of the service provider in which the amount is included in gross income as compensation. However, in accordance with § 1.83-6(a)(3), where the deduction relates to the transfer of substantially vested property, the deduction is available in accordance with the service recipient's method of accounting.

SECTION 6. EXAMPLES

The following facts apply for all of the examples below:

SP is an individual with a calendar year taxable year. PRS is a partnership with a calendar year taxable year. Except as otherwise stated, PRS's partnership agreement provides for all partnership items to be allocated to the partners in proportion to the partners' interests in the partnership. PRS's partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with § 1.704-1(b)(2)(iv), that liquidation proceeds will be distributed in accordance with the partners' positive capital account balances, and that any partner with a deficit balance in the partner's capital account following the liquidation of the partner's interest must restore that deficit to the partnership. All allocations and distributions to all parties are not recast under § 707(a)(2), and § 751(b) does not apply to any distribution. The partnership, its members, and the service providers elect the Safe Harbor provided in section 4 of this revenue procedure and file all affected returns consistent with the Safe Harbor, and each partnership interest transferred constitutes a Safe Harbor Partnership Interest under section 3.02 of this revenue procedure. The issuance of the partnership interest in each example is not

required to be capitalized under the rules of § 263 or other applicable provision of the Code. In examples in which the partnership interest transferred to the service provider is not substantially vested, there is not a plan that the service provider will forfeit the partnership interest.

(1) Example 1: Substantially Vested Profits Interest

Facts: PRS has two partners, A and B, each with a 50% interest in PRS. On March 1, 2005, SP agrees to perform services for the partnership in exchange for a partnership interest. Under the terms of the partnership agreement, SP is entitled to 10% of the future profits and losses of PRS, but is not entitled to any of the partnership's capital as of the date of transfer. Although SP must surrender the partnership interest upon termination of services to the partnership, SP will not surrender any share of the profits accumulated through the end of the partnership taxable year preceding the partnership taxable year in which SP terminates services.

Conclusion: Under section 4.03 of this revenue procedure, SP's interest in PRS is treated as substantially vested at the time of transfer. Under section 4.02 of this revenue procedure, the fair market value of the interest for purposes of § 83 is treated as being equal to its liquidation value (zero). Therefore, SP does not recognize compensation income under § 83(a) as a result of the transfer, PRS is not entitled to a deduction, and SP is not entitled to a capital account balance.

(2) Example 2: Substantially Vested Interest

Facts: PRS has two partners, A and B, each with a 50% interest in PRS. On March 1, 2005, SP pays the partnership $10 and agrees to perform services for the partnership in exchange for a 10% partnership interest that is treated as substantially vested under section 4.03 of this revenue procedure. Immediately before SP's $10 payment to PRS and the transfer of the partnership interest to SP in connection with the performance of services, the value of the partnership's assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) is $990.

Conclusion: Under section 4.02 of this revenue procedure, the fair market value of SP's interest in PRS at the time the interest becomes substantially vested is treated as being equal to its liquidation value at that time for purposes of § 83. Therefore, in 2005, SP includes $90 ($100 liquidation value less $10 amount paid for the interest) as compensation income under § 83(a), PRS is entitled to a deduction of $90 under § 83(h), and SP's initial capital account is $100 ($90 included in income plus $10 amount paid for the interest).

(3) Example 3: Substantially Nonvested Interest; No § 83(b) Election; Pre-Existing Partner

Facts: PRS has two partners, A and SP, each with a 50% interest in PRS. On December 31, 2004, SP agrees to perform services for the partnership in exchange for a 10% increase in SP's interest in the partnership from 50% to 60%. SP is not required to pay any amount in exchange for the additional 10% interest. Under the terms of the partnership agreement, if SP terminates services on or before January 1, 2008, SP forfeits any right to any share of accumulated,

undistributed profits with respect to the additional 10% interest. The partnership interest transferred to SP is not transferable and no election is made under § 83(b). SP continues performing services through January 1, 2008. PRS has taxable income of $500 in 2005 and $1,000 in each of 2006 and 2007. No distributions are made to A or SP during such period. On January 1, 2008, the value of the partnership's assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) is $3,500.

Conclusion: Under section 4.03 of this revenue procedure, the 10% partnership interest transferred to SP on December 31, 2004, is treated as substantially nonvested at the time of transfer. Because a § 83(b) election is not made, SP does not include any amount as compensation income attributable to the transfer, and correspondingly, PRS is not entitled to a deduction under § 83(h).

In accordance with the partnership agreement, PRS's taxable income for 2005 is allocated $250 to A and $250 to SP, and PRS's taxable income for each of 2006 and 2007 is allocated $500 to A and $500 to SP.

On January 1, 2008, SP's additional 10% interest in PRS is treated as becoming substantially vested under section 4.03 of this revenue procedure. At that time, the additional 10% interest in the partnership has a liquidation value of $350 (10% of $3,500). Under section 4.02 of this revenue procedure, the fair market value of the interest at the time it becomes substantially vested is treated as being equal to its liquidation value at that time for purposes of § 83. Therefore, in 2008, SP includes $350 as compensation income under § 83(a),

PRS is entitled to a deduction of $350 under § 83(h), and SP's capital account is increased by $350.

(4) Example 4: Substantially Nonvested Interest; No § 83(b) Election

Facts: PRS has two partners, A and B, each with a 50% interest in PRS. On December 31, 2004, SP pays the partnership $10 and agrees to perform services for the partnership in exchange for a 10% partnership interest. Under the terms of the partnership agreement, if SP terminates services on or before January 1, 2008, SP forfeits any rights to any share of accumulated, undistributed profits, but is entitled to a return of SP's $10 initial contribution. SP's partnership interest is not transferable and no election is made under § 83(b). SP continues performing services through January 1, 2008. PRS earns $500 of taxable income in 2005, and $1,000 in each of 2006 and 2007. A and B each receive distributions of $225 in 2005, but neither A nor B receive distributions in 2006 and 2007. PRS transfers $50 to SP in 2005, but does not make any transfers to SP in 2006 or 2007. On January 1, 2008, SP's partnership interest has a liquidation value of $300 (taking into account the unpaid partnership income credited to SP through that date).

Conclusion: Under section 4.03 of this revenue procedure, SP's partnership interest is treated as substantially nonvested at the time of transfer. Because a § 83(b) election is not made, SP does not include any amount as compensation income attributable to the transfer and, correspondingly, PRS is not entitled to a deduction under § 83(h). Under proposed § 1.761-1(b), SP is

not a partner in PRS; therefore, none of PRS's taxable income for the years in which SP's interest is substantially nonvested may be allocated to SP. Rather, PRS's taxable income is allocated exclusively to A and B. In addition, the $50 paid by PRS to SP in 2005 is compensation income to SP, and PRS is entitled to a deduction of $50 under § 162 in accordance with its method of accounting.

On January 1, 2008, SP's interest in PRS is treated as becoming substantially vested under section 4.03 of this revenue procedure. Under section 4.02 of this revenue procedure, the fair market value of the interest at the time the interest becomes substantially vested is treated as being equal to its liquidation value at that time for § 83 purposes. Therefore, in 2008, SP includes $290 ($300 liquidation value less $10 amount paid for the interest) as compensation income under § 83(a), PRS is entitled to a $290 deduction, and SP's capital account is increased to $300 ($290 included in income plus $10 amount paid for the interest).

(5) Example 5: Substantially Nonvested Interest; § 83(b) Election

Facts: The facts are the same as in Example 4, except that SP makes an election under § 83(b) with respect to SP's interest in PRS. The liquidation value of the interest is $100 at the time the interest in PRS is transferred to SP. SP continues performing services through January 1, 2008.

Conclusion: Under section 4.02 of this revenue procedure, the fair market value (disregarding lapse restrictions) of SP's interest in PRS at the time of transfer is treated as being equal to its liquidation value (disregarding lapse restrictions) at that time for § 83 purposes. Because a § 83(b) election is made,

in 2004 SP includes $90 ($100 liquidation value less $10 amount paid for the interest) as compensation income, PRS is entitled to a $90 deduction, and SP's initial capital account is $100 ($90 included in SP's income plus $10 amount paid for the interest). Under proposed § 1.761-1(b), as a result of SP's election under § 83(b), SP is treated as a partner starting from the date of the transfer of the interest to SP. Accordingly, SP includes in 2005 taxable income SP's $50 distributive share of PRS income, and the $50 payment to SP by PRS in 2005 is a partnership distribution under § 731. SP includes in 2006 and 2007 taxable income SP's $100 distributive shares of PRS income for those years.

(6) Example 6: Substantially Nonvested Interest; § 83(b) Election; Forfeiture; Net Profit

Facts: The facts are the same as in Example 5, except that SP terminates services on September 30, 2007, and is repaid the $10 that SP paid for the PRS interest in 2004. The partnership agreement provides that if SP's partnership interest is forfeited, SP's distributive share of all partnership items (other than forfeiture allocations) will be zero with respect to the interest for the taxable year of the partnership in which the interest is forfeited.

Conclusion: The tax consequences for 2004 through 2006 are the same as in Example (5). As a result of the forfeiture in 2007, PRS is required under § 1.83-6(c) to include in gross income $90 (the amount of the allowable deduction on the transfer of the interest to SP). In accordance with the partnership agreement, PRS also makes forfeiture allocations in 2007 to offset partnership income and loss that was allocated to SP and partnership

distributions to SP prior to the forfeiture. Cumulative net income of $150 was allocated to SP prior to the forfeiture ($50 in 2005 and $100 in 2006) and SP received a total of $60 of distributions from PRS ($50 in 2005 and $10 in 2007 (the repayment of SP's initial contribution to PRS)). Under proposed § 1.704-1(b)(4)(xii), the total forfeiture allocations to SP is $100 of partnership loss and deduction, the difference between $50 ($60 of distributions to SP less $10 of contributions to PRS by SP) and $150 (cumulative net income allocated to SP). Pursuant to the partnership agreement, none of the partnership income for the year 2007 is allocated to SP. In accordance with § 83(b)(1) (last sentence), SP does not receive a deduction or capital loss for the amount ($90) that was included as SP's compensation income as a result of the election under § 83(b).

(7) Example 7: Substantially Nonvested Interest; § 83(b) Election; Forfeiture; Net Loss

Facts: PRS has two partners, A and B, each with a 50% interest in PRS. On December 31, 2004, SP pays the partnership $10 and agrees to perform services for the partnership in exchange for a 10% partnership interest. Under the terms of the partnership agreement, if SP terminates services before January 1, 2008, SP forfeits any right to any share of accumulated, undistributed profits, but is entitled to a return of SP's $10 initial contribution. SP's partnership interest is not transferable. The partnership agreement provides that if SP's partnership interest is forfeited, SP's distributive share of all partnership items (other than forfeiture allocations) will be zero with respect to the interest for the taxable year of the partnership in which the interest is forfeited. At the time of the transfer, the

liquidation value of the 10% partnership interest is $100, and SP makes an election under § 83(b) with respect to the interest. In 2005, PRS earns $500 of taxable income, which is allocated and distributed $225 to each of A and B and $50 to SP. In 2006, PRS has net taxable loss of $1,000, $100 of which is allocated to SP. PRS does not make any distributions in 2006. PRS has no items of income, gain, loss, or deduction in 2007, other than gross income recognized under § 1.83-6(c). SP terminates services on September 30, 2007, and is repaid the $10 that SP paid for the PRS interest in 2004. PRS does not make any distributions in 2007, other than the return of SP's $10 contribution.

Conclusion: Under section 4.02 of this revenue procedure, the fair market value (disregarding lapse restrictions) of SP's interest in PRS at the time of transfer is treated as being equal to its liquidation value (disregarding lapse restrictions) at that time for purposes of § 83. Because a § 83(b) election is made, SP includes as compensation income in 2004 $90 ($100 liquidation value less $10 amount paid for the interest), PRS is entitled to a $90 deduction under § 83(h), and SP's initial capital account is $100 ($90 compensation income plus $10 amount paid for the interest). Under proposed § 1.761-1(b), as a result of SP's election under § 83(b), SP is treated as a partner starting from the date of the transfer of the interest to SP. Accordingly, SP includes in 2005 taxable income SP's $50 distributive share of PRS's income, and the $50 payment to SP in 2005 is a partnership distribution under § 731. SP includes in computing 2006 taxable income SP's $100 distributive share of PRS's loss.

As a result of the forfeiture in 2007, PRS is required under § 1.83-6(c) to include in gross income $90 (the amount of the allowable deduction on the transfer of the interest to SP). In accordance with the partnership agreement, PRS also makes forfeiture allocations in 2007 to offset partnership income and loss that was allocated to SP and partnership distributions to SP prior to the forfeiture. Cumulative net loss of $50 was allocated to SP prior to the forfeiture ($50 of income in 2005 and $100 of loss in 2006) and SP received a total of $60 of partnership distributions ($50 in 2005 and $10 in 2007 (the repayment of SP's initial contribution to PRS)). If PRS had unlimited items of gross income and gain, the total forfeiture allocations to SP under proposed § 1.704-1(b)(4)(xii) would be $100 of partnership income and gain, the difference between $50 ($60 distributions to SP less $10 of contributions to PRS by SP) and -$50 (cumulative net loss allocated to SP). However, PRS's only income in 2007 is the $90 of income recognized by PRS under § 1.83-6(c), all of which must be used to make forfeiture allocations to SP. Under section 4.04 of this revenue procedure, in 2007, SP must include in ordinary income $10 (the difference between the forfeiture allocations that would be required under proposed § 1.704-1(b)(4)(xii) if PRS had an unlimited amount of gross income and gain, $100, and the actual forfeiture allocations to SP, $90). PRS is not entitled to a deduction for the amount ($10) that SP is required to include in income under section 4.04 of this revenue procedure.

SECTION 7. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 93-27, 1993-2 C.B. 343, and Rev. Proc. 2001-43, 2001-2 C.B. 191, are obsoleted.

[4830-01-P]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-105346-03]

RIN 1545-BB92

Partnership Equity for Services

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Partial withdrawal of notice of proposed rulemaking, notice of proposed rulemaking, and notice of public hearing.

SUMMARY: This document withdraws the remaining portion of the notice of proposed rulemaking published in the **Federal Register** on June 3, 1971 (36 FR 10787) and contains proposed regulations relating to the tax treatment of certain transfers of partnership equity in connection with the performance of services. The proposed regulations provide that the transfer of a partnership interest in connection with the performance of services is subject to section 83 of the Internal Revenue Code (Code) and provide rules for coordinating section 83 with partnership taxation principles. The proposed regulations also provide that no gain or loss is recognized by a partnership on the transfer or vesting of an interest in the transferring partnership in connection with the performance of services for the transferring partnership. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by August 22, 2005.

Outlines of topics to be discussed at the public hearing scheduled for October 5, 2005, at 10 a.m. must be received by September 14, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-105346-03), 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-105346-03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the IRS Internet site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-105346-03).

FOR FURTHER INFORMATION CONTACT: Concerning the section 83 regulations, Stephen Tackney at (202) 622-6030; concerning the subchapter K regulations, Audrey Ellis or Demetri Yatrakis at (202) 622-3060; concerning submissions, the hearing, and/or to be placed on the building access list to attend the hearing, Robin Jones, (202) 622-7180 (not toll free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments

on the collection of information should be received by July 25, 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 may be minimized, including through the application of automated collection techniques or other forms of information technology; and

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

The following collections of information in this proposed regulation are in §1.83-3(l):

(1) Requirement that electing partnerships submit an election with the partnership tax return.

(2) Requirement that certain partners submit a document to the partnership;

(3) Requirement that such documents be retained; and

(4) Requirement that partnerships submit a termination document with the partnership tax return as one method of terminating the election.

These collections of information are required by the IRS to determine whether the amount of tax has been calculated correctly. The respondents are partnerships and partners or other service providers.

The estimated total annual reporting and/or recordkeeping burden is 112,500 hours.

The estimated annual burden per respondent/recordkeeper varies from .10 hours to 10 hours, depending on individual circumstances, with an estimated average of 1 hour for partnerships and .25 hour for a partner or service provider. The estimated number of respondents and/or recordkeepers is 100,000 partnerships and 50,000 partners or other service providers.

The estimated annual frequency of responses (used for reporting requirements only) is on occasion.

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

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

Background

Partnerships issue a variety of instruments in connection with the performance of services. These instruments include interests in partnership capital, interests in partnership profits, and options to acquire such interests (collectively, partnership equity). On June 5, 2000, the Treasury Department and the IRS issued Notice 2000-29 (2000-1 C.B. 1241), inviting public comment on the Federal income tax treatment of the exercise of an option to acquire a partnership interest, the exchange of convertible debt for a partnership interest, and the exchange of a preferred interest in a partnership for a common interest in that partnership. On January 22, 2003, the Treasury Department and the IRS published in the **Federal Register** (REG-103580-02) (68 FR 2930), proposed regulations regarding the Federal income tax consequences of noncompensatory partnership options, convertible equity, and convertible debt. In the preamble to those proposed regulations, the Treasury Department and the IRS requested comments on the proposed amendment to §1.721-1(b)(1) that was published in the **Federal Register** on June 3, 1971 (36 FR 10787), and on the Federal income tax consequences of the issuance of partnership capital interests in connection with the performance of services and options to acquire such interests. In response to the comments received, the Treasury Department and the IRS are withdrawing the proposed amendment to §1.721-1(b)(1) and issuing these proposed regulations, which prescribe rules on the application of section 83 to partnership interests and the Federal income tax consequences associated with the transfer, vesting, and forfeiture of partnership interests transferred in connection with the performance of services.

Explanation of Provisions

1. Application of Section 83 to Partnership Interests

Section 83 generally applies to a transfer of property by one person to another in connection with the performance of services. The courts have held that a partnership capital interest is property for this purpose. See Schulman v. Commissioner, 93 T.C. 623 (1989) (section 83 governs the issuance of an option to acquire a partnership interest as compensation for services provided as an employee); Kenroy, Inc. v. Commissioner, T.C. Memo 1984-232. Therefore, the proposed regulations provide that a partnership interest is property within the meaning of section 83, and that the transfer of a partnership interest in connection with the performance of services is subject to section 83.

The proposed regulations apply section 83 to all partnership interests, without distinguishing between partnership capital interests and partnership profits interests. Although the application of section 83 to partnership profits interests has been the subject of controversy, see, e.g., Campbell v. Commissioner, T.C. Memo 1990-162, aff'd in part and rev'd in part, 943 F.2d 815 (8th Cir. 1991), n. 7; St. John v. U.S., 84-1 USTC 9158 (C.D. Ill. 1983), the Treasury Department and the IRS do not believe that there is a substantial basis for distinguishing among partnership interests for purposes of section 83. All partnership interests constitute personal property under state law and give the holder the right to share in future earnings from partnership capital and labor. Moreover, some commentators have suggested that the same tax rules should apply to

both partnership profits interests and partnership capital interests. These commentators have suggested that taxpayers may exploit any differences in the tax treatment of partnership profits interests and partnership capital interests. The Treasury Department and the IRS agree with these comments. Therefore, all of the rules in these proposed regulations and the accompanying proposed revenue procedure (described below) apply equally to partnership capital interests and partnership profits interests. However, a right to receive allocations and distributions from a partnership that is described in section 707(a)(2)(A) is not a partnership interest. In section 707(a)(2)(A), Congress directed that such an arrangement should be characterized according to its substance, that is, as a disguised payment of compensation to the service provider. See S. Rep. No. 98-169, 98 Cong. 2d Sess., at 226 (1984).

Section 83(b) allows a person who receives substantially nonvested property in connection with the performance of services to elect to include in gross income the difference between: (A) the fair market value of the property at the time of transfer (determined without regard to a restriction other than a restriction which by its terms will never lapse); and (B) the amount paid for such property. Under section 83(b)(2), the election under section 83(b) must be made within 30 days of the date of the transfer of the property to the service provider.

Consistent with the principles of section 83, the proposed regulations provide that, if a partnership interest is transferred in connection with the performance of services, and if an election under section 83(b) is not made, then the holder of the partnership interest is not treated as a partner until the interest becomes substantially

vested. If a section 83(b) election is made with respect to such an interest, the service provider will be treated as a partner for purposes of Subtitle A of the Code. These rules are similar to the current rules pertaining to substantially nonvested stock in a subchapter S corporation. See §1.1361-1(b)(3) (upon an election under section 83(b), the service provider becomes a shareholder for purposes of subchapter S).

These principles differ from Rev. Proc. 2001-43. Under that revenue procedure, if a partnership profits interest is transferred in connection with the performance of services, then the holder of the partnership interest may be treated as a partner even if no section 83(b) election is made, provided that certain conditions are met.

Certain changes to the regulations under both subchapter K and section 83 are needed to coordinate the principles of subchapter K with the principles of section 83. Among the changes that are proposed in these regulations are: (1) conforming the subchapter K rules to the section 83 timing rules; (2) revising the section 704(b) regulations to take into account the fact that allocations with respect to an unvested interest may be forfeited; and (3) providing that a partnership generally recognizes no gain or loss on the transfer of an interest in the partnership in connection with the performance of services for that partnership. In addition, Rev. Procs. 93-27 (1993-2 C.B. 343), and 2001-43 (2001-2 C.B. 191), which generally provide for nonrecognition by both the partnership and the service provider on the transfer of a profits interest in the partnership for services performed for that partnership, must be modified to be consistent with these proposed regulations. Accordingly, in conjunction with these proposed regulations, the IRS is issuing Notice 2005-43 (2005-24 I.R.B.). That Notice

contains a proposed revenue procedure that, when finalized, will obsolete Rev. Procs. 93-27 and 2001-43. The Treasury Department and the IRS intend for these proposed regulations and the proposed revenue procedure to become effective at the same time. The proposed amendments to the regulations under section 83 and subchapter K, as well as the Notice, are described in further detail below.

The proposed revenue procedure and certain parts of the proposed regulations (as described below) only apply to a transfer by a partnership of an interest in that partnership in connection with the performance of services for that partnership (compensatory partnership interests). The Treasury Department and the IRS request comments on the income tax consequences of transactions involving related persons, such as, for example, the transfer of an interest in a lower-tier partnership in exchange for services provided to the upper-tier partnership.

2. Timing of Partnership's Deduction

Except as otherwise provided in §1.83-6(a)(3), if property is transferred in connection with the performance of services, then the service recipient's deduction, if any, is allowed only for the taxable year of that person in which or with which ends the taxable year of the service provider in which the amount is included as compensation. See section 83(h). In contrast, under section 706(a) and §1.707-1(c), guaranteed payments described in section 707(c) are included in the partner's income in the partner's taxable year within or with which ends the partnership's taxable year in which the partnership deducted the payments. Under §1.721-1(b)(2) of the current regulations, an interest in partnership capital issued by the partnership as compensation

for services rendered to the partnership is treated as a guaranteed payment under section 707(c). Some commentators suggested that the proposed regulations should resolve the potential conflict between the timing rules of section 83 and the timing rules of section 707(c).

Under the proposed regulations, partnership interests issued to partners for services rendered to the partnership are treated as guaranteed payments. Also, the proposed regulations provide that the section 83 timing rules override the timing rules of section 706(a) and §1.707-1(c) to the extent they are inconsistent. Accordingly, if a partnership transfers property to a partner in connection with the performance of services, the timing and the amount of the related income inclusion and deduction is determined by section 83 and the regulations thereunder.

In drafting these regulations, the Treasury Department and the IRS considered alternative approaches for resolving the timing inconsistency between section 83 and section 707(c). One alternative approach considered was to provide that the transfer of property in connection with the performance of services is not treated as a guaranteed payment within the meaning of section 707(c). This approach was not adopted in the proposed regulations due to, among other things, concern that such a characterization of these transfers could have unintended consequences on the application of provisions of the Code outside of subchapter K that refer to guaranteed payments. The Treasury Department and the IRS request comments on alternative approaches for resolving the timing inconsistency between section 83 and section 707(c).

3. Allocation of Partnership's Deduction

The proposed regulations provide guidance regarding the allocation of the partnership's deduction for the transfer of property in connection with the performance of services. Some commentators suggested that the proposed regulations require that the partnership's deduction be allocated among the partners in accordance with their interests in the partnership prior to the transfer.

Section 706(d)(1) provides generally that, if, during any taxable year of a partnership, there is a change in any partner's interest in the partnership, each partner's distributive share of any item of income, gain, loss, deduction, or credit of the partnership for such taxable year shall be determined by the use of any method prescribed by regulations which takes into account the varying interests of the partners in the partnership during the taxable year. Regulations have not yet been issued describing the rules for taking into account the varying interests of the partners in the partnership during a taxable year. Section 1.706-1(c)(2)(ii) provides that, in the case of a sale, exchange, or liquidation of a partner's entire interest in a partnership, the partner's share of partnership items for the taxable year may be determined by either: (1) closing the partnership's books as of the date of the transfer (closing of the books method); or (2) allocating to the departing partner that partner's pro rata part of partnership items that the partner would have included in the partner's taxable income had the partner remained a partner until the end of the partnership taxable year (proration method). The Treasury Department and the IRS believe that section 706(d)(1) adequately ensures that partnership deductions that are attributable to the

portion of the partnership's taxable year prior to a new partner's entry into the partnership are allocated to the historic partners.

Section 706(d)(2), however, places additional limits on how partnerships may allocate these deductions. Under section 706(d)(2)(B), payments for services by a partnership using the cash receipts and disbursements method of accounting are allocable cash basis items. Under section 706(d)(2)(A), if during any taxable year of a partnership there is a change in any partner's interest in the partnership, then (except to the extent provided in regulations) each partner's distributive share of any allocable cash basis item must be determined under the proration method. To allow partnerships to allocate deductions with respect to property transferred in connection with the performance of services under a closing of the books method, the proposed regulations provide that section 706(d)(2)(A) does not apply to such a transfer.

4. Accounting for Compensatory Partnership Interests

A. Transfer of compensatory partnership interest

Under the proposed regulations, the service provider's capital account is increased by the amount the service provider takes into income under section 83 as a result of receiving the interest, plus any amounts paid for the interest. Some commentators suggested that the amount included in the service provider's income under section 83, plus the amount paid for the interest, may differ from the amount of capital that the partnership has agreed to assign to the service provider. These commentators contend that the substantial economic effect safe harbor in the section 704(b) regulations should be amended to allow partnerships to reallocate capital

between the historic partners and the service provider to accord with the economic agreement of the parties.

The reallocation of partnership capital in these circumstances is not consistent with the policies underlying the substantial economic effect safe harbor and the capital account maintenance rules. The purpose of the substantial economic effect safe harbor is to ensure that, to the extent that there is an economic benefit or burden associated with a partnership allocation, the partner to whom the allocation is made receives the economic benefit or bears the economic burden. Under section 83, the economic benefit of receiving a partnership interest in connection with the performance of services is the amount that is included in the compensation income of the service provider, plus the amount paid for the interest. This is the amount by which the service partner's capital account should be increased.

As explained in section 6 below, a proposed revenue procedure issued concurrently with these proposed regulations would allow a partnership, its partners, and the service provider to elect to treat the fair market value of a partnership interest as equal to the liquidation value of that interest. If such an election is made, the capital account of a service provider receiving a partnership interest in connection with the performance of services is increased by the liquidation value of the partnership interest received.

B. Forfeiture of certain compensatory partnership interests

If an election under section 83(b) has been made with respect to a substantially nonvested interest, the holder of the nonvested interest may be allocated partnership

items that may later be forfeited. For this reason, allocations of partnership items while the interest is substantially nonvested cannot have economic effect. Under the proposed regulations, such allocations will be treated as being in accordance with the partners' interests in the partnership if: (a) the partnership agreement requires that the partnership make forfeiture allocations if the interest for which the section 83(b) election is made is later forfeited; and (b) all material allocations and capital account adjustments under the partnership agreement not pertaining to substantially nonvested partnership interests for which a section 83(b) election has been made are recognized under section 704(b). This safe harbor does not apply if, at the time of the section 83(b) election, there is a plan that a substantially nonvested interest will be forfeited. All of the facts and circumstances (including the tax status of the holder of the substantially nonvested interest) will be considered in determining whether there is a plan that the interest will be forfeited. In such a case, the partners' distributive shares of partnership items shall be determined in accordance with the partners' interests in the partnership under §1.704-1(b)(3).

Generally, forfeiture allocations are allocations to the service provider of partnership gross income and gain or gross deduction and loss (to the extent such items are available) that offset prior distributions and allocations of partnership items with respect to the forfeited partnership interest. These rules are designed to ensure that any partnership income (or loss) that was allocated to the service provider prior to the forfeiture is offset by allocations on the forfeiture of the interest. Also, to carry out the prohibition under section 83(b)(1) on deductions with respect to amounts included in

income under section 83(b), these rules generally cause a forfeiting partner to be allocated partnership income to offset any distributions to the partner that reduced the partner's basis in the partnership below the amount included in income under section 83(b).

Forfeiture allocations may be made out of the partnership's items for the entire taxable year. In determining the gross income of the partnership in the taxable year of the forfeiture, the rules of §1.83-6(c) apply. As a result, the partnership generally will have gross income in the taxable year of the forfeiture equal to the amount of the allowable deduction to the service recipient partnership upon the transfer of the interest as a result of the making of the section 83(b) election, regardless of the fair market value of the partnership's assets at the time of forfeiture.

In certain circumstances, the partnership will not have enough income and gain to fully offset prior allocations of loss to the forfeiting service provider. The proposed revenue procedure includes a rule that requires the recapture of losses taken by the service provider prior to the forfeiture of the interest to the extent that those losses are not recaptured through forfeiture allocations of income and gain to the service provider. This rule does not provide the other partners in the partnership with the opportunity to increase their shares of partnership loss (or reduce their shares of partnership income) for the year of the forfeiture by the amount of loss that was previously allocated to the forfeiting service provider.

In other circumstances, the partnership will not have enough deductions and loss to fully offset prior allocations of income to the forfeiting service provider. It appears

that, in such a case, section 83(b)(1) may prohibit the service provider from claiming a loss with respect to partnership income that was previously allocated to the service provider. However, a forfeiting partner is entitled to a loss for any basis in a partnership that is attributable to contributions of money or property to the partnership (including amounts paid for the interest) remaining after the forfeiture allocations have been made. See §1.83-2(a).

Comments are requested as to whether the regulations should require or allow partnerships to create notional tax items to make forfeiture allocations where the partnership does not have enough actual tax items to make such allocations. Comments are also requested as to whether section 83(b)(1) should be read to allow a forfeiting service provider to claim a loss with respect to partnership income that was previously allocated to the service provider and not offset by forfeiture allocations of loss and deduction and, if so, whether it is appropriate to require the other partners in the partnership to recognize income in the year of the forfeiture equal to the amount of the loss claimed by the service provider. In particular, comments are requested as to whether section 83 or another section of the Code provides authority for such a rule.

5. Valuation of Compensatory Partnership Interests

Commentators requested guidance regarding the valuation of partnership interests transferred in connection with the performance of services. Section 83 generally provides that the recipient of property transferred in connection with the performance of services recognizes income equal to the fair market value of the property, disregarding lapse restrictions. See Schulman v. Commissioner, 93 T.C. 623

(1989). However, some authorities have concluded that, under the particular facts and circumstances of the case, a partnership profits interest had only a speculative value or that the fair market value of a partnership interest should be determined by reference to the liquidation value of that interest. See §1.704-1(e)(1)(v); Campbell v. Commissioner, 943 F.2d 815 (8th Cir. 1991); St. John v. U.S., 1984-1 USTC 9158 (C.D. Ill. 1983). But see Diamond v. Commissioner, 492 F.2d 286 (7th Cir. 1974) (holding under pre-section 83 law that the receipt of a profits interest with a determinable value at the time of receipt resulted in immediate taxation); Campbell v. Commissioner, T.C. Memo 1990-162, aff'd in part and rev'd in part, 943 F.2d 815 (8th Cir. 1991).

The Treasury Department and the IRS have determined that, provided certain requirements are satisfied, it is appropriate to allow partnerships and service providers to value partnership interests based on liquidation value. This approach ensures consistency in the treatment of partnership profits interests and partnership capital interests, and accords with other regulations issued under subchapter K, such as the regulations under section 704(b).

In accordance with these proposed regulations, the revenue procedure proposed in Notice 2005-43 (2005-24 I.R.B.) will, when finalized, provide additional rules that partnerships, partners, and persons providing services to the partnership in exchange for interests in that partnership would be required to follow when electing under §1.83-3(l) of these proposed regulations to treat the fair market value of those interests as being equal to the liquidation value of those interests. For this purpose, the liquidation value of a partnership interest is the amount of cash that the holder of that interest

would receive with respect to the interest if, immediately after the transfer of the interest, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to the fair market value of those assets, and then liquidated.

6. Application of Section 721 to Partnership on Transfer

There is a dispute among commentators as to whether a partnership should recognize gain or loss on the transfer of a compensatory partnership interest. Some commentators believe that, on the transfer of such an interest, the partnership should be treated as satisfying its compensation obligation with a fractional interest in each asset of the partnership. Under this deemed sale of assets theory, the partnership would recognize gain or loss equal to the excess of the fair market value of each partial asset deemed transferred to the service provider over the partnership's adjusted basis in that partial asset. Other commentators believe that a partnership should not recognize gain or loss on the transfer of a compensatory partnership interest. They argue, among other things, that the transfer of such an interest is not properly treated as a realization event for the partnership because no property owned by the partnership has changed hands. They also argue that taxing a partnership on the transfer of such an interest would result in inappropriate gain acceleration, would be difficult to administer, and would cause economically similar transactions to be taxed differently.

Generally, when appreciated property is used to pay an obligation, gain on the property is recognized. The Treasury Department and the IRS are still analyzing whether an exception to this general rule is appropriate on the transfer of an interest in

the capital or profits of a partnership to satisfy certain partnership obligations (such as the obligations to pay interest or rent). However, the Treasury Department and the IRS believe that partnerships should not be required to recognize gain on the transfer of a compensatory partnership interest. Such a rule is more consistent with the policies underlying section 721 -- to defer recognition of gain and loss when persons join together to conduct a business -- than would be a rule requiring the partnership to recognize gain on the transfer of these types of interests. Therefore, the proposed regulations provide that partnerships are not taxed on the transfer or substantial vesting of a compensatory partnership interest. Under §1.704-1(b)(4)(i) (reverse section 704(c) principles), the historic partners generally will be required to recognize any income or loss attributable to the partnership's assets as those assets are sold, depreciated, or amortized.

The rule providing for nonrecognition of gain or loss does not apply to the transfer or substantial vesting of an interest in an eligible entity, as defined in §301.7701-3(a) of the Procedure and Administration Regulations, that becomes a partnership under §301.7701-3(f)(2) as a result of the transfer or substantial vesting of the interest. See McDougal v. Commissioner, 62 T.C. 720 (1974) (holding that the service recipient recognized gain on the transfer of a one-half interest in appreciated property to the service provider, immediately prior to the contribution by the service recipient and the service provider of their respective interests in the property to a newly formed partnership).

7. Revaluations of Partnership Property

The proposed regulations concerning noncompensatory partnership options published on January 22, 2003, contained special rules regarding the revaluations of partnership property while noncompensatory partnership options were outstanding. Specifically, the regulations proposed modifications to §1.704-1(b)(2)(iv)(f) and (h) to provide that any revaluation during the period in which there are outstanding noncompensatory options generally must take into account the fair market value, if any, of outstanding options. These proposed regulations do not contain similar provisions, because under recently proposed modifications to the regulations under §1.704-1(b)(2)(iv), the obligation to issue a partnership interest in satisfaction of an option agreement is a liability that is taken into account in determining the fair market value of partnership assets as a result of a revaluation. See REG-106736-00, 68 FR 37434 (June 24, 2003) (relating to the assumption of certain obligations by partnerships from partners).

8. Characterization Rule

The proposed regulations concerning noncompensatory partnership options published on January 22, 2003 contained a rule (§1.761-3) providing that the holder of a noncompensatory option is treated as a partner under certain circumstances. However, the Treasury Department and the IRS have concluded that these proposed regulations should not contain a similar rule for partnership options transferred in connection with the performance of services because of the possibility that constructive transfers of property, subject to section 83, may occur under circumstances other than those described in the proposed rules for treating the holder of a noncompensatory option as

a partner. The Treasury Department and the IRS request comments on whether anti-abuse rules are necessary to prevent taxpayers from using the rules in these proposed regulations or the rules in Notice 2005-43 to inappropriately shift items of partnership income or loss between the service provider and the other partners.

9. Retroactive Allocations

Section 761(c) generally allows a partnership to modify its agreement at any time on or prior to the due date for the partnership's return for the taxable year (without regard to extensions). Thus, for example, a partnership could, at the end of its taxable year, amend its partnership agreement to provide that a service provider was entitled to a substantially vested or nonvested interest in partnership profits and losses from the beginning of the partnership's taxable year. It is expected that, if a substantially vested compensatory partnership interest is transferred to an employee or independent contractor (or an election under section 83(b) is made with respect to the transfer of a substantially nonvested compensatory partnership interest to an employee or independent contractor), the partnership will report the transfer on Form W-2, "Wage and Tax Statement," or Form 1099-MISC, "Miscellaneous Income," as appropriate. The Form W-2 or Form 1099-MISC would be issued to the service provider by the partnership by January 31 of the year following the calendar year in which the partnership interest is transferred, and the partnership would file such forms with the Social Security Administration or IRS, respectively, by February 28 (March 31 if filed electronically) of the year following the calendar year in which the partnership interest is transferred. The service provider would be required to report any income recognized on

the transfer of the partnership interest on the service provider's return for the taxable year (of the service provider) in which the transfer occurs.

It is unclear whether the retroactive commencement date of such an interest should be treated as the date of the transfer of the interest for purposes of section 83 and other provisions of the Code outside of subchapter K. If the retroactive effective date of the interest is treated as the transfer date for all purposes, a number of administrative concerns arise. For example, the partnership may not, by the January 31 deadline, have the information necessary to issue Form W-2 or Form 1099-MISC to the service provider. Also, the service provider may not, by the due date for filing the section 83(b) election, have the information necessary to file the election. The Treasury Department and the IRS request comments on the timing for section 83 purposes of retroactive transfers of partnership interests and on any actions that may be appropriate to address the associated administrative concerns.

10. Information Reporting to Partners

As explained above, the proposed regulations treat the transfer of a partnership interest to a partner in connection with the performance of services as a guaranteed payment. To ensure that the service provider partner has the information necessary to include the transfer in income for the taxable year in which the transfer occurs (rather than the taxable year in which or with which ends the partnership taxable year in which the transfer occurs), the Treasury Department and the IRS are considering the possibility of amending the section 6041 regulations to provide that this type of guaranteed payment must be reported by the partnership on Form 1099-MISC, which is

required to be issued to the service provider on or before January 31 of the year following the calendar year of such transfer. The Treasury Department and the IRS request comments on whether such a requirement is appropriate and administrable.

Proposed Effective Date

These regulations are proposed to apply to transfers of property on or after the date final regulations are published in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the reporting burden, as discussed earlier in this preamble, is not expected to be significant. Partnerships with partnership agreements that contain the binding provisions referred to in §1.83-3(l) only will be required to submit a single election form in order to rely on the safe harbor described in that paragraph. Partnerships that desire to elect to use the safe harbor described in §1.83-3(l), but which do not have partnership agreements containing these provisions, are required to obtain partner-level consents to the election. However, these partnerships are expected to be rare. Moreover, in most cases the partners in such partnerships are not expected to be small businesses. Therefore, a Regulatory Flexibility Analysis under the

Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (a signed original and eight copies) that are submitted timely to the IRS. The IRS and the Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for October 5, 2005, beginning at 10 a.m. in the IRS 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 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 September 14, 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 reviewing outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Audrey Ellis and Demetri Yatrakis of the Office of Associate Chief Counsel (Passthroughs and Special Industries), and Stephen Tackney of the Office of Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in their development.

Withdrawal of Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, §1.721-1(b) of the notice of proposed rulemaking that was published in the **Federal Register** on June 3, 1971 (36 FR 10787) is withdrawn.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and record keeping requirements.

Proposed Amendments to the Regulations

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

PART 1--INCOME TAXES

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

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

Par. 2. Section 1.83-3 is amended as follows:

1. Paragraph (e) is amended by adding two new sentences after the first sentence.

2. Paragraph (l) is added.

The revision and addition read as follows:

§1.83-3 Meaning and use of certain terms.

* * * * *

(e) Property. * * * Accordingly, property includes a partnership interest. The previous sentence is effective for transfers on or after the date final regulations are published in the **Federal Register**. * * *

* * * * *

(l) Special rules for the transfer of a partnership interest. (1) Subject to such additional conditions, rules, and procedures that the Commissioner may prescribe in regulations, revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(b) of this chapter), a partnership and all of its partners may elect a safe harbor under which the fair market value of a partnership interest that is transferred in connection with the performance of services is treated as being equal to the liquidation value of that interest for transfers on or after the date final regulations are published in the **Federal Register** if the following conditions are satisfied:

(i) The partnership must prepare a document, executed by a partner who has responsibility for Federal income tax reporting by the partnership, stating that the

partnership is electing, on behalf of the partnership and each of its partners, to have the safe harbor apply irrevocably as of the stated effective date with respect to all partnership interests transferred in connection with the performance of services while the safe harbor election remains in effect and attach the document to the tax return for the partnership for the taxable year that includes the effective date of the election.

(ii) Except as provided in paragraph (l)(1)(iii) of this section, the partnership agreement must contain provisions that are legally binding on all of the partners stating that—

(A) The partnership is authorized and directed to elect the safe harbor; and

(B) The partnership and each of its partners (including any person to whom a partnership interest is transferred in connection with the performance of services) agrees to comply with all requirements of the safe harbor with respect to all partnership interests transferred in connection with the performance of services while the election remains effective.

(iii) If the partnership agreement does not contain the provisions described in paragraph (l)(1)(ii) of this section, or the provisions are not legally binding on all of the partners of the partnership, then each partner in a partnership that transfers a partnership interest in connection with the performance of services must execute a document containing provisions that are legally binding on that partner stating that—

(A) The partnership is authorized and directed to elect the safe harbor; and

(B) The partner agrees to comply with all requirements of the safe harbor with respect to all partnership interests transferred in connection with the performance of

services while the election remains effective.

(2) The specified effective date of the safe harbor election may not be prior to the date that the safe harbor election is executed. The partnership must retain such records as may be necessary to indicate that an effective election has been made and remains in effect, including a copy of the partnership's election statement under this paragraph (l), and, if applicable, the original of each document submitted to the partnership by a partner under this paragraph (l). If the partnership is unable to produce a record of a particular document, the election will be treated as not made, generally resulting in termination of the election. The safe harbor election also may be terminated by the partnership preparing a document, executed by a partner who has responsibility for Federal income tax reporting by the partnership, which states that the partnership, on behalf of the partnership and each of its partners, is revoking the safe harbor election on the stated effective date, and attaching the document to the tax return for the partnership for the taxable year that includes the effective date of the revocation.

Par. 3. Section 1.83-6 is amended by revising the first sentence of paragraph (b) to read as follows:

§1.83-6 Deduction by employer.

* * * * *

(b) Recognition of gain or loss. Except as provided in section 721 and section 1032, at the time of a transfer of property in connection with the performance of services the transferor recognizes gain to the extent that the transferor receives an amount that exceeds the transferor's basis in the property. * * *

* * * * *

Par. 4. Section 1.704-1 is amended as follows:

1. In paragraph (b)(0), an entry is added to the table for §1.704-1(b)(4)(xii).

2. In paragraph (b)(1)(ii)(a), a sentence is added at the end of the paragraph.

3. Paragraph (b)(2)(iv)(b)(1) is revised.

4. Paragraph (b)(2)(iv)(f)(5)(iii) is revised.

5. Paragraph (b)(4)(xii) is added.

6. Paragraph (b)(5) Example 29 is added.

The additions and revisions read as follows:

§1.704-1 Partner's distributive share.

* * * * *

(b) * * *(0) * * *

* * * * *

Substantially nonvested interests....................................1.704-1(b)(4)(xii)

* * * * *

(1) * * *

(ii) * * * (a) * * * In addition, paragraph (b)(4)(xii) and paragraph (b)(5) Example 29 of this section apply to compensatory partnership interests (as defined in §1.721-1(b)(3)) that are transferred on or after the date final regulations are published in the **Federal Register**.

* * * * *

(2) * * *

(iv) * * *

(b) * * *

(1) the amount of money contributed by that partner to the partnership and, in the case of a compensatory partnership interest (as defined in §1.721-1(b)(3)) that is transferred on or after the date final regulations are published in the **Federal Register**, the amount included on or after that date in the partner's compensation income under section 83(a), (b), or (d)(2).

* * * * *

(f) * * *

(5) * * *

(iii) In connection with the transfer or vesting of a compensatory partnership interest (as defined in §1.721-1(b)(3)) that is transferred on or after the date final regulations are published in the **Federal Register**, but only if the transfer or vesting results in the service provider recognizing income under section 83 (or would result in such recognition if the interest had a fair market value other than zero).

* * * * *

(4) * * *

(xii) Substantially nonvested interests--(a) In general. If a section 83(b) election has been made with respect to a substantially nonvested interest, the holder of the nonvested interest may be allocated partnership income, gain, loss, deduction, or credit (or items thereof) that will later be forfeited. For this reason, allocations of partnership items while the interest is substantially nonvested cannot have economic effect.

(b) Deemed Compliance with Partners' Interests in the Partnership. If a section 83(b) election has been made with respect to a substantially nonvested interest, allocations of partnership items while the interest is substantially nonvested will be deemed to be in accordance with the partners' interests in the partnership if--

(1) The partnership agreement requires that the partnership make forfeiture allocations if the interest for which the section 83(b) election is made is later forfeited; and

(2) All material allocations and capital account adjustments under the partnership agreement not pertaining to substantially nonvested partnership interests for which a section 83(b) election has been made are recognized under section 704(b).

(c) Forfeiture allocations. Forfeiture allocations are allocations to the service provider (consisting of a pro rata portion of each item) of gross income and gain or gross deduction and loss (to the extent such items are available) for the taxable year of the forfeiture in a positive or negative amount equal to--

(1) The excess (not less than zero) of the--

(i) Amount of distributions (including deemed distributions under section 752(b) and the adjusted tax basis of any property so distributed) to the partner with respect to the forfeited partnership interest (to the extent such distributions are not taxable under section 731); over

(ii) Amounts paid for the interest and the adjusted tax basis of property contributed by the partner (including deemed contributions under section 752(a)) to the partnership with respect to the forfeited partnership interest; minus

(2) The cumulative net income (or loss) allocated to the partner with respect to the forfeited partnership interest.

(d) Positive and negative amounts. For purposes of paragraph (b)(4)(xii)(c) of this section, items of income and gain are reflected as positive amounts, and items of deduction and loss are reflected as negative amounts.

(e) Exception. Paragraph (b)(4)(xii)(b) of this section shall not apply to allocations of partnership items made with respect to a substantially nonvested interest for which the holder has made a section 83(b) election if, at the time of the section 83(b) election, there is a plan that the interest will be forfeited. In such a case, the partners' distributive shares of partnership items shall be determined in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section. In determining whether there is a plan that the interest will be forfeited, the Commissioner will consider all of the facts and circumstances (including the tax status of the holder of the forfeitable compensatory partnership interest).

(f) Cross references. Forfeiture allocations may be made out of the partnership's items for the entire taxable year of the forfeiture. See §1.706-3(b) and paragraph (b)(5) Example 29 of this section.

* * * * *

(5) * * *

Example 29. (i) In Year 1, A and B each contribute cash to LLC, a newly formed limited liability company classified as a partnership for Federal tax purposes, in exchange for equal units in LLC. Under LLC's operating agreement, each unit is entitled to participate equally in the profits and losses of LLC. The operating agreement also provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, that liquidation proceeds will be

distributed in accordance with the partners' positive capital account balances, and that any partner with a deficit balance in that partner's capital account following the liquidation of the partner's interest must restore that deficit to the partnership. At the beginning of Year 3, SP agrees to perform services for LLC. In connection with the performance of SP's services and a payment of $10 by SP to LLC, LLC transfers a 10% interest in LLC to SP. SP's interest in LLC is substantially nonvested (within the meaning of §1.83-3(b)). At the time of the transfer of the LLC interest to SP, LLC's operating agreement is amended to provide that, if SP's interest is forfeited, then SP is entitled to a return of SP's $10 initial contribution, and SP's distributive share of all partnership items (other than forfeiture allocations under §1.704-1(b)(4)(xii)) will be zero with respect to that interest for the taxable year of the partnership in which the interest was forfeited. The operating agreement is also amended to require that LLC make forfeiture allocations if SP's interest is forfeited. Additionally, the operating agreement is amended to provide that no part of LLC's compensation deduction is allocated to the service provider to whom the interest is transferred. SP makes an election under section 83(b) with respect to SP's interest in LLC. Upon receipt, the fair market value of SP's interest in LLC is $100. In each of Years 3, 4, 5, and 6, LLC has operating income of $100 (consisting of $200 of gross receipts and $100 of deductible expenses), and makes no distributions. SP forfeits SP's interest in LLC at the beginning of Year 6. At the time of the transfer of the interest to SP, there is no plan that SP will forfeit the interest in LLC.

(ii) Because a section 83(b) election is made, SP recognizes compensation income in the year of the transfer of the LLC interest. Therefore, SP recognizes $90 of compensation income in the year of the transfer of the LLC interest (the excess of the fair market value of SP's interest in LLC, $100, over the amount SP paid for the interest, $10). Under paragraph (b)(2)(iv)(b)(1) of this section, in Year 3, SP's capital account is initially credited with $100, the amount paid for the interest ($10) plus the amount included in SP's compensation income upon the transfer under section 83(b) ($90). Under §§1.83-6(b) and 1.721-1(b)(2), LLC does not recognize gain on the transfer of the interest to SP. LLC is entitled to a compensation deduction of $90 under section 83(h). Under the terms of the operating agreement, the deduction is allocated equally to A and B.

(iii) As a result of SP's election under section 83(b), SP is treated as a partner starting from the date of the transfer of the LLC interest to SP in Year 3. Section 1.761-1(b). In each of years 3, 4 and 5, SP's distributive share of partnership income is $10 (10% of $100), A's distributive share of partnership income is $45 (45% of $100), and B's distributive share of partnership income is $45 (45% of $100). In accordance with the operating agreement, SP's capital account is increased (to $130) by the end of Year 5 by the amounts allocated to SP, and A's and B's capital accounts are increased by the amounts allocated to A and B. Because LLC satisfies the requirements of paragraph (b)(4)(xii) of this section, LLC's allocations in years 3, 4 and 5 are deemed to be in accordance with the partners' interests in the partnership.

(iv) As a result of the forfeiture of the LLC interest by SP in year 6, LLC is required to recognize income ($90) equal to the amount of the allowable deduction on the transfer of the LLC interest to SP under §1.83-6(c). LLC repays SP's $10 capital contribution to SP, reducing SP's capital account to $120. Under the terms of the operating agreement, because SP forfeited SP's interest, SP's distributive share of all partnership items (other than forfeiture allocations) is zero for Year 6. To reverse SP's prior allocations of LLC income, LLC makes forfeiture allocations of $30 of deductions ($0 (the difference between the $10 distributed to SP and the $10 contributed to LLC by SP) minus $30 (the cumulative net LLC income allocated to SP) to SP in Year 6. Notwithstanding section 706(c) and (d), these allocations may be made out of LLC's partnership items for the entire taxable year of the forfeiture. Thus, in Year 6, $30 of deductions are allocated to SP, and the remaining $220 of net operating income ($200 of gross receipts and $90 of income under §1.83-6(c) less $70 of remaining deductions) are allocated to A and B equally for tax purposes. In accordance with section 83(b)(1) (last sentence), SP does not receive a deduction or capital loss for the amount ($90) that was included in SP's compensation income. Because LLC satisfies the requirements of paragraph (b)(4)(xii) of this section, LLC's allocations in year 6 are deemed to be in accordance with the partners' interests in the partnership.

* * * * *

Par. 5. Section 1.706-3 is added to read as follows.

§1.706-3 Property transferred in connection with the performance of services.

(a) Allocations of certain deductions under section 83(h). The transfer of property subject to section 83 in connection with the performance of services is not an allocable cash basis item within the meaning of section 706(d)(2)(B).

(b) Forfeiture allocations. If an election under section 83(b) is made with respect to a partnership interest that is substantially nonvested (within the meaning of §1.83-3(b)), and that interest is later forfeited, the partnership must make forfeiture allocations to reverse prior allocations made with respect to the forfeited interest. See §1.704-1(b)(4)(xii). Although the person forfeiting the interest may not have been a

partner for the entire taxable year, forfeiture allocations may be made out of the partnership's items for the entire taxable year.

(c) Effective date. This section applies to transfers of property on or after the date final regulations are published in the **Federal Register**.

Par. 6. In §1.707-1, paragraph (c) is amended by revising the second sentence to read as follows:

§1.707-1 Transactions between partner and partnership.

* * * * *

(c) Guaranteed Payments. * * * However, except as otherwise provided in section 83 and the regulations thereunder, a partner must include such payments as ordinary income for that partner's taxable year within or with which ends the partnership taxable year in which the partnership deducted such payments as paid or accrued under its method of accounting. * * *

* * * * *

Par. 7. In §1.721-1, paragraph (b) is revised to read as follows.

§1.721-1 Nonrecognition of gain or loss on contribution.

* * * * *

(b)(1) Except as otherwise provided in this section or §1.721-2, section 721 does not apply to the transfer of a partnership interest in connection with the performance of services or in satisfaction of an obligation. The transfer of a partnership interest to a person in connection with the performance of services constitutes a transfer of property to which section 83 and the regulations thereunder apply. To the extent that a

partnership interest transferred in connection with the performance of services rendered by a decedent prior to the decedent's death is transferred after the decedent's death to the decedent's successor in interest, the fair market value of such interest is an item of income in respect of a decedent under section 691.

(2) Except as provided in section 83(h) and 1.83-6(c), no gain or loss shall be recognized by a partnership upon--

(i) The transfer or substantial vesting of a compensatory partnership interest; or

(ii) The forfeiture of a compensatory partnership interest. See §1.704-1(b)(4)(xii) for rules regarding forfeiture allocations of partnership items that may be required in the taxable year of a forfeiture.

(3) For purposes of this section, a compensatory partnership interest is an interest in the transferring partnership that is transferred in connection with the performance of services for that partnership (either before or after the formation of the partnership), including an interest that is transferred on the exercise of a compensatory partnership option. A compensatory partnership option is an option to acquire an interest in the issuing partnership that is granted in connection with the performance of services for that partnership (either before or after the formation of the partnership).

(4) To the extent that a partnership interest is--

(i) Transferred to a partner in connection with the performance of services rendered to the partnership, it is a guaranteed payment for services under section 707(c);

(ii) Transferred in connection with the performance of services rendered to a

partner, it is not deductible by the partnership, but is deductible only by such partner to the extent allowable under Chapter 1 of the Code.

(5) This paragraph (b) applies to interests that are transferred on or after the date final regulations are published in the **Federal Register**.

* * * * *

Par. 8. Section 1.761-1(b) is amended by adding two sentences to the end of the paragraph to read as follows.

§1.761-1 Terms defined.

* * * * *

(b) * * * If a partnership interest is transferred in connection with the performance of services, and that partnership interest is substantially nonvested (within the meaning of §1.83-3(b)), then the holder of the partnership interest is not treated as a partner solely by reason of holding the interest, unless the holder makes an election with respect to the interest under section 83(b). The previous sentence applies to

partnership interests that are transferred on or after the date final regulations are published in the **Federal Register**. * * * * *

/s/ Mark E. Matthews
Deputy Commissioner for Services and Enforcement.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 22, 2005
JS-2462

Remarks of Randal K. Quarles
Acting Under Secretary of the United States Treasury
at the Annual Meeting of the
European Bank for Reconstruction and Development

I am very pleased to be in Belgrade for the European Bank for Reconstruction and Development's 14th Annual Meeting. I'd like to thank our hosts from Serbia and Montenegro for their work in ensuring the success of this event. And at the very outset, I also want to thank Noreen Doyle for her years of service to the EBRD. She has dedicated 13 years of her career to the Bank, beginning as the head of syndications in 1992, and most recently serving as the First Vice President. We all wish her well in her future endeavors.

It has been a remarkable year for the region – one that has affirmed the fundamental importance of peaceful democratic change to a successful transition to an open market economy. The second wave of peaceful revolutions spreading east and south has drawn inspiration from the EU-8 accession countries that have demonstrated the concrete benefits of completing the transition to market-oriented democracies. Now the new democratic reformers are using their political mandates to achieve major breakthroughs on economic reforms and the fight against corruption.

In Georgia, the state has stepped back from the brink of financial collapse. By no longer tolerating corruption, the government increased revenues by 50 percent in one year and is meeting its commitments to its people in full and on time for the first time in its history. Not satisfied with marginal refinements, it completely rewrote the tax code, making it one of the most investor friendly in the region. In return, confidence and investment have soared.

In Ukraine, we remain impressed by the new government's commitment to tackle corruption through strengthening the rule of law. The government has eliminated a wide range of exemptions and privileges that were previously exploited by large companies to
evade tax obligations. This is a good start. Moving ahead rapidly on other priority reforms will demonstrate that Ukraine's authorities are serious about leading Ukraine to its rightful place in Europe.

Serbia and Montenegro experienced their own transition from dictatorship to democracy and are now poised to reap the benefits of reform and strengthening relations with the international community. Following last year's elections, the government moved forward resolutely on economic stability, privatization and development of the financial sector. The July 2004 agreement with the London Club was a landmark achievement, which normalized the country's relations with international capital markets. We hope that
progress on bringing the final war crimes indictees to justice in The Hague will allow the U.S. to resume supporting EBRD operations in Serbia.

Romania has demonstrated how democratic and economic development can be mutually reinforcing. A surprise opposition victory served to reignite the country's movement toward EU membership by freeing the government's hand to take on entrenched interests and improve the investment climate. The introduction of the flat tax has been accompanied by efforts to improve tax collection and strengthen anti-corruption legislation. Early results have been positive with higher revenues and registered employment indicating a shift out of the shadow economy.

The changes sweeping the region represent a new wave of transition, potentially as transformational as the dramatic events of 1989-1991. But the trends are by no means inevitable and must be nurtured if the high expectations of citizens are to be fulfilled.

In the Kyrgyz Republic, the people have taken a stance against the corrupt status quo in favor of change. It is our hope that the recent changes will result in free and fair elections in July. If this happens, the new government will need to show that democracy can deliver the economic opportunity that was denied under the old regime.

In some countries the people have yet to have their say. I would like to reiterate the U.S. stance on Belarus -- we stand with those struggling for democracy in Europe's last dictatorship.

In Uzbekistan, we are seriously disturbed about recent events and believe the EBRD should give these events careful consideration during its upcoming review of the Uzbek country strategy in July.

Given the tremendous changes sweeping east and south, it is only natural that the EBRD should continue to play a major role in supporting economic and political transformation in the region.

To do so, the EBRD must look back to its creation and renew itself as an institution. It must refocus on its transition mandate by directing its resources to those poorer countries of the region where its transformational effect can be the greatest. It must take the valuable lessons learned in the advanced transition countries and apply them to those countries that are still making this transition.

And to effectively apply the lessons learned to the early and intermediate transition countries, the EBRD must be willing to recognize its successes. This includes acknowledgment of when its work is done and it is time to move on.

In several countries, the EBRD is already at that point. The eight countries of Central and Eastern Europe that joined the EU last spring have completed their transition. While EBRD s work is done, these countries will have support for their economic convergence into the EU from EU structural and cohesion funds and the European Investment Bank. I
wish to repeat our call for the EBRD to cease new operations in the EU-8 within the next two to three years. Our intention is to acknowledge their remarkable success. And most importantly, to free the Bank to focus completely on the less advanced countries of operation and to serve them with the same dedication and intensity of purpose that it brought to the EU-8.

Sometimes in response to our call for a movement south and east, we hear the objection that this move is not practical. We hear that the poorer countries of the region are too risky. We hear of the obstacles to investment and the barriers to activity.

But when we hear of the difficulties of operating in the poorer countries in the region, we must remember that there were no easy investments in Hungary or Estonia or Slovenia in 1991. Yet the Bank dove in, and both the region and the EBRD prospered. I am convinced that with the vision and professionalism and dedication that have characterized the management and staff of this Bank since its inception, we can do it again.

As the Bank expands its operations in the early and intermediate transition countries, I want to reiterate our long-standing support for efforts to expand financing for local entrepreneurs, particularly micro, small, and medium-sized enterprises. These
entrepreneurs are essential to creating a vibrant, market-oriented economy, and, as stakeholders in their communities, they facilitate the development of more open and transparent government. We hope that the EBRD will fully staff and use the Group for Small Business and the Direct Investment Facility, among others, to advance the Bank s efforts in this area.

At a time when so many countries in the region are taking steps to fight corruption, I

want to emphasize the importance we attach to the EBRD's work in this area. Because democracy and free markets depend on an open, transparent, and rule-based system of law, the elimination of corruption is a vital component of the EBRD's transition objectives. Consequently, the Legal Transition Program and other work in this area have
been as important to the Bank's mission as its financial operations.

To promote good governance effectively in the region, the EBRD must make sure that its own operations are consistent with best practices. There have been several positive developments on this front, including the implementation of a COSO system of internal
controls, new measures leading toward full independence of the evaluation function, work underway to revise the Code of Conduct, and a planned, annual anti-corruption report.

The Bank, however, must make further improvements in public disclosure, particularly by making its budget and the minutes of Board meetings available to the public as is done by other international financial institutions. The Bank should also make public its draft country strategies for comment. In addition, the EBRD must take further steps to ensure the operational independence of its internal audit and compliance functions. Furthermore, reviewing the operation of the Board should be part of the process of bringing the Bank in line with best current corporate governance practices.

In conclusion, let me reiterate our fundamental point -- now is the time for the EBRD to renew itself as an institution so that it might maximize its impact going forward. The Bank was created to bring the former communist countries into the community of free, open societies. To remain true to its mission, the EBRD should recognize where the mission has been accomplished and what tools have been instrumental to that success so that it is in the best possible position to seize the historical opportunities developing elsewhere in the region.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

April 22, 2005
JS-2463

Remarks By United States Treasury Assistant Secretary Quarles Harvard Symposium on Building the Financial System of the 21st Century: An Agenda for Europe and the United States Eltville, Germany April 22, 2005

I am delighted to participate again in this Symposium. Being an after dinner speaker at the first session presents opportunities and risks. The opportunity is that I can talk about any topic without fear of repeating what others have said. Risks, in that I am standing between you and a good night's sleep after such a wonderful meal. I will seize the opportunity by talking about the US-EU Informal Financial Markets Regulatory Dialogue. I will try to minimize the risks by being as brief as possible.

The three messages I would like you to take away tonight are that (1) the dialogue is moving to the next stage; (2) markets are driving this process; and (3) convergence is happening.

The US-EU Financial Markets Regulatory Dialogue began three years ago. The Treasury, the lead in the United States, is joined by the SEC, the Federal Reserve, and other regulators on an ad hoc basis, in meetings with the European Commission. The dialogue works informally, quietly and professionally.

About 1-1/2 years ago, I spoke about the attributes of the Dialogue to this Symposium. There was polite applause, but I detected a certain skepticism. During the last year and a half, the weight of opinion has shifted. By all accounts, the Dialogue has proven its worth. By promoting quiet discussion and understanding, and avoiding hectoring or public brinkmanship, the Dialogue has assisted in problem solving, has evolved to focus on implementation and forward looking issues, and has helped deepen cooperation.

In the first two years of the Dialogue, both sides were frankly reactive, because there was a lot to react *to*. Both needed to respond quickly to events as they arose. We sought to address "spillover effects" of legislation adopted for domestic regulatory reasons on both sides of the Atlantic, but with distinct implications for international firms. The Financial Conglomerates Directive and the Sarbanes-Oxley Act are the two best examples. Give and take on both sides allowed implementation to proceed, taking into account special attributes of each other's markets without sacrificing the letter and spirit of the legislation.

We were able to work thorough the issues because we share similar objectives of promoting dynamic and sound global capital markets, although each side goes about its business differently. Through frequent discussion and taking each other's views into account, we worked through difficult issues and engendered mutual trust.

With passage of much of the EU's Financial Services Action Plan, the focus of the Dialogue has broadened to include the practicalities of the Plan's active implementation. This will prove every bit as challenging as the work already completed.

Implementation of Basle II, which you will discuss tomorrow, is one example. It has

been taken up at all Dialogue sessions. While the Basle Accord Implementation Group is charged with addressing implementation details, the Dialogue has provided a useful reminder 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 should incorporate provisions emerging from Basle, including those being developed on trading books of investment banks.

Other hot implementation issues include the Market in Financial Instruments Directive (MiFID), in which details of the implementing measures should respect the delicate compromises reached on that legislation--particularly regarding internationalization of trades--and the Prospectus and Transparency Directives on which I will comment later.

Problem solving and reaction will always be part of the Dialogue. But having gotten past the first wave of reaction, the Dialogue has been able to shift gears. We have developed a forward-looking agenda that identifies key issues for building an increasingly integrated transatlantic capital market.

The United States well knows from its history that innovative and flexible financial markets not only provide the capital needed to fuel investment, but they also discipline economic agents and reward efficiency. "Growth" has been a buzzword of the Bush Administration; we want to see a global economy with vibrant growth in many economies, rather than the uneven pattern that now holds. We are well aware of the many studies in Europe showing that full implementation of a liberal pan-European financial system will boost EU growth by at least one percentage point per annum in a decade's time. US firms are also some of the key European financial institutions that can make higher sustained growth a reality.

For all of these reasons, we are also watching closely many aspects of European capital market development. The depth of our interest might surprise some observers, but it should come as no surprise to you. For example, we are keenly interested in Europe's progress on clearing and settlement, mutual funds, corporate governance, auditing supervision, takeover bids, and insurance. On the takeover directive, the erection of barriers to US investment in Europe under the guise of "reciprocity" or "national champions" could impede European economic dynamism. On insurance, both reinsurance as well as the Solvency II project to strengthen capital adequacy standards, Dialogue participants are actively exchanging views.

Banking issues, such as retail banking, mergers and acquisitions, and a legal framework for payment services, are other topics to be taken up soon. We are keenly interested in the Commission's efforts to promote cross-border retail banking mergers and competition in Europe. The advent of inter-state banking in the United States is a parallel and it is one that bolstered our economy's dynamism. These are all areas that hold significant promise for reducing transaction costs and bringing benefits to consumers.

We want to broaden the reach of the Dialogue, while retaining its informal nature. We will be continuing to reach out to the academic community, private sector, member state governments and legislatures.

As implementation issues are now coming to the fore, it is natural that the EU supervisory committees develop their own cooperative dialogues with their US counterparts. CESR has dialogues with the SEC and US CFTC; the US National Association of Insurance Commissioners is engaging with the newly created Committee of European Insurance and Occupational Pension Supervisors; and officials of the Committee of European Banking Supervisors already have visited Washington for initial consultations with US bank regulators. The Dialogue will be infused with the substance of the work concerning each of these supervisory dialogues.

My second proposition tonight is that markets are driving the agenda. Markets are always ahead of the regulators, and frankly that's how it should be. It's analogous to the advice that my father provided me that "if you don't miss at least two or three

planes a year, you're spending too much time in airports." If the regulators aren't a little behind the market in a few areas at any given time, they would be stifling innovation and evolution. The regulators' task is to promote investor protection, while ensuring that prudential and supervisory activities do not stifle efficiency gains. For effective regulation, the regulators must work with the markets. The global trend toward transparency is key to letting regulators and markets achieve the right balance. Open and full consultation with markets is essential. Politics is inevitable in our societies, but if politics are allowed to trump sound policies, we will all be hurt.

While EU financial markets are big, they are not fully integrated. Thus, implementation of enacted directives and the Commission's follow-on measures that it will propose this summer are of critical importance. In order for Europe to reap the fruits of a single capital market, regulators in each member state must implement these measures in identical fashion and enforce them consistently. Markets are pushing for this – demanding streamlined reporting requirements and supervision to gain efficiencies at the EU level.

In the United States, large US banks increasingly hold the preeminent share of assets. In Europe, as consolidation and mergers take hold, especially cross-country, concentration will also strengthen. And it is not just Europe and the US – several years ago, there were 16 major banks in Japan. Now, Japanese bank balance sheets are becoming stronger and "conglomerization" – to use a Japanese term of art that I'm fairly sure is not an English word – is taking root with three large banking entities taking hold.

While markets are increasingly global, regulation is national. Moreover, regulatory requirements are increasing – understandably in the light of recent developments. But these requirements can be duplicative across jurisdictions, thus piling up additional costs for global institutions. Limiting client operations, or segmenting them into different accounts to deal in different financial products subject to different regulatory regimes, is costly and inefficient. Financial firms and their clients understandably demand better.

So, how do we square this circle – how do we match the global reach of markets with the national orientation of regulation? The reality is that supervision is already going global and it is doing so through convergence. As policy-makers, we have a duty to ensure that convergence orients itself around high quality standards and not a race to the bottom.

Four years ago there was an interesting analysis of the politics of international capital market harmonization. The hypothesis was that a dominant financial center serves as a "regulatory anchor," basically making decisions that the rest of the world would have to emulate for competitive reasons. In essence, the US was viewed as the dominant center.

With the policy measures under its Financial Services Action Plan, the EU is in the process of creating a second "dominant" center. Data in the IMF's most recent Global Financial Stability Report paint the picture. The sum of stock market capitalization, debt securities and bank assets in the EU was nearly $47 trillion in 2003; in the US the total was around $41 trillion. Together they account for two-thirds of the world total.

One risk of having a second pillar in the international financial regulatory system is that we could lose the "anchor" that has helped us to avoid a race to the bottom. Two large regulatory centers could engage in competition to attract capital that leads to excessively low regulation. Under certain conditions, the two sides could also engage in the opposite behavior, seeking to exceed one another with ever-higher levels of regulation that could frustrate innovation and efficiency in the financial markets. Our cooperation in this and other forums is an important means by which we can avoid these pitfalls.

A few years ago, very few people would have known the alphabet soup of international regulation – BCBS; IOSCO, IAIS, etc. Now, these organizations are

known quantities. Their activities are also on the plate of the world's financial officials. In March, I attended the Financial Stability Forum meeting in Tokyo, which heard progress reports from each of the key supervisory bodies.

And the regulatory alphabet soup does not just exist at the global level. It also exists at the US-European level. CESR and the SEC are working on credit rating agencies, and on implementation and enforcement of IAS. CESR and the CFTC developed a common work plan on transatlantic derivatives. CEIOPS and NAIC are working on information sharing and re-insurance issues, and the PCAOB with European auditing supervisors.

I already discussed the "conglomerization" underway among global banks. Consolidated comprehensive supervision and Basel II are a natural reflection of this process. So is the fact that the Financial Conglomerates Directive was patterned on the principles of the Joint Forum and that Europe's Solvency 2 Directive is striving to emulate Basel II. Convergence has far to go, but the trend is unmistakable.

In that regard, let me touch on convergence for listings in the US and European market. Endorsement of IAS by the EU followed improved IASB governance and IASB's improvement of its accounting standards. Requiring the 7,000 EU listed companies to use IAS was a dramatic move that gave a push to accounting convergence. And I am pleased to note that the SEC is working on a roadmap for accepting IFRS accounts without reconciliation in the US in the next few years.

Meanwhile, the IASB and FASB are making progress on the convergence exercise for global accounting standards, pursuant to the Norwalk Agreement. Japan is closely following these developments. While I doubt accounting and auditing practices will ever be identical in our jurisdictions, I hope that if accountants worldwide follow a similar standard, and follow that standard similarly, then accounting statements could become in time broadly similar throughout the world. Such convergence – in terms of principles and practice – could lay the basis for ushering in a truly global capital market. It is important not to cast doubts in the public mind about the integrity and technical strength of accounting standard setting by interjecting politics into the process.

In this context it is disappointing to see the old canard -- "reciprocity" – reappear. For years, US firms have listed securities in the Euromarkets on the basis of statements using US GAAP. Some now argue that US firms listing in Euromarkets should be required to follow IAS because the SEC does not recognize the IAS accounts prepared by EU firms. I think such an approach would be a mistake. Such a shortsighted policy would only hurt the depth and liquidity of the Euromarkets.

To conclude, we strongly support Europe's FSAP and are committed to working with Europe to promote a strong Transatlantic Capital Market anchored in best global practices. The US-EU Financial Markets Regulatory Dialogue is thriving and moving on to the next steps; it is evolving to meet new challenges posed by markets; and it is supporting regulatory convergence between the US and Europe. I am looking forward to remaining engaged with all of you on these issues and to hearing the ideas that come out of this conference.

Thank you.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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May 23, 2005
JS-2464

Testimony of Deputy Assistant Secretary (Tax Analysis) of Treasury Robert J. Carroll before the Senate Finance Subcommittee on Taxation and IRS Oversight

Mr. Chairman, Senator Jeffords, and Distinguished Members of the Committee.

Thank you for the opportunity to discuss the individual alternative minimum tax. The alternative minimum tax, or AMT, is an example of a tax provision that was intended to address a relatively small, targeted problem that has had unintended consequences, grown far beyond its original purpose, and created a far larger problem than it was ever intended to address. Unfortunately, because of the way the AMT is now intertwined with the rest of the individual income tax, a long-term solution to the AMT problem needs to be considered in the broader context of reform of the income tax.

REPORTS

- Full Report

Mr. Chairman, Senator Jeffords, and Distinguished Members of the Committee.

Thank you for the opportunity to discuss the individual alternative minimum tax. The alternative minimum tax, or AMT, is an example of a tax provision that was intended to address a relatively small, targeted problem that has had unintended consequences, grown far beyond its original purpose, and created a far larger problem than it was ever intended to address. Unfortunately, because of the way the AMT is now intertwined with the rest of the individual income tax, a long-term solution to the AMT problem needs to be considered in the broader context of reform of the income tax.

History of the AMT

The predecessor of the AMT – the minimum tax -- was first enacted in 1969 in an attempt to insure that a small group of high-income individuals who had managed to avoid paying any income tax would pay at least a minimum amount of tax. Then Treasury Secretary Barr noted in his testimony before the Joint Economic Committee of Congress in 1969 that 155 taxpayers with incomes over $200,000 paid no tax in 1966. The AMT we have today is projected to affect over 50 million taxpayers by 2015.

Moreover, even though the minimum tax and later the AMT did reduce the number of high-income taxpayers who otherwise would have paid no income tax, neither provision has been successful in attaining the original goal of ensuring that all high-income taxpayers pay at least some tax. Each year several thousand high-income taxpayers continue to be nontaxable, generally for various combinations of legitimate reasons and in spite of the AMT.

Several major and many minor changes since 1969 have transformed the original minimum tax into the current alternative minimum tax which, for too many taxpayers, is now a second income tax that runs parallel to the regular individual income tax. The broad reach and design flaws of the AMT result in a tax system that is complex, unfair, and discourages economic growth. Taxpayers must comply with two parallel tax systems – even for the many millions who do the calculations but ultimately have no AMT liability.

The AMT: A Looming Problem

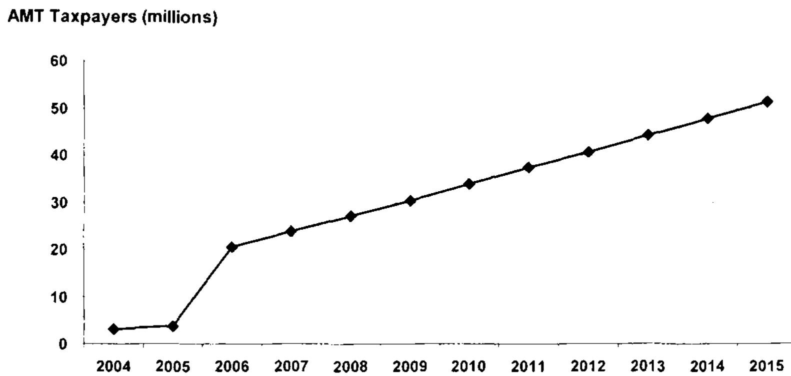
The AMT is a parallel tax system with its own tax base, exemption amounts, tax rates, and usable tax credits. A taxpayer's AMT liability is essentially the difference between the liability calculated under the AMT and the liability calculated under the regular income tax. The AMT itself is not an especially complex tax. It is the requirement that taxpayers understand and comply with two parallel tax systems makes the AMT complex. Moreover, because many taxpayers become subject to the AMT for reasons that are not the result of tax-motivated planning, many taxpayers are not aware that they will be affected by the AMT until they complete their tax returns. They become unsuspecting – and unintended – victims of the AMT.

The major reason the AMT has become such a growing problem is that, unlike the regular tax, this parallel tax system is not indexed for inflation. The AMT tax rate thresholds, the AMT

exemption, and its phase-out are all fixed in nominal terms. Consequently, the passage of time and the erosive effects of inflation have steadily increased the size and scope of the AMT. Because of budgetary constraints and the large and ever-increasing amount of revenue from the AMT, solving the AMT problem in isolation would be extremely difficult.

The large AMT exemption has generally kept the vast majority of taxpayers free from the reach of the AMT. Indeed, each of the major tax cuts enacted by the Congress in the last several years have included provisions to increase the AMT exemption or other provisions to prevent a large increase in the number of AMT taxpayers. The higher AMT exemption and the provision to allow all personal credits to be claimed against the AMT – the so-called "AMT patch" – both remain in effect through 2005.

Chart 1: Number of AMT Taxpayers



Note: Assumes EGTRRA and JGTRRA sunsets are repealed and the temporary AMT provisions are allowed to expire in 2005.

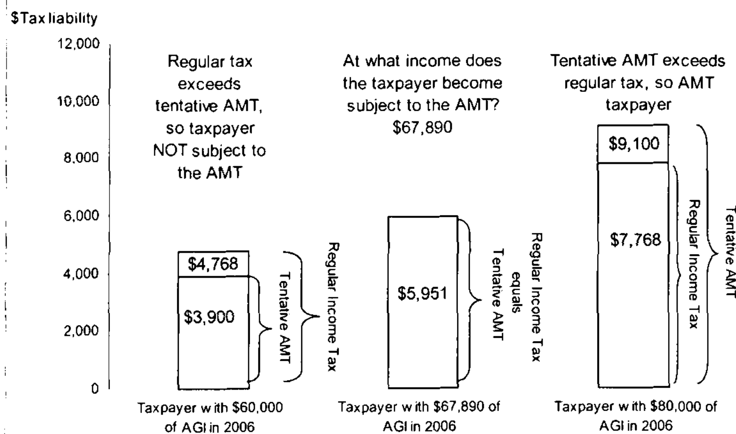
Source: U.S. Department of Treasury, Office of Tax Analysis

Beginning in tax year 2006, after the temporary AMT provisions expire, the number of taxpayers projected to be affected by the AMT rises sharply, from 3.8 million in 2005 to 20.5 million in 2006 (Chart 1). By 2015, 51.3 million or 45 percent of all taxpayers with income tax are projected to be subject to the AMT.

The AMT will increasingly affect middle-income taxpayers. In tax year 2005, about 13 percent of taxpayers with incomes between $100,000 and $200,000 will be subject to the AMT. But, when taxpayers file their tax returns in the spring of 2007 for tax year 2006, over 75 percent of taxpayers in this income group will be subject to the AMT.

To put this into perspective, consider how the AMT will affect a hypothetical joint filer with two children in tax year 2006 (see Chart 2). The taxpayer calculates tax liability under both the regular tax and the AMT and pays whichever is larger. The illustration reveals that in 2006 the hypothetical taxpayer becomes subject to the AMT when his income exceeds $67,890. The AMT is no longer a tax that applies only to the high income.

Chart 2: An illustration for a joint filer with two children in 2006



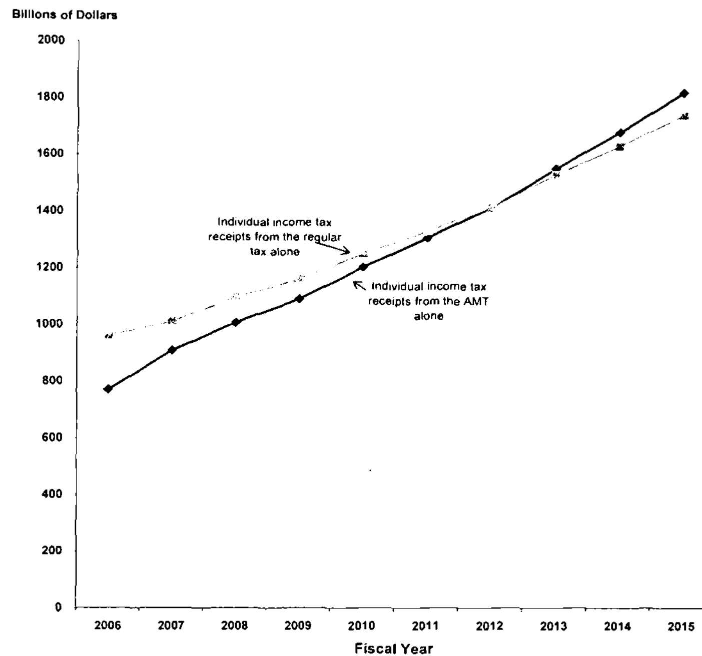
Note: Taxpayer is assumed to be married, file jointly, with two children, wage income only, and use the standard deduction

Source: US Department of the Treasury, Office of Tax Analysis

The AMT also increasingly affects families with children because it does not allow deductions for personal exemptions. Nearly all AMT taxpayers will lose at least part of the benefit of the 2001 through 2004 tax cuts, including some who will lose all the benefit. And many unsuspecting AMT taxpayers are subject to an effective marginal tax rate of 35 percent even though the maximum statutory AMT rate is only 28 percent because of the phase-out of the AMT exemption.

The increases in the number of AMT taxpayers over the next decade will be accompanied by dramatic increases in tax revenues from the AMT. AMT revenue will increase from $18 billion in 2005 to $210 billion in 2015 (roughly 11 percent of total individual income tax revenue). In fact, by 2013 the revenue raised by the AMT alone actually exceeds the revenues from the regular tax (Chart 3). Both the large numbers of taxpayers affected and the large amount of revenue suggest that the AMT problem will have to be addressed in the context of broader changes to the tax system.

Chart 3: Revenue from the Regular Tax Versus the AMT



Note Assumes EGTRRA and JGTRRA sunsets are repealed and the temporary AMT provisions expire in 2005

Source U S Department of Treasury, Office of Tax Analysis

Tax Reform and the AMT

In many respects, the AMT is a poster child for the need to reform the tax system. The AMT fails to meet all three of the criteria the President laid out when creating the Advisory Panel for Reform of the Federal Tax System. First, the AMT is not simple. The AMT requires taxpayers to comply with two parallel tax systems, often does not warn taxpayers that they have to deal with the second system, and the second system itself is unnecessarily complicated. Second, the AMT does not promote economic growth. In fact, the extra compliance costs and for many taxpayers the higher marginal tax rates imposed by the AMT discourages economic growth. And, third, the AMT is not fair. It disproportionately affects large families. It disallows some legitimate expenses incurred by taxpayers in order to earn income. It affects many middle-income and upper-middle-income taxpayers, but does not affect many taxpayers with the highest incomes.

Given the large revenue impact of the AMT and the extent to which the AMT is closely related and intertwined with the regular income tax, we need to consider broader solutions that will involve changes to the regular income tax. Thus, it is both inevitable and timely that the long-term solution to the AMT problem will be through broad reform of the income tax. Inevitable, because budgetary constraints preclude simple AMT repeal. Timely, because our overly

complicated tax system, which distorts economic decision-making and discourages economic growth, is in dire need of reform.

The current tax system imposes large costs on our economy by distorting the economic decisions of households and businesses, and tax reform that reduces those costs would encourage economic growth and improve living standards. Fundamental tax reform could increase our capital stock by 10 to 15 percent and ultimately increase real GDP by as much as 2 to 6 percent. More uniform treatment of different types of income, businesses and individuals could also produce significant economic gains by improving the allocation of economic resources and reducing economic waste.

The complexity of the income tax leaves many taxpayers with the sense that the system is unfair because others use special provisions to pay less tax. This sense of unfairness undermines voluntary compliance. It also encourages taxpayers to believe that they, too, should seek out tax minimizing strategies and behavior. In turn, that behavior only increases the economic costs and inefficiencies of our tax system.

Major revisions to our tax code occur every few years, with minor changes almost every year. Frequent changes in the tax code and uncertainty about the future make it difficult for individuals and businesses to make economic decisions. One goal of tax reform is a more stable tax system. Taxpayers should be able to plan without having to gamble about the future of the tax system.

The U.S. tax system not only imposes a cost to the economy by distorting households' and businesses' economic decisions and slowing economic growth, but it also imposes direct costs on taxpayers measured by the value of the time and resources devoted to complying with the tax system that could be put to more productive uses. According to the IRS, business and individual taxpayers spend more than 6 billion hours per year to comply with the tax system. To put this in perspective, this translates into a million and a half additional IRS agents. The total compliance costs of the income tax are estimated to be roughly $130 billion annually – about 13 cents for eve dollar in income tax revenues collected.[1] These compliance costs include both out-of-pocket cost and the time taxpayers spend to learn about the tax laws, keep and assemble necessary records, an prepare and submit tax returns.

Recent estimates are that individual taxpayers (including sole proprietors) spent roughly 3.5 billio hours annually complying with the tax system. According to a recent study based on IRS data, compliance costs for individuals – including the value of taxpayers' time – are roughly $90 billio a year. On average, individuals spent 26 hours a year on their federal income taxes and spent an average of $157 on out-of-pocket costs for the services of tax professionals, filing fees, software purchases, etc., in tax year 2002. Although taxpayers with self-employment income tend to have more complex affairs and spend more time and money on their taxes, even taxpayers without any self-employment income spend an average of 15 hours and $76 in out-of-pocket costs each year determining their tax obligations.

IRS estimates that businesses spend over 3 billion hours a year complying with the tax system. One analyst estimates the total cost to be about $40 billion annually. Recent academic research

indicates that compliance costs are the highest for the very largest businesses. Those with over $5 million in assets reported compliance costs of nearly $25 billion per year.

Certainly, a simpler tax system could decrease these burdens substantially and put these resources to more productive uses.

Criteria of a Well-Functioning Tax System

We suggest five criteria for evaluating proposals for tax reform: simplicity; pro-growth; fairness; fiscal responsibility; and stability.

A tax system should be easy to understand, have reasonable filing and record keeping requirements, including reduction or elimination of return filing, if possible, and have low cost and non-intrusive tax administration.

A tax system should be consistent with a strong economy. Business and household decisions should not be based on the tax code as little as possible. The tax code should promote economic growth by removing tax distortions and should maintain U.S. international competitiveness

A tax system should be fair. It should provide equal tax treatment of similarly situated taxpayers (horizontal equity) and a reasonable degree of progressivity, imposing higher taxes on those with a greater ability to pay (vertical equity).

A tax system should be fiscally sound. It should raise sufficient revenue to fund the federal programs that government chooses to provide.

A tax system should be stable. It should be resistant to frequent changes, especially those that change taxpayers' legitimate expectations.

The President's Tax Reform Panel

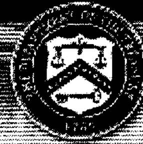
The President has made reforming our tax system a key priority. The President's Advisory Panel on Federal Tax Reform, named by the President earlier this year, is developing options to reform our tax system to make it simpler, fairer and more pro-growth. The Tax Panel brings a fresh perspective to tax reform. The members of the Panel are both independent and open-minded and are not wedded to particular approaches to tax reform. The Panel has a mandate to consider all options. The only constraints in the Panel's mandate are that its proposals should be revenue neutral, they should recognize the importance of housing and charitable giving to our American society, and that one of its options must include reform of the current income tax.

The Panel has been holding public hearings here in Washington, DC, and across the country to obtain the views of a wide range of knowledgeable and interested individuals about the problems with the current tax system and the merits of alternative ways to improve or reform the current system.

We are looking forward to the Panel's final report to the Secretary of the Treasury due by July 31. The options developed by the Panel will provide critical input for the recommendations on tax reform – including recommendations to address the AMT problem – the Secretary will then make to the President and the President will then make to the Congress.

Thank you again, Mr. Chairman, Senator Jeffords, and Members of the Committee for the opportunity to appear before you today. We look forward to working together with this Committee and others in the Congress on the AMT issue, on tax reform in general, and on other issues. I would be pleased to answer questions from the Committee.

PRESS ROOM



FROM THE OFFICE OF PUBLIC AFFAIRS

May 23, 2005
JS-2465

The Honorable John W. Snow
Prepared Remarks to: American Institute of Certified Public Accountants
Washington, DC

Thanks so much for having me here this afternoon. I hope you're having a terrific meeting, and that you're spending some quality time with your representatives on Capitol Hill. They need to hear your valuable perspective on the financial issues of the day!

Before I get started today I want to commend this group for your 360 Degrees of Financial Literacy effort. Treasury's Office of Financial Education is delighted to be working with you on national financial education efforts; our partnership is awfully important to the young people who will benefit from those efforts.

It has been said that, regardless of how much money you have, wisdom has to be acquired on the installment plan. Similarly, it is true that regardless of an individual's income, saving must be done steadily, deliberately, over a lifetime. Learning about how to become, and stay, financially healthy, is a life-long pursuit as well. So I want to thank you for giving back on this issue. It's a great gift to generations of Americans.

Speaking of generational issues, and of helping young Americans see a brighter financial future... I really appreciate the chance to talk with you today about a couple of policy items that I know are important to you in your profession, and that are of utmost importance to our President: strengthening the nation's Social Security system and reforming our tax code.

The President's leadership on Social Security is providing our country with a tremendous opportunity to save the program for current and near retirees and improve it for younger generations. His initiative to study and re-vamp the tax code offers great hope for increasing economic growth and decreasing taxpayer headaches!

Conversations like this are an important part of reaching decisions as to what, exactly, should be done in both of these critical areas.

Before we get into Social Security, I do want to talk about the American economy a little bit. Social Security and our tax code are such important parts of our economy – and the reform choices that are made in Washington will have such an impact – that I think it's important to start there.

We've seen amazing economic times in the last few years. Well-timed tax cuts, combined with sound monetary policy set by the Federal Reserve Board, got our economy moving when we needed it most. They gave business and industry the room they needed to grow, and they took over from there. As a result, economic growth was 4.4 percent last year, the strongest in five years.

We have had terrific news on jobs – 23 straight months of job growth. On the first Friday of this month, the Labor Department announced that 274,000 jobs were

created in April. The economy has created a total of 3.5 million new jobs since May 2003. That's great news – the best news – for 3.5 million families.

The President has made clear his commitment to strengthen our economy further. In addition to the Social Security and tax reform that I want to talk about in detail, this commitment also includes reducing the budget deficit, reducing the regulatory burden on business, and passing energy legislation. We expect the deficit to total 3.5 percent of GDP this fiscal year. Tight controls on discretionary spending and increased revenue as a result of economic expansion are expected to cut the deficit by more than half, to well under two percent of GDP, by fiscal year 2009.

The Treasury announced two weeks ago that we expect to pay down $42 billion in debt in the second quarter of this year, which is very good news and is primarily the result of higher individual tax receipts.

All of the strong economic indicators, and our ability to pay down debt, point to the fact that reducing the tax burden proved to be a successful economic stimulus. And when the economy is growing and spending is controlled, we can also reduce our deficit.

But the job of keeping our economy unencumbered is a never-ending one, indeed. From tax cuts to good trade policy, regulations and energy policy, we need to work on it every day, and we need to work on keeping it strong for the future, for the long-term. Reforming our Social Security and tax systems both address some critical long-term economic issues.

For example, the President's Advisory Panel on Tax Reform is working right now to come up with some options that will encourage growth and save Americans much of the time and headache that they currently spend complying with the tax code.

No one knows that headache better than the people here today, and I appreciate the fact that you have reached out to the tax panel to offer help and advice. We welcome your input.

A few raw facts illustrate well the problems of our current code: American taxpayers and businesses spend an estimated $130 billion dollars in lost time and money trying to comply with our increasingly unwieldy tax code. That's $130 billion in resources that could be used to create jobs, invest in new business, or spur consumer spending. The $130 billion burden our tax code places on the American people is a drag on economic growth and an unnecessary headache for Americans.

The President has asked that the fine people on the advisory panel be guided by the goals of increased fairness, simplicity and ease of understanding, and economic growth and job creation. He has also asserted that any reform proposal should carry on the good traditions of recognizing the importance of homeownership and charity in our society.

The panel has held 9 meetings so far and have heard testimony from about 90 expert witnesses. They are also receiving a wide range of critiques and ideas from all over the country. They're doing great work, and I am looking forward to receiving their recommendations by the end of July.

Please take a look at the tax panel's website for more information. The site, www.taxreform.gov, includes a great new summary of the issues and key themes the panel is considering.

I appreciate the President's leadership on tax reform, and I deeply admire his leadership when it comes to the national discussion on Social Security reform.

The President doesn't believe in burying one's head in the sand... which is essentially what you have to do to ignore the serious nature of the Social Security problem. The Social Security Trustees – for whom I serve as Board Chairman – issued our annual report on the financial health of the programs' trust funds on

March 23rd, and the numbers contained in that report leave little doubt that the system is financially unsustainable, and in need of expeditious and lasting change.

The Trustees' report showed that Social Security cash flows peak in 2008 and turn negative in 2017, and the trust fund itself will be exhausted in 2041. The unfunded obligation, that is, the difference between the present values of Social Security inflows (plus the trust fund) and outflows, is $11.1 trillion on a permanent basis, and $4.0 trillion over the next 75 years.

Now, the President doesn't believe that we should make up that shortfall with tax increases. The report showed just how much we would have to raise taxes to achieve long-term balance: the payroll tax rate would have to be raised immediately by 3.5 percentage points to make the system whole on a permanent basis. In other words, the payroll tax would have to be increased by nearly 30 percent.

That kind of tax increase would have significant, negative economic repercussions. Americans would start taking home less pay, and that's bad for countless facets of our economy. I imagine that you appreciate what I'm saying, as people who work closely with small businesses... and especially those of you who are small employers yourselves. Because employers, regardless of size, shoulder half of that tax increase – because they pay that tax on all of their employees. For the smallest of employers I fear that much of a tax increase would force you to make terrible choices, from lay-offs to health benefit cuts. And it would make hiring new people even more difficult.

Increasing payroll taxes hurts the economy and it hurts job creation, period. We know this from talking to job-creators – primarily small-business owners – all over the country, and that's why the President is against it.

It is also worth noting that payroll tax increases have been the standard "solution" to Social Security's problems, and they have never solved the problem! Payroll taxes have been raised some 20 times since Social Security was established – and it has failed to make the system solvent.

Tax increases aren't the answer, so the President has encouraged the Congress to propose a variety of ideas that might be, and he has put a number of ideas on the table as well.

The President has spoken very plainly about the realities of Social Security. Inevitably, workers face a reduction in benefits because the system will go broke in 2041. He has suggested a progressive indexing plan to make sure that those who are most in need – low-income workers – will be protected from that reduction in benefits.

The President proposes that, in the future, benefits for low-income workers should grow faster than benefits for people who are better off. By slowing the rate of increase of benefits for wealthier Americans, most of the funding challenges facing Social Security would be solved and the government will make good on this commitment: If you work hard and pay into Social Security your entire life, you will not retire into poverty.

A variety of other options are available to solve the rest of the solvency problem, and the President will work with Congress on any good-faith proposal that does not raise the payroll tax rate or harm our economy.

When the President took this issue to the country in his State of the Union Address, he said his objective was to engender a broad national dialogue to get people talking about this issue. He wanted Americans to talk about Social Security, and a national conversation has resulted.

People have been talking about the issue from the halls of Congress to the halls of local shopping malls. The President's leadership has drawn critical attention to the problem and is creating movement. Progress, real progress, is being made.

I imagine that you are talking about it with your spouse and family members, your business partners, customers and employees. Those conversations are critical, and I hope our meeting here today can help make them even more lively, more productive.

I know that you understand that if you are 55 or older your Social Security benefits are solid. They will not change. You know that you don't need to change your retirement plan or strategy because of Social Security reform, period.

But now I'll ask: how many of you have children or even grandchildren? It's those children and grandchildren, those young workers and future workers, who we need to be worried about. They are the ones for whom we need to fix this system.

The issue of Social Security is really a matter of basic arithmetic, and the threat to Social Security in the near future makes more sense when you look at the simple arithmetic. Social Security has enough money now because for decades we have had more than enough workers paying into the system, supporting the retirees drawing benefits.

In 1950, there were 16 workers to support every beneficiary of Social Security - a very comfortable ratio of those paying in versus those drawing benefits. Today there are only 3.3 workers supporting every beneficiary. By the time today's youngest workers – some of you may have children in that age group – turn 65, there will only be two workers supporting each retiree.

Just three years from now, in 2008, the first baby boomers will begin to retire. According to the new Trustees' report, the government will begin to pay out more in Social Security benefits than it collects in payroll taxes in 2017 – that's just 12 years from now. By 2041, when younger workers begin to retire, the system will be bankrupt.

We must make Social Security better for those younger workers.

Raising their payroll taxes won't make it better. What the President would like to see, instead, for future generations is an ability to save some of their payroll taxes, to build a nest egg that belongs to them, not to the government. Something they could pass on to their heirs. A nest egg that would give workers the prospect of a retirement that is far better than the rapidly-weakening promise of Social Security benefits.

Albert Einstein believed, and the President and I agree, that compound interest is one of the most powerful forces in the universe.

With voluntary personal accounts, younger workers would have the chance to learn about their financial choices, build a nest egg and benefit from sound long-term investment in the free market system without disrupting the system of benefits for today's retired beneficiaries.

Former Democratic Congressmen Tim Penny and Charlie Stenholm wrote something very important in a recent op-ed. They said that "opposing personal accounts is not a substitute for offering a positive solution for dealing with the challenges that face Social Security." They went on to say, astutely, that they "believe that if Social Security were being created from scratch today, Americans would want to include a way to help everyone build up a nest egg." The President and I couldn't agree more.

Social Security reform that doesn't raise payroll tax rates, that protects benefits for today's seniors, and that improves the system dramatically for our children and grandchildren ca*n be achieved*.

We are part of an exciting moment in American history, where a President's courageous leadership has inspired a national discussion and, I'm confident, will lead to historic results. I encourage you to be involved.

Thank you for having me here today to talk about the really historic policy efforts that are underway right now. This is an exciting time to be in government, and I'm extremely proud to be helping the President as we seek to achieve a safe and promising financial future for all Americans.

Thanks again; I'd be happy to take your questions now.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 23, 2005
js-2466

Address of Under Secretary Stuart Levey
The American Israel Public Affairs Committee Policy Conference 2005

It is a real pleasure to be speaking with you today. I have been an admirer of the great work this organization does since my days on the one-year program at Hebrew University in 1983 and 1984. I want to commend you for the important work that you are doing to promote strong ties between Israel and the United States and to advocate for a lasting peace in the Middle East.

The world's view of terrorism today is very different from when I attended my first AIPAC event. In 2005, people all over the world have come to recognize terrorism as among the most serious threats to freedom. Sparked by the attacks of 9/11, the world now recognizes the fight against terrorism as a vital cause. Brutal attacks from Madrid to Riyadh to Bali have shown that this threat is limited neither by region nor by ethnicity. And world leaders are beginning to see that terrorism is an absolute wrong - unjustifiable by cause or context. One striking symbol of this progress is that U.N. Secretary General Kofi Annan very recently published a report urging the U.N. to proclaim "loud and clear that terrorism can never be accepted or justified in any cause whatsoever." And significant for this audience, he also asserted that "The right to resist occupation ... cannot include the right to deliberately kill or maim civilians." We have come a long way.

These changes are welcome, but long overdue. For me, as I suspect for many of you, the events of 9/11 were shocking, but they did not introduce us to the threat of terrorism. Those of us here today have long been well aware of this threat, mindful that there were groups out there whose murderous attacks were limited only by means and opportunity. We all remember the Munich Olympics and Leon Klinghoffer and Pan Am 103 and Entebbe and Maalot and so many more. We all knew all along that terrorist groups could not be reasoned with or negotiated with, and that they sought nothing but destruction. As President Bush articulated in his address to you last year, "[Terrorists] kill without mercy. They kill without shame. And they count their victories in the death of the innocent."

You can imagine, then, how meaningful it is for me to play a role in this Administration's efforts to combat terrorism. I start off every morning reading the daily intelligence book, and then spend my day working to undercut the supply-lines of terrorist groups. It is, quite honestly, exhilarating. I often feel like the baseball players I used to watch growing up who, when asked about salary issues, would say "Are you kidding?? I get paid to do something that I love. I would do this for free." That is not something you hear very often these days from baseball players, but if you walked around my office, I think you would hear it quite a bit.

I would like to talk with you today about the work that we in the Treasury Department and the rest of the US Government are doing to track and disrupt the flow of money to terrorists.

To start, allow me to first introduce my office. I am the Under Secretary of the Treasury for Terrorism and Financial and Intelligence, or "TFI." TFI is a relatively new office. It was created in 2004 to oversee the Treasury Department's enforcement and intelligence functions aimed at stopping illicit money flows to terrorists and other criminals. The office brings a wide range of authorities and capabilities together under a single umbrella, allowing us to wield a range of tools

against various threats - whether they are terrorists, narcotics traffickers, proliferators of WMD or rogue regimes, like Iran and North Korea. We levy economic sanctions to pressure obstructionist regimes, and we have the ability to freeze the assets of wrongdoers. We also use regulatory authorities to help banks and other U.S. institutions implement systems to detect and halt corrupt money flows. Diplomatically, we work with governments around the world, pushing them to act with us against terrorists and other bad actors and to take critical steps to stem the flow of illicit finances.

I sometimes say that TFI fills an important niche in our national security system. When the U.S. is confronted with an overseas threat that is unreceptive to diplomatic outreach and when military action is not an option, TFI's tools - such as sanctions or the leverage we exert through the international financial bodies - are often the best authorities available to exert pressure and to wield a tangible impact.

Of all of the threats that we confront, terrorism is at the center of our sights. Combating terrorism effectively requires that we fight our enemies not only on the battlefield, but also in banks, money exchange houses, and underground financial networks. We do this both through targeted actions, such as blocking the accounts of terrorist financiers and front companies and sanctioning corrupt banks, and by systemic actions, such as by working with countries around the world, prodding them to put systems in place that will allow them to take similar actions.

It is now universally accepted that attacking terrorist financing is one of the most important ways we have to attack a terrorist organization. There are a number of reasons for this: first, money trails do not lie. Financial intelligence tends to be very reliable and people do not send money to another person for no reason at all. Tracking financial transactions is therefore often the best way to identify terrorists and their facilitators. Second, financing is a vulnerability for a terrorist group. Every time terrorists raise, store, or move money, they expose themselves to surveillance and attack. And third, while individual attacks may be inexpensive, it takes quite a bit of money to run a terrorist organization of global reach. Al Qaida paid the Taliban $10 to $20 million a year for safe haven. These organizations also need money to train, recruit, pay off operatives' families, purchase false travel documents, and so on. For all of these reasons, we are making our fight against terrorist financing a central part of the overall counterterrorism campaign.

I would like to focus today on charities, a funding channel that has proved to be especially attractive to terrorist groups -- al Qaida and HAMAS in particular. These organizations have long exploited the images of widows and orphans to fund an agenda of terror. There are a number of reasons why charities are so often abused by terrorists.

- Charities naturally focus their relief efforts on areas of conflict, which tend to also be prime locations for terrorist networks. Charities provide excellent cover for the movement of money, personnel, and even military supplies to and from high-risk areas.
- Unlike the funds of for-profit organizations, charitable funds are meant to move in one direction only; accordingly, large purported charitable transfers can move without a corresponding return of value and without arousing suspicion.
- Charities attract large numbers of unwitting donors along with the witting, thus increasing the amount of money available to terrorists.
- The "legitimate" activities of these charities, such as the operation of schools, religious institutions, and hospitals, create fertile recruitment grounds, allowing terrorists to generate support for their causes and to propagate extremist ideologies.
- To the extent that these charities provide genuine relief, which nearly all of them do, they benefit from public support and an attendant disinclination by many governments to take enforcement action against them.

We have attacked this problem aggressively, on multiple fronts. First, we have taken enforcement action to shut down those charities that we know to be aiding terrorists. To date, we have identified and designated more than thirty charitable organizations as supporters of terrorist groups, from al Qaida to HAMAS and

Palestinian Islamic Jihad.

Where the charities have a presence in the United States, we have frozen their assets and prevented them from engaging in any further fund-raising or donations. Where appropriate, we have also taken coordinated action with law enforcement. In the cases of the Holy Land Foundation and the Al Haramain Islamic Foundation, we blocked the assets of the organizations on the same day as law enforcement agents executed search warrants. We were thus able to ensure that no money flowed through these groups to terrorists as the investigations proceeded.

When the charities do not have a U.S. presence, we designate them domestically to prevent U.S. donors from contributing and to ensure that any money that transits the United States in the name of the charity is blocked. We also approach our international partners and the United Nations, where appropriate, to internationalize the sanctions. A good example of this is the HAMAS-affiliated Al Aqsa Foundation. Through its offices in Europe, Yemen, and elsewhere, Al Aqsa acted as a conduit of money for HAMAS. International action has now been taken against this organization: German authorities closed their Al Aqsa Foundation office, Dutch authorities blocked the charity's assets in The Netherlands, and criminal charges were pursued against three Al Aqsa Foundation officials in Denmark for supporting terrorism. Branch offices of Al Aqsa continue to function in other countries, however, and we will continue to pressure those governments to close the entire organization down.

One very positive development is that we are beginning to see international banks using the U.S. list of designated entities to screen transactions, even when they are under no domestic requirement to do so. Recently, a delegation from our office to Kuwait watched as a local bank demonstrated how it uses our list to determine whether to block or complete a transaction. These practices broaden the impact of U.S. designations exponentially, and we will continue to urge financial institutions to protect themselves against abuse in this manner.

Our most recent enforcement action against a charity took place on May 4, when we designated a Palestinian Islamic Jihad (PIJ) front, the Elehssan Society. I do not need to tell this audience about PIJ, which, as recently as February of this year, took responsibility for a terrorist attack in Tel-Aviv that killed five and wounded over 50. The Elehssan Society served as the fund-raising arm of PIJ in Gaza and the West Bank. It distributed funds to the families of PIJ prisoners and suicide bombers. We will continue to pursue this organization and any that rise up to take its place.

As we take enforcement actions, we have witnessed a noticeable deterrent impact on complicit donors who in the past might have used charities to direct money to terrorists. Our reporting indicates that once-willing donors are now thinking twice or balking altogether at sending money through charitable fronts, knowing that it may expose them to investigation or legal action.

This highlights an advantage that we enjoy in the financial arena of the war on terrorism: our targets have something to lose. In contrast to terrorist operatives who may be willing to die for their hateful cause, terrorist financiers typically live public lives with all that entails: property, occupation, family, and social position. Being publicly identified as a financier of terror threatens an end to all of this, lending our actions a real deterrent impact. We will continue to hold donors who knowingly contribute to terrorist organizations personally accountable as terrorists - just as much as operatives themselves.

Of course, the great majority of charitable donors in this country are well intentioned and are genuinely looking to help those in need. In one sense, our actions have warned such donors away from corrupt charities and encouraged them to be more careful with their donations in general. This is a success in its own right.

We recognize, however, that enforcement actions have also discouraged some well-intentioned donors from giving altogether, cutting off sources of needed relief. This predicament is especially acute in the Palestinian Territories, where HAMAS, PIJ, and other terrorist groups have so infiltrated the charitable sector that it is

difficult for innocent overseas donors to find a safe conduit for relief. We therefore see a particularly urgent need in this area to assure that such secure channels exist, beyond the reach of terrorists. In February, I met with President Abbas and various Israeli officials, in part to explore this idea. I was gratified to receive support and agreement from all sides. The Palestinian Authority needs to be able to provide a social safety net to the poor - that niche cannot be filled by terrorist organizations if there is to be peace. We are currently working with the relevant parties to develop options through which such aid can be provided safely, and I am hopeful that we will be able to do so.

Another regional focus of ours in addressing charities and terrorism has been the Gulf, and Saudi Arabia in particular. For too long, wealthy donors and multinational charities in Saudi Arabia were underwriting terrorism of all kinds, without any meaningful controls. Since 9/11, our government has worked aggressively to press the Saudis to take action against these financiers and to clean up their charitable sector. It is true that the Saudis have come a long way to improve their efforts against terrorist financing. It is also true that they probably had the furthest to go. Some progress has been made. The Saudis have closed down the domestic offices of the designated charity Al Haramain. In addition, until they are prepared to oversee their charitable sector properly, they have prohibited nearly all charities from moving money outside the country altogether.

One byproduct of these steps is that Palestinian terrorist groups, HAMAS in particular, have seen a sharp drop-off in funding from Saudi Arabia. While perhaps unintentional on the part of the Saudis, this is a real success, and one that Israeli officials told me had made a noticeable impact.

Of course, much remains for the Saudis to do. We impatiently await the creation of a commission to monitor the charitable sector, and continue to insist that this commission regulate all Saudi charities, without exception of such groups as the Muslim World League and the International Islamic Relief Organization, or "IIRO." Also, in addition to the export of terrorist funds, we are extremely concerned about the export of terrorist ideologies. These teachings are as indispensable to terrorists as money, and possibly even more dangerous. We must do all we can to ensure that extremist, violent ideologies are not disseminated under the cover of religious organizations, charities, or schools.

We are also continuing to press our European allies to address terrorist charities in their countries. The European Union has not yet reached agreement that Hizbollah should be designated a terrorist organization. HAMAS has been designated, but several prominent HAMAS charities continue to operate openly. Progress has been slow, but we will continue to stress these issues at every opportunity. We are still hopeful that our European counterparts will take a more aggressive role in combating terrorism of all kinds.

Time does not allow me to explore the work we are doing with respect to charities in all regions of the world, or the work we are doing in other sectors to counter the various conduits that terrorists have exploited to move money illicitly. I would like to note one other area, however, that I think will be of interest.

Last May, the Treasury Department designated Syria's primary international bank - the Commercial Bank of Syria - as a "primary money laundering concern," based on a lack of financial transparency and other issues, including terrorist financing. Pursuant to this designation, we issued a proposed rule that, when adopted in final form, will oblige U.S. financial institutions to sever all correspondent relations with this bank. This designation has had a remarkable impact on a notorious state sponsor of terrorism. The bank represents Syria's gateway to the international financial system and its access to international currencies like the U.S. Dollar.

In connection with the proposed rule, we delivered a long list of demands to the Syrians, ranging from reform of their banking sector to immediate, effective action to cut the flow of funds and other support across the Syrian border to terrorists and insurgents in Iraq. Over the past year, the Syrian Government has sought desperately to avoid finalization of this proposed rule and has taken some steps to address our concerns. In key respects, though, we remain unsatisfied - especially

about the support of terrorism and the Iraqi insurgency coming from within Syria. Syria will either take effective steps to address our concerns, or we will cut it off from our financial system.

The question I am asked most frequently is "How are we doing in fighting terrorist financing?" It is difficult to quantify our successes. Al Qaida does not release financial statements, and we will never know precisely how much money intended for terrorists never reached their hands due to our efforts. We therefore find ourselves discussing proxies for the ultimate questions: How many donors and facilitators have been captured; how many channels for moving terrorist funds have been designated and blocked; or how many countries are equipped to monitor and interdict illicit financing channels. Each of these benchmarks points to only one aspect of the problem, though, and imperfectly at that. Most revealing, to my mind, is intelligence reporting that - although anecdotal - speaks to the difficulty with which terrorists are raising, moving, and storing money. The information available to us is encouraging. We are seeing terrorist groups avoiding formal financing channels and instead resorting to riskier and more cumbersome conduits like bulk cash smuggling. Most importantly, we have indications that terrorist groups like al Qaida and HAMAS are feeling the pressure and are hurting for money.

It is critical, though, that we remain aggressive and adaptive. Terrorists and their supporters are constantly exploring new means to move and store money, and we cannot afford to become set in our ways. Those who work with me will tell you that I am not complacent and not very patient either. I can assure you that we will bring every intelligence and enforcement tool at our disposal to bear in attacking the financial underpinnings of terrorism. We have no higher priority.

Thank you.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 23, 2005
JS-2467

Treasury Secretary John W. Snow
Remarks to the National Association of State Treasurers
Legislative Conference
May 23, 2005

Thank you for having me here today. It's a pleasure to spend some time with the people who "safeguard the public purse!"

Every member of this group has weighty responsibilities, and I appreciate the goal of this organization to promote and encourage the highest ethical standards for its members.

Because when it comes to finance – whether it's the public or the private sector – the element of trust is critical. And without ethical standards and honest behavior, precious trust is quickly lost, and very slowly re-gained.

We've seen that in recent years with corporate scandals and corruption, and we've made progress in reminding corporate CEOs and boards and others that no one is above the law.

Yours is a group that has helped in those efforts, and I want to thank you for what you've done to rebuild investor confidence, boost market confidence and protect shareholder value. Your voices are very important in this area, and we welcome your input and the example you set.

A key element in your jobs – and in mine – is always remembering that the money comes from the people, from their work and the sweat of their brow. The money in state and federal coffers it is not magically generated by the government. As long as we remember where it came from, we will always respect it.

I appreciate the chance to talk with you today about a couple of issues that involve the people's money like no other, and they are issues that are of utmost importance to our President: strengthening the nation's Social Security system and reforming our tax code.

The President's leadership on Social Security is providing our country with a tremendous opportunity to save the program for current and near retirees and improve it for younger generations. His initiative to study and re-vamp the tax code offers great hope for increasing economic growth and decreasing taxpayer headaches!

Conversations like this are an important part of reaching decisions as to what, exactly, should be done in both of these critical areas.

Before we get into Social Security, I do want to talk about the American economy a little bit. Social Security and our tax code are such important parts of our economy – and the reform choices that are made in Washington will have such an impact – that I think it's important to start there.

We've seen amazing economic times in the last few years. Well-timed tax cuts, combined with sound monetary policy set by the Federal Reserve Board, got our economy moving when we needed it most. They gave business and industry the room they needed to grow, and they took over from there. As a result, economic growth was 4.4 percent last year, the strongest in five years.

We have had terrific news on jobs – 23 straight months of job growth. On the first Friday of this month, the Labor Department announced that 274,000 jobs were created in April. The economy has created a total of 3.5 million new jobs since May 2003. That's great news – the best news – for 3.5 million families.

The President has made clear his commitment to strengthen our economy further. In addition to the Social Security and tax reform that I want to talk about in detail, this commitment also includes reducing the budget deficit, reducing the regulatory burden on business, and passing energy legislation. We expect the deficit to total 3.5 percent of GDP this fiscal year. Tight controls on discretionary spending and increased revenue as a result of economic expansion are expected to cut the deficit by more than half, to well under two percent of GDP, by fiscal year 2009.

The Treasury announced two weeks ago that we expect to pay down $42 billion in debt in the second quarter of this year, which is very good news and is primarily the result of higher individual tax receipts.

All of the strong economic indicators, and our ability to pay down debt, point to the fact that reducing the tax burden proved to be a successful economic stimulus. And when the economy is growing and spending is controlled, we can also reduce our deficit.

But the job of keeping our economy unencumbered is a never-ending one, indeed. From tax cuts to good trade policy, regulations and energy policy, we need to work on it every day, and we need to work on keeping it strong for the future, for the long-term. Reforming our Social Security and tax systems addresses some critical long-term economic issues.

For example, the President's Advisory Panel on Tax Reform is working right now to come up with some options that will encourage growth and save Americans much of the time and headache that they currently spend complying with the tax code.

A few raw facts illustrate well the problems of our current code: American taxpayers and businesses spend an estimated $130 billion dollars in lost time and money trying to comply with our increasingly unwieldy tax code. That's $130 billion in resources that could be used to create jobs, invest in new business, or spur consumer spending. The $130 billion burden our tax code places on the American people is a drag on economic growth and an unnecessary headache for Americans.

The President has asked that the fine people on the advisory panel be guided by the goals of increased fairness, simplicity and ease of understanding, and economic growth and job creation. He has also asserted that any reform proposal should carry on the good traditions of recognizing the importance of homeownership and charity in our society.

The panel has held 9 meetings so far and have heard testimony from about 90 expert witnesses. They are also receiving a wide range of critiques and ideas from all over the country. They're doing great work, and I am looking forward to receiving their recommendations by the end of July.

Please take a look at the tax panel's website for more information. The site, www.taxreform.gov, includes a great new summary of the issues and key themes the panel is considering.

I appreciate the President's leadership on tax reform, and I deeply admire his leadership when it comes to the national discussion on Social Security reform.

The President doesn't believe in burying one's head in the sand... which is essentially what you have to do to ignore the serious nature of the Social Security problem. The Social Security Trustees – for whom I serve as Board Chairman – issued our annual report on the financial health of the programs' trust funds on March 23rd, and the numbers contained in that report leave little doubt that the system is financially unsustainable, and in need of expeditious and lasting change.

The Trustees' report showed that Social Security cash flows peak in 2008 and turn negative in 2017, and the trust fund itself will be exhausted in 2041. The unfunded obligation, that is, the difference between the present values of Social Security inflows (plus the trust fund) and outflows, is $11.1 trillion on a permanent basis, and $4.0 trillion over the next 75 years.

Now, the President doesn't believe that we should make up that shortfall with tax increases. The report showed just how much we would have to raise taxes to achieve long-term balance: the payroll tax rate would have to be raised immediately by 3.5 percentage points to make the system whole on a permanent basis. In other words, the payroll tax would have to be increased by nearly 30 percent.

That kind of tax increase would have significant, negative economic repercussions. Americans would start taking home less pay, and that's bad for countless facets of our economy. Employers, regardless of size, would shoulder the other half of that tax increase – because they pay that tax on all of their employees. For the smallest of employers I fear that much of a tax increase would force them to make terrible choices, from lay-offs to health benefit cuts. And it would make hiring new people even more difficult.

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Tax increases aren't the answer, so the President has encouraged the Congress to propose a variety of ideas that might be, and he has put a number of ideas on the table as well.

The President has spoken very plainly about the realities of Social Security. Inevitably, workers face a reduction in benefits because the system will go broke in 2041. He has suggested a progressive indexing plan to make sure that those who are most in need – low-income workers – will be protected from that reduction in benefits.

The President proposes that, in the future, benefits for low-income workers should grow faster than benefits for people who are better off. By slowing the rate of increase of benefits for wealthier Americans, most of the funding challenges facing Social Security would be solved and the government will make good on this commitment: If you work hard and pay into Social Security your entire life, you will not retire into poverty.

A variety of other options are available to solve the rest of the solvency problem, and the President will work with Congress on any good-faith proposal that does not raise the payroll tax rate or harm our economy.

When the President took this issue to the country in his State of the Union Address, he said his objective was to engender a broad national dialogue to get people talking about this issue. He wanted Americans to talk about Social Security, and a national conversation has resulted.

People have been talking about the issue from the halls of Congress to the halls of

local shopping malls. The President's leadership has drawn critical attention to the problem and is creating movement. Progress, real progress, is being made.

I imagine that you are talking about it with your spouse and family members, your business partners, customers and employees. Those conversations are critical, and I hope our meeting here today can help make them even more lively, more productive.

I know that you understand that if you are 55 or older your Social Security benefits are solid. They will not change. You know that you don't need to change your retirement plan or strategy because of Social Security reform, period.

But now I'll ask: how many of you have children or even grandchildren? It's those children and grandchildren, those young workers and future workers, who we need to be worried about. They are the ones for whom we need to fix this system.

The issue of Social Security is really a matter of basic arithmetic, and the threat to Social Security in the near future makes more sense when you look at the simple arithmetic. Social Security has enough money now because for decades we have had more than enough workers paying into the system, supporting the retirees drawing benefits.

In 1950, there were 16 workers to support every beneficiary of Social Security - a very comfortable ratio of those paying in versus those drawing benefits. Today there are only 3.3 workers supporting every beneficiary. By the time today's youngest workers – some of you may have children in that age group – turn 65, there will only be two workers supporting each retiree.

Just three years from now, in 2008, the first baby boomers will begin to retire. According to the new Trustees' report, the government will begin to pay out more in Social Security benefits than it collects in payroll taxes in 2017 – that's just 12 years from now. By 2041, when younger workers begin to retire, the system will be bankrupt.

We must make Social Security better for those younger workers.

Raising their payroll taxes won't make it better. What the President would like to see, instead, for future generations is an ability to save some of their payroll taxes, to build a nest egg that belongs to them, not to the government. Something they could pass on to their heirs. A nest egg that would give workers the prospect of a retirement that is far better than the rapidly-weakening promise of Social Security benefits.

Albert Einstein believed, and the President and I agree, that compound interest is one of the most powerful forces in the universe.

With voluntary personal accounts, younger workers would have the chance to learn about their financial choices, build a nest egg and benefit from sound long-term investment in the free market system without disrupting the system of benefits for today's retired beneficiaries.

Former Democratic Congressmen Tim Penny and Charlie Stenholm wrote something very important in a recent op-ed. They said that "opposing personal accounts is not a substitute for offering a positive solution for dealing with the challenges that face Social Security." They went on to say, astutely, that they "believe that if Social Security were being created from scratch today, Americans would want to include a way to help everyone build up a nest egg." The President and I couldn't agree more.

Social Security reform that doesn't raise payroll tax rates, that protects benefits for today's seniors, and that improves the system dramatically for our children and grandchildren ca*n be achieved.*

We are part of an exciting moment in American history, where a President's courageous leadership has inspired a national discussion and, I'm confident, will lead to historic results. I encourage you to be involved.

Thank you for having me here today to talk about the really historic policy efforts that are underway right now. This is an exciting time to be in government, and I'm extremely proud to be helping the President as we seek to achieve a safe and promising financial future for all Americans.

Thanks again; I'd be happy to take your questions now.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 24, 2005
js-2468

Statement of Timothy D. Adams
Nominee for Under Secretary of the Treasury for International Affairs
to the Committee on Finance
United State Senate

Chairman Grassley, Ranking Member Baucus, and members of the Committee on Finance, thank you for the opportunity to appear before you today. I am honored that President Bush nominated me to serve as Under Secretary of the Treasury for International Affairs and, if confirmed, to have the opportunity to work with Secretary John W. Snow, the Treasury staff and others in the administration.

If confirmed, I also look forward to working closely with this committee, the United States Senate and your colleagues in the House of Representatives to advance the President's economic agenda and to further the well-being of the American people.

I also want to thank Senator McConnell for introducing me. I have known the Senator for many years and am honored by his presence here today. Finally, I want to thank my wife Jennifer and our children for their unwavering support of my great passion, which is public service.

Indeed, if I am confirmed, this will be my third stint working in the Federal government, and I look forward to bringing my skills, knowledge and experiences to help address the great challenges before us and to seize the historic opportunities to advance the cause of freedom and improve living conditions everywhere.

For over 20 years, my academic and professional pursuits have helped prepare me for this position. My undergraduate and graduate work strongly focused on economic policy, especially international economic policy, and foreign affairs. Further, I co-founded and managed for seven years a highly respected consulting firm that advised leading financial institutions and corporations on global economic trends, conditions and policy.

I also served as Chief of Staff to two Treasury Secretaries (Paul O'Neill and John W. Snow), advising on key international economic issues, among other responsibilities. I participated in most of the important international events that Secretary O'Neill and Secretary Snow attended during the three year period 2001-2003, including meetings of the G7, APEC, G20, IMF, and the World Bank, as well as numerous bilateral meetings and foreign trips. I believe that I have a firm understanding of the critical international economic issues that confront the U.S. as well as the important participants and institutions.

In addition to policy issues, I also have substantial management experience in both the private and public sector. The Office of International Affairs at the Treasury Department is a large and critical organization with scores of talented people, and if confirmed, I will pay close attention to the management issues facing this office.

Finally, I believe that I bring to this challenging position important personal attributes, such as an inclusive, practical and analytical approach to problem solving and a diplomatic demeanor.

If confirmed, I will immediately tackle several pressing issues, including growing global imbalances, China's stable integration into the global financial system, preventing financial crisis and ensuring that development assistance is more effective -- especially in Africa. I will also work to implement the President's vision for the Middle East, establish closer ties with Latin America, open foreign markets for U.S. good and services, and support transitioning economies and democracies. Finally, I will continue to push the critical importance of economic growth, good governance, the rule of law and capital formation so that all parts of the global economy will become more vibrant and prosperous in the future.

Mr. Chairman, Senator Baucus, I am grateful for this opportunity to appear before you today. I would be pleased to answer any questions you and the other members of the Committee may have.

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FROM THE OFFICE OF PUBLIC AFFAIRS

May 24, 2005
2005-5-24-13-51-29-18826

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 $77,291 million as of the end of that week, compared to $78,410 million as of the end of the prior week.

I. Official U.S. Reserve Assets *(in US millions)*						
	May 13, 2005			May 20, 2005		
TOTAL	78,410			77,291		
1. Foreign Currency Reserves [1]	Euro	Yen	TOTAL	Euro	Yen	TOTAL
a. Securities	11,706	14,682	26,388	11,618	13,802	25,420
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	11,414	2,951	14,365	11,336	2,923	14,259
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]			15,184			15,159
3. Special Drawing Rights (SDRs) [2]			11,431			11,412
4. Gold Stock [3]			11,041			11,041
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets						
	May 13, 2005			May 20, 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		
	May 13, 2005	May 20, 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.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 25, 2005
JS-2469

The Honorable John W. Snow
Prepared Remarks
Financial Literacy and Education Commission Meeting
Washington, DC

It's my pleasure to welcome you all to the Treasury Department, and to its historic Cash Room.

We often talk about the history that echoes in this room... but I want to point out that history is still being made in this room today, and your group is a perfect example of that fact.

Yours is the kind of public-private coordination that really makes a difference in people's lives, and you are to be commended for that. Every time your work gives a young person – or a new American, or a baby boomer – the tools and knowledge they need to strengthen their financial future and protect themselves from identity theft, you have made an historic contribution to our country.

Every time a student leaves a "Teach Children to Save Day" event and opens a savings account, your work has made a difference. Every time a worker learns more about saving for their retirement from mymoney.gov or the 1-888-mymoney hotline, your work has mattered. And, down the road, when fewer young people are declaring bankruptcy and the national savings rate has increased... your work will have changed lives.

So I want to thank you for your commitment to this issue that is fundamentally important to all Americans. I'm extremely proud that President Bush and his administration are so dedicated to this cause. And I'm looking forward to seeing the national strategy for financial education next month, which I know you've worked very hard on.

You are capitalizing on a tremendous opportunity to start fresh with a new generation... to ensure that tomorrow's young adults understand how important it is to save, and how to protect themselves from identity theft, in the same way that they understand the basics of physical health or road safety.

As I've traveled the country to talk about saving and strengthening Social Security, it has been easy to see that there is a tremendous *interest* on the part of high school and college students to learn the financial facts of life. Young people want to know how to manage a credit card, how to save and invest. They have a growing appreciation for how important it is to save for retirement at the beginning of a career, not at the end.

As my son often tells me, young people don't believe Social Security will be there for them... so they want to learn about how to invest and save for their own retirement. The President and I hope that they will have the opportunity to save, to build a nest egg, as part of the Social Security system, and I believe that this interest in financial learning among younger generations will really help the launch and success of personal accounts.

One of the best things to come out of the Social Security debate so far has to do with financial education. Thanks to the President's leadership, more Americans understand how Social Security really works, and why its fiscal future is bleak.

There is also an increased appreciation for the need to get involved in one's own retirement future. Participating in the Social Security debate is part of that involvement, as is contributing to one's 401(k) or IRA.

The shape of the Social Security program for future generations is still a work in progress, but I believe that we can be very proud of the financial education that the debate has engendered thus far.

Thank you again for the excellent work you are doing on this Commission... I don't want to delay that work any longer, so I'll let you start this meeting by welcoming Chairman Dreier to the stage. Mr. Chairman, thank you for joining us...

FROM THE OFFICE OF PUBLIC AFFAIRS

May 25, 2005
JS-2470

Secretary John W. Snow
Prepared Remarks to Hunter College High School Students
Washington, DC

Good afternoon, and welcome to the Department of the Treasury. It's terrific to have you here, and I hope you enjoy your time in this historic building. Before you leave here today, don't forget to look at the wonderful statue of our first Treasury Secretary, Alexander Hamilton, outside the building's south entrance. Hamilton was an immigrant to this country, but lived much of his life as a New Yorker; his incredible life history should make you, his fellow New Yorkers, very proud.

I'm very happy to be able to talk with you today; spending time with sharp students like you is a real pleasure.

I want to commend you for studying government, and for your academic achievements. I know that you study very hard. But even with a lot of studying, sometimes it can be difficult to see the real-life importance of what you are learning. My hope is that our discussion today will help make what you've learned in class more "real."

I know that you have a keen interest in government, and I imagine you've learned quite a bit about the political parties - isn't it interesting how each party started and evolved? And you're learning about the checks-and-balances of our government, and how our founders designed it this way to get the best results for the people. After all, what makes our government special is that it was designed "of the people, by the people, for the people."

For so many decades, the parties have fought each other, battled for power and engaged in fascinating philosophical debates. But some of the greatest achievements of the two-party system have occurred when the two parties really work together, without animosity, to achieve great reforms, great good for our country.

Today, President Bush is encouraging the political parties to put aside their partisan bickering for the sake of *your* generation... specifically, so that we can strengthen and preserve the Social Security system for your benefit.

I know that retirement and Social Security must seem like such far-away parts of your life that you barely think about them. And I understand that; it's very natural. But I also hope you know that the national debate, the national dialogue about Social Security reform is really about you! The youngest generations of Americans stand to benefit so much from this debate... so I encourage you to read the newspaper and talk to your parents and teachers about it.

Your grandparents are the ones who receive Social Security benefits now... but reforming the system actually won't impact them. For anyone at or over the age of 55, the President has pledged that the system and its benefits won't change at all.

It could change for you. It must change for you. And it must change for the better. The results of this reform effort will impact the American economy, the amount of

taxes you'll pay when you're older, and whether you will be able to look forward to a comfortable retirement when you are done working.

Here's where we are right now: As your parents can tell you, part of each of their paychecks goes to fund Social Security. Workers pay half of the tax, and their employers pay the other half. If they are self-employed, they pay the whole tax themselves. That money goes to pay the Social Security benefits of *their* parents – that's your grandparents' generation.

Right now, this works pretty well because there are more than three people paying that tax for every one person collecting the benefits (receiving a Social Security check).

As you know from buying things to share with your friends – like splitting the cost of a pizza – the more people chipping in, the less each person pays.

When your generation is working and paying those taxes, there will only be two of you paying for the benefits of every retiree. Unless each of you pays a lot more in taxes – something the President doesn't think would be fair – then there won't be enough money to pay the full, promised benefits for your parents.

You see, when your parents' generation – called the baby boomers because there are so many of them – begins to retire, it will dramatically increase the cash flow demands of the system. By the year 2041 – when some of your parents are still collecting benefits and when you yourselves are beginning to approach retirement – if nothing is done to change the system, benefits would have to be cut, abruptly, by 26 percent and would continue to fall thereafter.

The problem only gets worse with every passing year, as generations get smaller in number and people live longer lives. Throughout the future of the system it will be more than $11 trillion short.

This is serious stuff. It can be downright frightening. But the good news is that we don't have to accept that as our future... it doesn't have to be *your* future.

The President wants to work with the Congress to make Social Security solvent - so that it runs "in the black," not in debt. He also wants to see your generation have the ability to save your own money in a personal account. That means you'd be able to build a nest egg of your very own that wouldn't belong to the government.

And, very importantly, the President wants to make sure that the taxes you pay when you are working full-time aren't too high. He wants workers to keep as much of the money they earn as possible. That's good for workers and it's good for our economy, for our prosperity.

I know you are learning in this class that government affects everyone. This issue of Social Security is a very good example of that fact. The decisions made by your government – that means your locally elected leaders, your state legislators, your governor, Congress and the President – really do impact your life. They impact your present and, in this case, they profoundly impact your future.

So while your retirement seems to be a million years away right now... take it from me, the time will go by quickly and it's never too early to think about saving money for the future. I hope that you'll follow the Social Security debate and think about what type of reform would make the future brighter for you.

We are all part of an exciting moment in American history, where a President's courageous leadership has inspired a national discussion and, I'm confident, will lead to historic results. I encourage you to be involved, whether it's talking about the issue with your parents and teachers, or writing a letter to your Members of Congress.

If we act now, we can make sure that Social Security, and our economy, are on sound financial footing for your generation.

I really appreciate the chance to talk with you about this important issue, and would be happy to take your questions now.

FROM THE OFFICE OF PUBLIC AFFAIRS

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May 25, 2005
JS-2471

Treasury and IRS Propose Regulations on Retirement Plans
Proposed Rules Allow Members of the National Guard and Reserve to Contribute to Retirement Plans While on Active Duty

WASHINGTON, DC -- The Treasury Department and IRS today issued proposed regulations relating to the section 415 limits on benefits and contributions under qualified retirement plans. These regulations consolidate past guidance on changes in the law over the past 25 years and provide additional guidance that answers many outstanding questions for plan sponsors and administrators. The regulations will, among other things, address the application of the defined benefit limits when an employee receives multiple benefit streams beginning at different ages and the treatment of compensation paid after an individual terminates employment.

Significantly, the proposed regulations will specifically provide that National Guard and Reserve members are permitted to continue to contribute to their employer's retirement plan while on active duty. "We believe it is important that members of the National Guard and Reserve not lose the opportunity to save for retirement while they are serving our country," said Eric Solomon, Treasury's Acting Deputy Assistant Secretary for Tax Policy.

The rules relating to post termination compensation and the associated clarifications on the ability to contribute to retirement plans for members of the National Guard and Reserve will also apply to section 403(b) tax deferred annuities and Section 457 eligible deferred compensation plans. Plan administrators may rely on today's proposed regulations immediately to allow service members to contribute to qualified retirement plans.

The proposed regulations will formally go into effect in years beginning in 2007. A public hearing on the proposal is scheduled for August 17, 2005.

REPORTS

- Proposed Regulations

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 11

[REG-130241-04]

RIN 1545-BD52

Limitations on Benefits and Contributions Under Qualified Plans

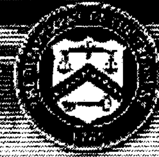
AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed amendments to the regulations under section 415 of the Internal Revenue Code regarding limitations on benefits and contributions under qualified plans. The proposed amendments would provide comprehensive guidance regarding the limitations of section 415, including updates to the regulations for numerous statutory changes since regulations were last published under section 415. The proposed amendments would also make conforming changes to regulations under sections 401(a)(9), 401(k), 403(b), and 457, and would make other minor corrective changes to regulations under section 457. These regulations will affect administrators of, participants in, and beneficiaries of qualified employer plans and certain other retirement plans. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by July 25, 2005. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for August 17, 2005, at 10 a.m., must be received by July 27, 2005.

PRESS ROOM



FROM THE OFFICE OF PUBLIC AFFAIRS

May 25, 2005
JS-2472

Statement from Treasury Secretary Snow on House Financial Service Committee passage of GSE Reform Legislation

Today's action by the House Financial Services Committee on GSE reform legislation moves the process forward.

As the process continues, we will be working with the House and Senate to ensure that the bill is strengthened so that the final product provides for a strong, independent regulator which has all the necessary tools to do the job. Directing the regulator to place limits on the size of the GSE's retained mortgage portfolio is a critical element of reform.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 26, 2005
JS-2473

**Testimony of Treasury Secretary John W. Snow
Before the
Senate Committee on Banking, Housing and Urban Affairs
on the Treasury Department's
"Report to Congress on International Economic and
Exchange Rate Policies"
May 26, 2005**

Chairman Shelby, ranking member Sarbanes, members of the Committee, it is a great pleasure to appear before you to testify on the Treasury Department's latest report on "International Economic and Exchange Rate Policies."

The May 2005 Report encompasses a period of strong global economic performance, which reflects both great opportunity and challenge. The global expansion remains robust, more so than in many decades.

Addressing imbalances in the global economy is a shared responsibility among the major economic regions of the world. While imbalances occur as the patterns of trade and investment flows shift between economic regions, uneven rates of growth in the major economies and inefficient or distortionary policies restrict adjustments and put stress on the global financial systems. Economic policymakers must address these imbalances now; waiting increases the risk that adjustments will occur abruptly.

We know that the international economy performs best when large economies embrace free trade, the free flow of capital, and flexible currencies. Obstacles in any of these areas prevent smooth adjustments. At best, such obstacles result in less than maximum growth; at worst, they create distortions and increase risks.

The United States is doing its part to address imbalances by aggressively tackling our fiscal deficit and our long-term liabilities. Because of strong growth and appropriate fiscal policy, the U.S. budget deficit in 2004 was well below projections, and with recent data, I expect improvement in our fiscal deficit position this year as well. [Some private forecasters predict that our fiscal deficit will be below 3% of GDP this year if we continue to hold the line on spending.] We are also working to put in place innovative policies to increase the savings rate. But our actions alone will not be sufficient.

I expect strong economic growth in the United States to continue. This is in the U.S. interest, and the world's. It is an essential component of our deficit reduction strategy as strong growth results in rising government receipts, as we have been seeing. But it is important to recognize that there is also no one-to-one correspondence between reductions in our fiscal and current account deficits. We do not, and will not, have a current account target. The best contribution the United States can make to our own people and the global economy is to keep our economic house in order and ensure continued strong growth.

Our actions alone will not be sufficient to unwind global imbalances. Simply put, large imbalances will continue if growth in our major trading partners continues to lag. European and Japanese GDP together exceeds that in the United States. Some European countries, such as Ireland and Spain, continue to perform well.

But on the continent, notable weaknesses persist, and Japanese growth, while turning upward, remains modest. These economies must continue to adopt and implement vigorous and necessary structural reforms to establish robust rates of growth – both for the good of their own citizens and to contribute to reduction in the imbalances in the global economy.

The Treasury Department's Report to Congress on International Economic and Exchange Rate Policies outlines the currency practices of America's major trading partners. The report addresses the third -- and most immediately pressing -- element of the effort to address global imbalances: the imperative of exchange rate flexibility, especially in emerging Asian economies.

The report finds that no major trading partner of the United States met the technical requirements of the statute for designation during the period covered, which is the second half of 2004. However, it would be a mistake to interpret this conclusion as acquiescence with the foreign exchange policies of many of America's trading partners. In fact Treasury is actively engaged with several economies to promote the adoption of flexible, market-based exchange policies and to help facilitate broader adjustment. Most notable among these is China.

While the currency report that you have before you discusses several countries I would like to focus my remarks here on China. China's rigid currency regime has become highly distortionary. It poses risks to the health of the Chinese economy, such as sowing the seeds for excess liquidity creation, asset price inflation, large speculative capital flows, and over-investment. It also poses risks to its neighbors, since their ability to follow more independent and anti-inflationary monetary policies is constrained by competitiveness considerations relative to China. Sustained, non-inflationary growth in China is important for maintaining strong global growth and a more flexible and market-based renminbi exchange rate would help the Chinese achieve this goal.

A more flexible system will also support economic stability, which we understand is of paramount concern to Chinese leadership. China's ten-year-long pegged currency regime may have contributed to stability in the past, although it no longer does so, as China has grown to be a more significant participant in global trade and financial flows. Currently, China relies largely on administrative controls to manage its economy – controls that are cumbersome and increasingly ineffective. An independent monetary policy will allow China to more easily and effectively pursue price stability, stabilize growth, and respond to economic shocks. China has a history of significant swings in credit-fueled investment and inflationary pressures and these have often ended in "hard landings." Such swings are disruptive to the Chinese economy and may prove more disruptive in the future – not only to China but also to the global economy.

A more flexible system will allow for a more efficient allocation of resources and higher productivity. The current system is fueling over-investment and excessive reliance on export-led growth while under-emphasizing domestic consumption. Moreover, much of the investment and capital flows into these favored sectors and projects may not prove profitable under market-determined prices, which could lead to another investment hard landing, more non-performing loans and a weakened banking sector.

And a more flexible system would also quell speculative capital inflows that are costly to China's government and increasingly likely to prove disruptive. China's ability to sterilize capital inflows is increasingly limited and harmful to its banking sector.

Finally, recent history has taught us that it's better to move from a fixed to a flexible currency system during from a position of strength, and not when economic weakness compels reform.

Chinese officials have publicly acknowledged the need to move to a more flexible system, have repeatedly vowed to do so, and have undertaken the necessary and appropriate steps to prepare for such a move.

In September of 2003, I began an intensive engagement with China, aimed at hastening China's move to a more flexible exchange rate. I believe that this financial diplomacy has yielded important results. Since then, China has taken critical steps to establish the necessary financial environment and infrastructure to support exchange rate flexibility.

- It has introduced a foreign currency trading system permitting onshore spot trades in eight foreign currency pairs and allowing banks to act as market makers.
- It has adopted measures to increase the volume of foreign exchange trading, for example: eliminating the foreign exchange surrender requirement for many commercial firms; allowing domestic Chinese insurance firms and the national social security fund to invest in overseas capital markets; and increasing the amount of foreign currency business travelers can take out of the country.
- It has taken steps to develop foreign exchange market instruments and increase financial institutions' experience in dealing with fluctuating currencies. Foreign exchange forward contracts can now be offered in China; foreign exchange futures are being developed; and domestic Chinese banks can now trade dollars against other foreign currencies, not just remnimbi.
- It has also acted to strengthen its financial sector and regulation, so that this sector is more resilient to any fluctuations in exchange rates.

As a result of our approach, of constant intense engagement, China is now ready to introduce flexibility and should do so now.

Unfortunately, the debate on China's currency regime is clouded by a number of misconceptions of U.S. policy. Allow me to address a couple of these. First, we are not calling for an immediate full float with fully liberalized capital markets. This would be a mistake at this time – China's banking sector is not prepared. What we are calling for is an intermediate step that reflects underlying market conditions and allows for a smooth transition – when appropriate – to a full float.

Second, we recognize that a more flexible system in China, in and of itself, will not solve global imbalances – as I have said, this is a shared responsibility. However, greater flexibility in China and other Asian economies is a necessary component.

Third, some argue that a more flexible system will prove deflationary and increase Chinese unemployment. In fact, a flexible system will provide China with a more sophisticated array of policy tools – namely an independent monetary policy – that will prove much more effective in achieving price stability and the ability to adjust to shocks.

Our engagement with China over the past two years, including fruitful accomplishments associated with Treasury's joint Technical Cooperation Program, leaves me with little doubt that China is now prepared to begin reform of its currency regime.

In fact, I believe that the risks associated with delay far outweigh any concerns with immediate reform. The current system poses a risk to China's economy, its trading partners, and global economic growth. Concerns of competitiveness with China also constrain neighboring economies in their adoption of more flexible exchange policies.

As the report that was sent to Congress last week states, if current trends continue without substantial alteration, China's policies will likely meet the technical requirements of the statute for designation. China is now ready and should move without delay in a manner and magnitude that is sufficiently reflective of underlying market conditions.

As the need for adjustment is global, multilateral organizations are addressing the need for flexibility. The Group of Seven finance ministers and central bank governors have adopted a policy, stated in its communiqués, that "...more flexibility

in exchange rates is desirable for major countries or economic areas that lack such flexibility to promote smooth and widespread adjustments in the international financial system, based on market mechanisms." The Asian Development Bank and the Asia-Pacific Economic Cooperation (APEC) have also publicly stressed the importance of flexible currency regimes.

The chief officers of the International Monetary Fund and the Asian Development Bank have also stressed the need for currency flexibility. I have called on the International Monetary Fund (IMF), as part of its strengthening of multilateral and regional surveillance, to report on the potential contribution of emerging Asia to unwinding global imbalances, including an analysis of the regional impact of the Chinese foreign exchange system. As policy-makers, we have a responsibility to fully understand these important forces that are shaping the global economy. As the central international institution for global monetary cooperation, with a wealth of technical expertise, the IMF is best placed to undertake this work, and indeed has the responsibility for doing so.

It is critical that we address the issues of imbalances aggressively and in a cooperative spirit with the goal of raising global growth. Nothing would do more damage to the prospects of increasing living standards throughout the world than efforts to inhibit the flow of trade. However, it is incumbent on China to address concerns before mounting pressures worldwide to restrict trade harm the openness of the international trading system.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 26, 2005
js-2474

Statement of Treasury Secretary John W. Snow on First Quarter GDP Growth

Today's announcement that real GDP grew at a 3.5 percent annual rate in the first quarter shows that the foundation of America's economy continues to be sound and strong. Payroll jobs are up by 3.5 million, the homeownership rate is at a record high, and, at 5.2%, the unemployment rate is below the average of each of the past three decades. Furthermore, today's GDP report revised wages and salaries for the end of last year much higher, showing added strength in income for U.S. workers. America's economy has been moving in the right direction and Americans are seeing results because of President Bush's commitment to reducing their tax burden.

President Bush is committed to keeping the economy on the path of healthy growth by making the tax cuts permanent, reducing the burden of frivolous lawsuits, passing a national energy policy, and strengthening Social Security.

FROM THE OFFICE OF PUBLIC AFFAIRS

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May 27, 2005
JS-2475

Statement of Treasury Secretary John W. Snow on Resignation of Acting Assistant Secretary for Financial Institutions Gregory Zerzan

The Treasury is preparing to bid farewell to a highly valued member of its team. Gregory Zerzan has served in Treasury's Office of Domestic Finance since March of 2003, first as Deputy Assistant Secretary for Financial Institutions Policy and currently as Acting Assistant Secretary for Financial Institutions. His expertise and contributions on legislative and policy matters involving financial institutions have been invaluable, and he has been a highly effective leader within the Office of Domestic Finance, as well as among the Treasury management team. Greg's sharp mind and engaging personality will be missed by his colleagues and staff, and I speak on behalf of the Department in saying we wish him the very best in his future endeavors.

REPORTS

- Zerzan Resignation Letter

The Honorable George W. Bush
President of the United States
The White House
Washington, DC 20500

Dear Mr. President:

It has been my privilege to serve your Administration for over two years. In that time, I have been honored to help play a part in many historic undertakings, including overseeing the Terrorism Risk Insurance Program, reforming the regulation of the government sponsored enterprises, and helping to keep the promise of Social Security for future generations.

It is with a heavy heart, therefore, that I now tender my resignation from service as Acting Assistant Secretary for Financial Institutions in the United States Treasury, effective June 20, 2005. I am grateful to you and the many fine people with whom I have served, and I will always feel privileged to have worked to promote your leadership in keeping America safe both at home and abroad. Thank you for honoring me with your trust.

Sincerely,
Gregory Zerzan

FROM THE OFFICE OF PUBLIC AFFAIRS

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May 27, 2005
JS-2476

Treasury and IRS Issue Guidance on Personal Use of Corporate Aircraft

WASHINGTON, DC -- Today the Treasury Department and the IRS issued guidance on the tax treatment of the personal use of corporate aircraft for entertainment travel. The Notice issued today explains how to apply the American Jobs Creation Act of 2004 (AJCA) limitation on the costs that a business may deduct when an executive uses the company's aircraft for entertainment travel. This Notice provides interim guidance until regulations are promulgated.

Under prior law, if an employee used a business aircraft for entertainment travel, the employer could deduct the cost of providing the flight. As is commonly the case with fringe benefits, the employee is then required to report the value of the flight as additional income for tax purposes. Previously, while the employer generally would deduct the total cost of providing the flight, often many thousands of dollars, the employee would add only a relatively small amount, calculated under the Department of Transportation's Standard Industry Fare Levels (SIFL) formula, to income. For flights by executives, this asymmetry between the large amount the company deducted and the small amount the executive included as taxable income was addressed by the AJCA.

Under the AJCA, the business' deduction may no longer exceed the amount that the executive takes into income for the entertainment use of the aircraft. The definition of "entertainment use" in the guidance is taken from the existing statute. Generally, "entertainment use" is considered an amusement or recreational activity, such as traveling to a sporting event or to a vacation destination. If the purpose of the trip is business related entertainment, the limitation enacted by the AJCA applies to the executive as well.

Today's Notice clarifies who is covered by the limitation, describes the relevant costs, and illustrates the allocation of the costs for an entertainment flight. Although the Notice focuses on aircraft, the principles of the Notice may apply to other entertainment as well.

REPORTS

- A copy of the Notice

Part III - Administrative, Procedural, and Miscellaneous

Deductions for Entertainment Use of Business Aircraft

Notice 2005-45

This notice provides interim guidance to taxpayers on the limitation under § 274(e) of the Internal Revenue Code on the deductible amount of trade or business expenses for use of a business aircraft for entertainment. Section 274(e) was amended by § 907 of the American Jobs Creation Act of 2004 (AJCA), effective for amounts incurred after October 22, 2004. The rules provided in this notice apply until regulations are effective.

A. BACKGROUND

Under § 274(a)(1)(A), no deduction is allowed for an activity generally considered to be entertainment, amusement, or recreation, unless the taxpayer establishes that the activity is directly related to or (in certain cases) associated with the active conduct of the taxpayer's trade or business. Section 274(a)(1)(B) disallows deductions for facilities used in connection with entertainment, amusement, or recreational activity, regardless of connection to the taxpayer's trade or business.

Section 1.274-2(b)(1) of the Income Tax Regulations provides that entertainment means any activity of a type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at night clubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing,

vacation and similar trips. Similar activities relating solely to the taxpayer's family also may constitute entertainment. Entertainment may include an activity that satisfies the personal, living, or family needs of an individual, such as providing food and beverages or a hotel suite to a business customer or the customer's family. Entertainment does not include activities, however, that are clearly not regarded as constituting entertainment, such as the provision of supper money by an employer to an employee working overtime, the maintenance of a hotel room by an employer for lodging of employees while in business travel status, or the use of an automobile in the active conduct of a trade or business even though also used for routine personal purposes such as commuting to and from work. Under § 1.274-2(b)(1)(ii), an objective test is used to determine whether an activity is of a type generally considered to constitute entertainment.

Section 274(e) provides exceptions to the general disallowance provisions of § 274(a). Prior to amendment by the AJCA, § 274(e)(2) excepted expenses from § 274(a) "to the extent that the expenses are treated by the taxpayer" as compensation to the employee/recipient of the entertainment activity. Section 274(e)(9) similarly excepted expenses to the extent that the expenses are treated by the taxpayer as income to persons who are not employees.

Section 274(o) provides that the Secretary shall prescribe regulations necessary to carry out the purposes of the section.

Generally, § 1.61-21(b) requires an employee to include in gross income the fair market value of a fringe benefit, such as an entertainment flight (reduced by any

reimbursement or statutory exclusion). For employee flights on employer-provided noncommercial aircraft, § 1.61-21(g) provides that an employer may value such flights using the Standard Industry Fare Level (SIFL) formula. Under § 1.61-21(g)(14)(i), an employer that uses the SIFL formula in a calendar year to value any flight provided to an employee during a calendar year must use the SIFL formula to value all flights provided to employees during that calendar year. The fringe benefit rules under § 1.61-21(g) generally apply to all service providers, including employees, independent contractors, partners, and directors. The regulations do not permit valuation of a flight by reference to the employer's costs.

Ann. 85-113, 1985-31 IRB 31, allows an employer to elect the frequency at which in-kind fringe benefits are treated as paid. The benefits must be treated as paid no later than the end of each calendar year, but in-kind fringe benefits provided during the last two months of a calendar year may be treated as paid during the subsequent calendar year. See Ann. 85-113, sections 1 and 5(a).

In *Sutherland Lumber-Southwest, Inc. v. Comm'r*, 114 T.C. 197 (2000), *aff'd* 255 F.3d 495 (8th Cir. 2001), *acq.* AOD 2002-02 (Feb. 11, 2002), the Tax Court held that the amount a taxpayer may deduct for the cost of entertainment-related flights under the § 274(e)(2) exception is not limited to the amount included in the income of the employees and corporate officers who took the flights. Rather, the court held that a taxpayer may deduct the full cost of an employee's or officer's non-business flight on the taxpayer's aircraft if the taxpayer includes in the recipient's income the value of the flights computed under the rules of § 1.61-21. As a result, a deduction greater than the

amount included in the recipient's income was allowable.

The ACJA amendment to § 274(e)(2) and (9) is intended to overturn *Sutherland Lumber-Southwest, Inc. v. Comm'r.* H.R. Conf. Rep. No. 108-755, at 798 (2004). Specifically, as amended by § 907 of the AJCA, the § 274(e)(2) and (9) exceptions to the § 274(a) disallowance apply in the case of a "specified individual" only "to the extent that the expenses do not exceed the amount of expenses" that are treated as compensation to the specified individual. A specified individual is any individual who is subject to the requirements of § 16(a) of the Securities Exchange Act of 1934 (15 U.S.C. § 78p(a)) with respect to the taxpayer, or who would be subject to those requirements if the taxpayer were an issuer of equity securities referred to in that section. Section 274(e)(2)(B).

Thus, in the case of a specified individual, the § 274(e)(2) and (9) exceptions apply only to the extent that a taxpayer treats as compensation to the specified individual an amount equal to or greater than the amount of deductible entertainment expenses allocable to entertainment provided to the specified individual. Expenses allocable to entertainment provided to the specified individual that are not treated as compensation to the specified individual are disallowed.

This notice specifically addresses expenses paid or incurred in connection with the use of aircraft as entertainment. Section 274 (e)(2) and (9), however, apply to all expenses subject to § 274(a). Taxpayers may apply the principles of this notice to expenses paid or incurred in connection with other entertainment activities.

B. APPLICATION

(1) In general

In general, the use of an aircraft for an employee's or other recipient's entertainment, amusement, or recreation is subject to § 274(a) unless excepted by § 274(e). Expenses for entertainment use of an aircraft by a specified individual are disallowed except to the extent of the amount treated as compensation to the specified individual, as provided in this notice. The amount disallowed with regard to a specific flight also is reduced by any amount that a specified individual reimburses the taxpayer for that flight.

(2) Use of aircraft for entertainment

Whether an aircraft is used for entertainment of a specified individual is determined without regard to the ownership of the aircraft. Therefore, the costs of leased or chartered aircraft are subject to disallowance under § 274(a) (unless excepted by § 274(e)) and this notice. Furthermore, § 274(a) and (e) and this notice apply to the costs of aircraft operated on a regular schedule or used for bona fide security concerns (as provided in § 1.132-5(m)).

(3) Specified individuals

A "specified individual" is either an individual who is subject to § 16(a) of the Securities Exchange Act of 1934 with respect to the taxpayer, or an individual who would be subject to § 16(a) if the taxpayer were an issuer of equity securities referred to in that section. "Specified individual" includes every person who (a) is the direct or indirect beneficial owner of more than 10 percent of any class of any registered equity security (other than an exempted security), (b) is a director or officer of the issuer of the

security, (c) would be the direct or indirect beneficial owner of more than 10 percent of any class of a registered equity security if the taxpayer were an issuer of equity securities, or (d) is comparable to an officer or director of an issuer of equity securities. Thus, a "specified individual" is an officer, director, or more than 10% owner of a corporation taxed under subchapter C or subchapter S, or a personal service corporation. For partnership purposes, "specified individual" includes any partner that holds a more than 10% equity interest in the partnership, general partner, officer, or managing member of a partnership. "Specified individual" also includes a director or officer of a tax-exempt entity.

The provisions of this notice apply to the use of an aircraft for the entertainment of a specified individual of a party related to the taxpayer within the meaning of § 267(b) or § 707(b). Thus, if X and Y are related corporations within the meaning of § 267(b) and Y provides entertainment use of an aircraft to A, who is a specified individual as to X, Y's costs are disallowed (except to the extent treated as compensation to A or reimbursed by A) under § 274(e)(2)(B).

For purposes of this notice, a specified individual is the recipient of entertainment provided to a spouse or family member of the specified individual or to another person because of the person's relationship to the specified individual. See § 1.61-21(a)(4). Thus, costs allocable to entertainment provided to a spouse, family member, or other person are attributed to the specified individual for purposes of determining the amount of disallowed costs. As used hereafter in this notice, the term "specified individual" includes any person to whom a taxpayer has provided entertainment that is attributable

to a specified individual under this paragraph.

(4) Expenses of aircraft subject to disallowance

For purposes of calculating the amount of expenses for entertainment use of an aircraft that are disallowed (except to the extent treated as compensation to or reimbursed by a specified individual) under § 274(e)(2)(B) or (9), taxpayers must take into account all of the expenses of maintaining and operating the aircraft (all fixed and operating costs). These expenses include, but are not limited to, fuel costs; salaries for pilots, maintenance personnel, and other personnel assigned to the aircraft; meal and lodging expenses of flight personnel; take-off and landing fees; costs for maintenance and maintenance flights; costs of on board refreshments, amenities, or gifts; hangar fees (at home or away); management fees; depreciation; amounts deductible under § 179 ; in the case of chartered aircraft, all costs billed for the charter (including amounts for flight time, waiting time, fuel, and overnight expenses); and, in the case of leased aircraft or other leased equipment, lease payments.

(5) Method of allocating expenses to flights

For purposes of § 274(e)(2)(B) and (9), the total deductible expenses attributable to the aircraft must be allocated to expenses for use of the aircraft for entertainment of specified individuals and expenses for all other uses. A taxpayer must allocate expenses for each taxable year using either occupied seat hours or occupied seat miles flown by the aircraft and must apply the chosen method consistently for all usage for the taxable year. Occupied seat hours or miles is the sum of the hours or miles flown by an aircraft multiplied by the number of seats occupied for each hour or mile. For example,

a flight of 6 hours with three passengers aboard results in 18 occupied seat hours. See the special rule for "deadhead" flights, below.

Taxpayers must aggregate all fixed and variable expenses to determine the total expenses paid or incurred during the taxable year and divide the amount of total expenses by total occupied seat hours or occupied seat miles flown to determine the cost per occupied seat hour or occupied seat mile. Taxpayers may calculate the cost per occupied seat hour or occupied seat mile separately for each aircraft or may aggregate the costs of aircraft of similar cost profiles. For example, the costs of a turboprop aircraft may not be aggregated with the costs of a jet aircraft and the costs of a two-engine jet aircraft may not be aggregated with the costs of a four-engine jet aircraft.

The amount disallowed under § 274 is the sum of (a) the cost of each occupied seat hour (or mile) flown by a specified individual for entertainment purposes, less (b) the sum of the amount treated as compensation and the amount reimbursed for each specified individual and each flight. Therefore, to determine the amount subject to disallowance, taxpayers must allocate the costs to the specific entertainment flight provided to a specified individual and compare the cost of each flight to the amount treated as compensation to or reimbursed by the specified individual for that flight.

Example

A taxpayer's aircraft is used for Flights 1, 2, and 3, of 5 hours, 5 hours, and 4 hours, respectively, during the taxpayer's taxable year. On Flight 1, there are four passengers, none of whom are specified individuals or traveling for entertainment. On

Flight 2, passengers A and B are specified individuals traveling for entertainment and passengers C and D are not specified individuals or are not traveling for entertainment. On Flight 3, all four passengers (A, B, E, and F) are specified individuals traveling for entertainment. The taxpayer incurs $56,000 in expenses for the operation of the aircraft for the taxable year.

The aircraft is operated for a total of 56 occupied seat hours for the period (four passengers times 5 hours or 20 occupied seat hours for Flight 1, plus four passengers times 5 hours or 20 occupied seat hours for Flight 2, plus four passengers times 4 hours or 16 occupied seat hours for Flight 3). The cost per occupied seat hour is $1,000 ($56,000/56 hours). The total entertainment usage of the aircraft for specified individuals subject to disallowance is 26 occupied seat hours (two passengers for 5 hours each on Flight 2 and four passengers for 4 hours each on Flight 3) and the total cost subject to disallowance is $26,000 (26 occupied seat hours X $1,000).

For purposes of determining the amount disallowed (to the extent not treated as compensation or reimbursed), $5,000 ($1,000 X 5 hours) each is allocable to A and B for Flight 2, and $4,000 ($1,000 X 4 hours) each is allocable to A, B, E, and F for Flight 3.

For Flight 2, the taxpayer treats $1,200 (the fair market value of the flight) as compensation to A, and B reimburses the taxpayer $500. The taxpayer may deduct $1,700 of the cost of Flight 2 allocable to A and B. The deduction for the remaining $8,300 cost allocable to entertainment provided to A and B on Flight 2 is disallowed (with respect to A, $5,000 less the $1,200 treated as compensation, and with respect to

B, $5,000 less the $500 reimbursed). For Flight 3, the taxpayer treats $1,300 (the fair market value of the flight) each as compensation to A, B, E, and F. The taxpayer may deduct $5,200 of the cost of Flight 3. The deduction for the remaining $10,800 cost allocable to entertainment provided to A, B, E, and F on Flight 3 is disallowed ($4,000 less the $1,300 treated as compensation to each specified individual).

(6) Special rule for "deadhead" flights

For purposes of this notice, an aircraft returning empty from a flight after discharging passengers or traveling empty to pick up passengers (deadheading) is treated as having the same number and character of occupied seat miles or hours as the leg or legs of the trip on which passengers are aboard.

(7) Allocation of expenses on trips of a specified individual involving both business and entertainment

The costs of a flight provided to a specified individual that includes a segment or segments for business and for entertainment must be allocated to the business and entertainment use. The entertainment cost is the excess of the total cost of the flights (by occupied seat hours or miles) over the cost of the flights that would have been taken without the entertainment segment or segments.

Example. G, a specified individual, is the sole passenger on an aircraft on a two-hour flight from City A to City B. The flight from City A to City B is for business. G then travels on a three-hour flight from City B to City C for entertainment purposes, and returns from City C to City A on a four-hour flight. G's flights have resulted in nine occupied seat hours (two for the first segment, plus three for the second segment, plus

four for the third segment). If G had returned directly to City A from City B, the flights would have resulted in four occupied seat hours. Five occupied seat hours are allocable to G's entertainment use of the aircraft (nine total occupied seat hours less four occupied seat hours). If the taxpayer's cost per occupied seat hour is $1,000, $5,000 must be allocated to G's entertainment use of the aircraft ($1,000 X five occupied seat hours). The amount disallowed is $5,000 less any amount the taxpayer treats as compensation to G or G reimburses the taxpayer for this flight.

(8) Non-commercial flight valuation consistency rule

Under § 1.61-21(g)(14)(i), a taxpayer who uses the SIFL formula in a calendar year to value any flight provided to an employee must use the SIFL formula to value all flights provided to employees during that calendar year. The Internal Revenue Service and the Treasury Department plan to amend these regulations to permit taxpayers to value the entertainment use of aircraft by specified individuals under the fair market value rules of § 1.61-21(b), but continue to value flights for other employees and for specified individuals not traveling for entertainment using the SIFL formula. Until regulations are published, taxpayers may rely on this notice to allow this inconsistency in the treatment of specified and non-specified individuals for income inclusion purposes. If the amount treated as compensation is greater than the amount of the taxpayer's costs (as determined under this notice) for a flight, however, the taxpayer's deduction is limited to the taxpayer's costs.

(9) Interaction with § 162(m)

Any amount for the entertainment use of an aircraft that is treated by the taxpayer as compensation to a specified individual who is also a "covered employee" (as defined in § 162(m)(3)) is subject to § 162(m). Thus, to the extent the covered employee's "applicable employee remuneration" (as defined in § 162(m)(4)), including remuneration related to entertainment, exceeds $1,000,000, the taxpayer's deduction is disallowed under § 162(m).

(10) Costs treated as compensation

The amount of costs to which this notice applies is reduced by an amount treated as compensation to a specified individual who is an employee of the taxpayer if the amount is treated as compensation for the flight on the taxpayer's income tax return as originally filed and as wages for purposes of chapter 24 (relating to withholding of income tax at the source on wages). See § 1.274-2(f)(2)(iii)(A) and Ann. 85-113. For a specified individual who is not the taxpayer's employee, costs are treated as compensation if the amount for the flight is included in an information return under Part III of subchapter A of chapter 61 (unless not required to be reported under those provisions). See § 1.274-2(f)(2)(iii)(B).

C. REQUEST FOR COMMENTS

The Service and the Treasury Department request comments on issues arising under this notice. Comments should be submitted in writing on or before August 1, 2005, and should include a reference to Notice 2005-45. Comments may be submitted to CC:PA:LPD:PR (Notice 2005-45), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Alternatively, comments may be

submitted electronically via the following e-mail address: Notice.Comments@irscounsel.treas.gov. Please include "Notice 2005-45" in the subject line of any electronic communications.

Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Notice 2005-45), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224. All comments are available for public inspection and copying.

D. EFFECTIVE DATE

This notice applies to expenses incurred after June 30, 2005. The Service will not challenge a reasonable method of determining disallowed expenses incurred after October 22, 2004, and before July 1, 2005. Application of this notice to determine disallowed expenses is a reasonable method.

E. TRANSITION RULE FOR REPORTING DISALLOWED EXPENSES

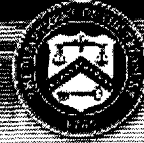
A taxpayer that incurs expenses to which § 274(e), as amended by the AJCA, applies in a taxable year ending after October 22, 2004, but on or before May 27, 2005, may apply the disallowance of expenses for that taxable year against expenses incurred in the taxpayer's first taxable year ending after May 27, 2005. Thus, for example, a calendar year taxpayer may choose to adjust its taxable income either (a) for its 2005 taxable year to reflect the disallowance of expenses to which this notice applies that are incurred after October 22, 2004, and before January 1, 2006, or (b) for its 2004 taxable year to reflect the disallowance of the portion of the expenses incurred after October 22, 2004, and before January 1, 2005, and for its 2005 taxable year to reflect the

disallowance of the portion of the expenses incurred after December 31, 2004, and before January 1, 2006.

DRAFTING INFORMATION

The principal author of this notice is Michael A. Nixon of the Office of the Associate Chief Counsel (Income Tax & Accounting). For further information regarding this notice, contact Mr. Nixon or Christian Wood at (202) 622-4930 (not a toll-free call).

PRESS ROOM



FROM THE OFFICE OF PUBLIC AFFAIRS

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May 27, 2005
JS-2477

IMF Concludes Article IV Consultation with the United States

The Treasury Department is releasing today the concluding statement by the staff of the International Monetary Fund (IMF) following this year's Article IV consultation with the United States. This statement represents IMF staff's independent judgment and assessment of U.S. economic performance and policies.

Release of this statement is consistent with the United States' longstanding, strong support for enhanced transparency of the IMF. The United States also plans to release the IMF staff report and Public Information Notice on the U.S. Article IV review following the Executive Board's discussion of the mission later this summer.

REPORTS

- International Monetary Fund 2005 Concluding Statement of the Fund Mission

INTERNATIONAL MONETARY FUND

2005 Article IV Consultation with the United States of America

Concluding Statement of the Fund Mission

(May 25, 2005)

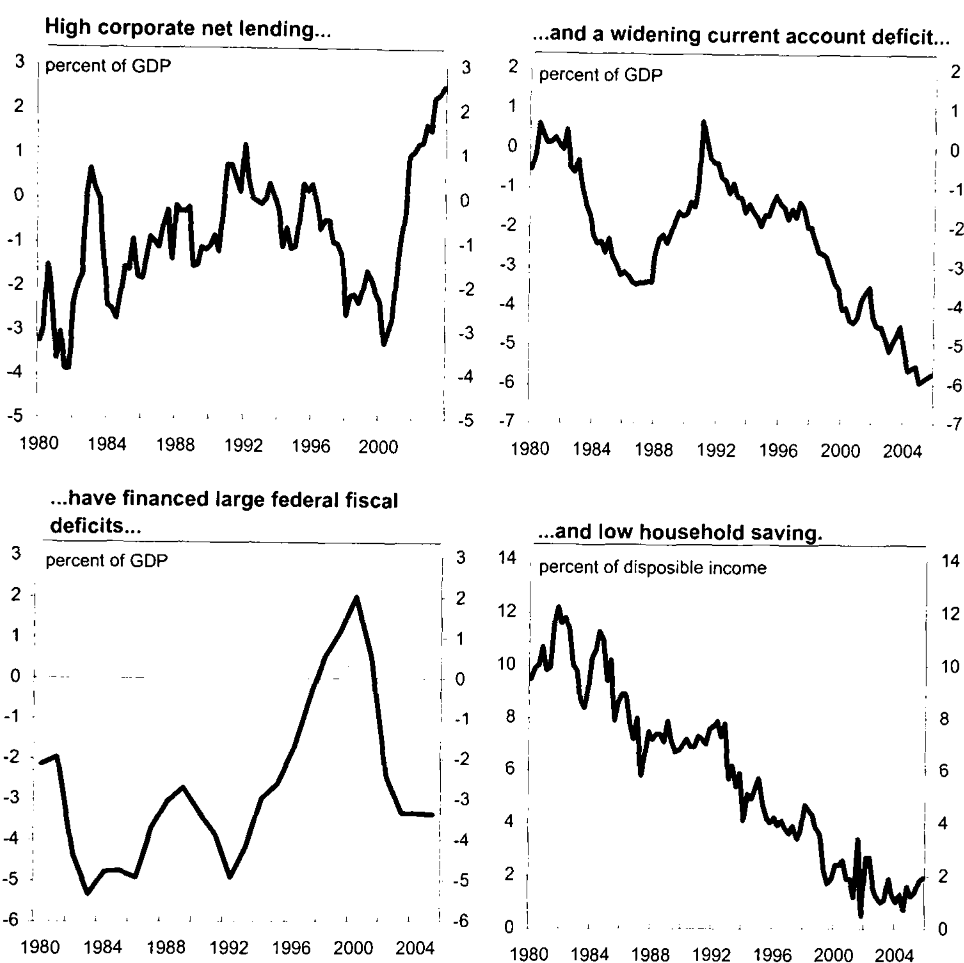
1. ***The United States has continued to be the main locomotive of global growth.*** Over the past year, the expansion has solidified as robust productivity growth and high corporate profits have contributed to a strong rebound in business investment and an acceleration in employment. As the output gap has narrowed, the policy focus has appropriately shifted toward a steady removal of stimulus in a manner that supports macroeconomic stability and sustained growth.

2. ***Looking ahead, there is general agreement that the U.S. outlook for 2005 and 2006 appears broadly favorable.*** As the expansion matures, GDP growth is projected to slow to around 3½ percent in the coming two years, reflecting the withdrawal of policy stimulus, higher oil prices, and the return of the household saving rate to a more sustainable level, partly offset by a diminution of the drag from net exports. Although productivity growth is projected to ease somewhat, the remaining small output gap would help contain inflationary pressures. Nonetheless, the current account deficit is likely to remain around its recent record highs, in part because increasing U.S. foreign indebtedness and higher interest rates cause the net factor income balance to weaken.

3. ***While the U.S. economy is again expected to outperform other G-7 members, the challenge is to safeguard the outlook from the considerable uncertainties and risks, particularly against the background of looming demographic challenges.***

- ***A record-low household saving rate and a large federal fiscal deficit are being supported by unprecedented borrowing from foreigners and domestic firms.*** This unusual constellation of financial flows has sustained growth by keeping long-term interest rates low and stimulating house prices. However, this creates a number of vulnerabilities, including the possibility of a marked slowdown of household spending, particularly were the housing market to cool.

- ***External imbalances present a significant risk to the global economy.*** The U.S. current account deficit and its counterparts elsewhere in the world are widely viewed as unsustainable. A gradual adjustment of the U.S. external position and exchange rate remains the most likely scenario, especially if it involves stronger growth in the rest of the world. The challenge is to support the adjustment by stronger U.S. national saving to avoid the burden falling on investment and growth, both in the United States and abroad. Moreover, there will be limits to the global demand for U.S. assets, and there is a risk that an abrupt and disorderly shift in investor preferences could have a significant adverse effect on interest rates and global capital markets.



Source: Haver Analytics.

- ***While continued strong productivity growth would buttress the outlook, a sudden drop could have significant repercussions.*** A continuation of the exceptional productivity growth observed since the recent downturn would provide further support to household wealth and spending, the fiscal position, and capital inflows. However, a significantly faster-than-anticipated productivity slowdown would increase cost pressures, pushing up global interest rates and risk premiums, and rendering even more challenging the goal of achieving fiscal and current account sustainability.

- ***A closing output gap and higher commodity prices imply a less benign inflation outlook.*** Although core PCE inflation and inflation expectations have remained contained, the federal funds rate is still close to zero in real terms and unit labor costs have started to rise. At the same time, softer-than-expected indicators of activity in recent months have highlighted the risk that high oil prices could dampen domestic spending.

- ***The leading edge of the baby-boom generation is only a few years away from retirement***. Although the long-term rise in the old-age dependency rate is modest compared with other industrial countries, the shift implies an enormous additional burden on government programs, most notably as regards health care, and will weigh further on the household saving rate.

4. ***These considerations underscore the importance of U.S. leadership in implementing the G-7 Agenda for Growth***. In combination with structural reforms and greater exchange rate flexibility in major trading partners, the key challenge for the United States will be to achieve fiscal consolidation and higher national saving. Together with policies to address long-term fiscal sustainability and maintain high productivity growth, this would provide a solid basis for continuing economic prosperity.

Monetary policy

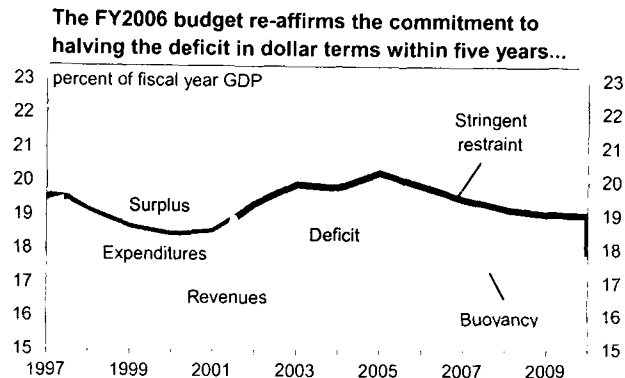
5. ***The Federal Reserve has successfully balanced the need to support activity while preserving price stability in recent years***. After having injected extraordinary stimulus over the downturn, the Fed appropriately reversed course in mid-2004 as the expansion became increasingly self-sustained and deflation risks receded, and has since raised the federal funds rate in 25 basis point moves to 3 percent.

6. ***The mission supports the Federal Reserve's gradual and flexible approach to monetary tightening***. The Fed's commitment to price stability has ensured that inflation expectations have remained anchored in the face of substantial shocks to energy and other commodity prices. Coupled with a skillful communications strategy, this has strengthened the expectations channel and enabled a gradual pace of tightening. At the same time, the past year has also witnessed substantial changes in market forecasts of the pace of future interest rate hikes, illustrating confidence in the Fed's willingness to respond rapidly to changing circumstances. While expectations of tightening have recently been scaled back, the Federal Open Market Committee's (FOMC's) May 3 statement has appropriately cautioned that more forceful action would be required if price pressures continued to intensify.

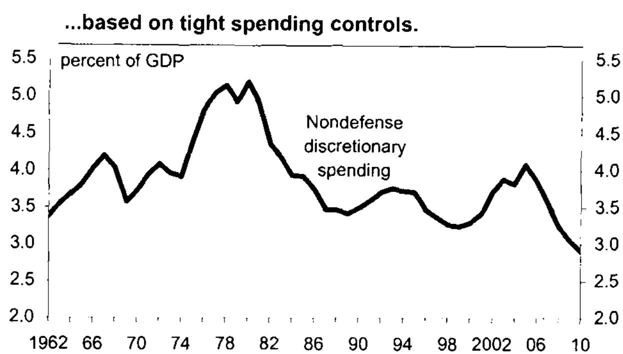
7. ***The Federal Reserve is highly transparent and its communications strategy is highly effective.*** Several steps have recently been taken to further increase transparency—including shortening the publication lag for FOMC minutes and extending the horizon of forecasts. More fundamentally, the Committee has also debated whether to adopt an explicit inflation objective. As we have suggested before, the experience in other countries illustrates that defining the central bank's inflation objective more clearly can help further anchor inflation expectations and long-term bond yields, without unduly constraining the ability of policymakers to meet shorter-term stabilization objectives.

Fiscal policy

8. ***The Administration's call for deficit reduction is welcome.*** The FY 2004 outturn was significantly better than expected; recent tax revenue data suggest overperformance in FY 2005; and this year's Budget Resolution has endorsed the goal of halving the nominal deficit by FY 2009. That said, budget targets for next year and beyond do not appear ambitious—the structural budget balance would only improve by around 1½ percent of GDP through FY 2009. Moreover, the assumed compression in the ratio of nondefense discretionary spending is unprecedented, and no account has been taken of funding for operations in Iraq and Afghanistan after FY 2006 or of pressures to limit the growing scope of the Alternative Minimum Tax.



The FY2006 budget re-affirms the commitment to halving the deficit in dollar terms within five years...



...based on tight spending controls.

Sources: OMB; and IMF staff calculations.

9. ***The current favorable growth conjuncture suggests room for bolder deficit reduction over the coming years.*** Annual reductions in the fiscal deficit of roughly 1 percent of GDP through structural measures over the next few years—aimed at achieving a balanced budget excluding Social Security early in the next decade—would ease the burden on monetary policy to contain inflation pressures as the economy returns to full employment and could likely be achieved without placing an undue drag on activity. It would also support national saving, domestic investment, and the external position, forming an important pillar in the international strategy for reducing external imbalances and the associated vulnerabilities. Most importantly, by significantly lowering the federal debt ratio over time, it would provide fiscal room to cope with impending pressures on health and retirement programs and reduce the burden on future generations.

10. ***Expenditure discipline will be an essential part of any deficit reduction, but tax reform should also play a role in supporting fiscal sustainability.*** The President's Advisory Panel on Federal Tax Reform has been charged with reporting on ways to simplify the tax system and improve its efficiency—an undertaking that the mission strongly supports—in a revenue-neutral manner. However, the magnitude of the fiscal adjustment needed and the strict spending discipline already assumed make it seem prudent to explore options for revenue enhancements. Measures that would help avoid having to unwind recent tax rate cuts and their associated supply-side benefits include broadening the income tax base by curbing

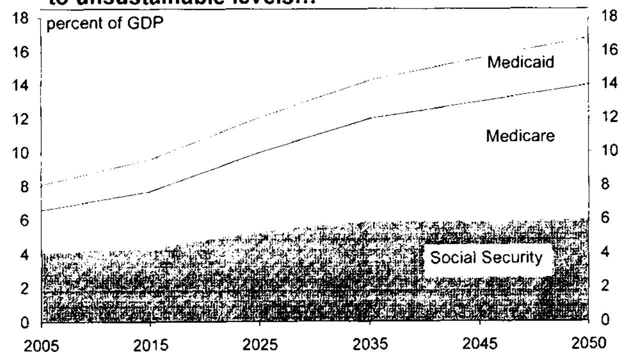
deductions, such as the generous treatment of mortgage interest, or introducing a national consumption-based tax.

11. ***A legislated budget rule could help support fiscal responsibility***. Both domestic and international experience suggests that legislated budget rules can be helpful in enhancing budget discipline, particularly if supported by political consensus. However, the expiration of the Budget Enforcement Act (BEA) seems to have coincided with a weakening of fiscal discipline, including through the use of sunset provisions in recent tax legislation. The Administration has re-iterated its support for a number of useful proposals, but it is unfortunate that these have not been carried forward, and that pay-as-you-go provisions would be limited to expenditure measures.

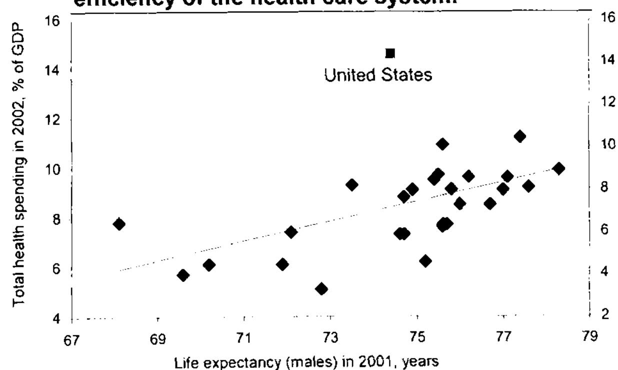
Entitlement reform

12. ***Reforms of retirement and (in particular) health care entitlement programs are essential for long-term fiscal sustainability***. Although much of the recent debate has been on Social Security, federal health care spending has been rising at a much faster pace, reflecting cost pressures on the broader U.S. health care system. Coupled with the new prescription drug benefit and the rise in the elderly population in coming decades, the unfunded liability of the Medicare system has been estimated at 200 percent of GDP over the next 75 years, dwarfing the 30 percent of GDP liability of the Social Security system.

In the absence of reform, spending on entitlement programs, especially for health care, is set to grow to unsustainable levels...



...and international comparisons suggest that there is considerable scope for improving the efficiency of the health care system.



Sources: OMB; and OECD.

13. ***It is questionable whether Medicare spending can be contained without reforms to the overall health care sector***. The public sector already finances about half of all U.S. health spending, including through the Medicare and Medicaid programs, and total U.S. health care outlays are nearly twice the OECD average as a share of GDP, without seeming to yield commensurate benefits in terms of health outcomes. Administration proposals—including malpractice reform—together with the provisions of the 2003 Medicare Modernization Act could help moderate price pressures, but the added prescription drug benefit significantly worsened Medicare's financial position. With the

Medicaid system under similar strains, a large uninsured population, growing numbers of the elderly, and a projected tripling of public health care outlays as a ratio to GDP in coming decades, further steps are urgently needed to improve the efficiency of the system.

14. ***We welcome the current debate on measures to address the solvency of the Social Security system***. The Administration has helpfully lent its support to the principle of "progressive price indexation," which would significantly reduce Social Security's unfunded liabilities by curbing the growth of accrued benefits for higher-income households. The emphasis on containing benefit growth appears appropriate, but additional options should be considered to help eliminate the funding shortfall, such as an increase in the retirement age or raising the cap on the Social Security payroll tax. However, as we have emphasized in previous years, the key priority is to ensure that reforms that fully fund the system are not delayed, since this would only increase the adjustments that will eventually be needed.

15. ***The Administration proposal to permit younger workers to divert a portion of their Social Security contributions into personal retirement accounts (PRAs) would pose fiscal challenges***. While PRAs hold the potential for raising the return on Social Security contributions, they would also imply a significant increase in federal deficits and debt in coming decades as off-budget liabilities are recognized, albeit offset over time by lowering future benefits as the PRAs mature. Even if such instruments were to be introduced, it would be essential that they be coupled with other measures that assure the long-run solvency of the Social Security system.

Structural policies

16. ***Structural reforms to support saving and capital accumulation would help sustain high labor productivity growth***. Recent Administration initiatives are aimed at establishing an "ownership society" by lowering taxes on capital income and facilitating access to capital markets for a wider segment of the population. The steady decline in coverage by defined-benefit pension plans and employer-sponsored health care plans in recent years has meant that financial risks carried by households have already been increasing. This suggests the importance of public policies that encourage appropriate saving decisions, such as by promoting retirement plans in which participation is the default option.

17. ***The U.S. financial sector has proven exceptionally resilient in recent years, but there remains scope for further reform***. The Administration has taken the welcome step of proposing legislation to strengthen the supervision and limit the size of the housing government sponsored enterprises (GSEs) to contain systemic risk in mortgage markets. Recent developments—including the large new liabilities taken on by the Pension Benefit Guarantee Corporation—illustrate the need for reforms that increase funding requirements and strengthen risk-based premiums for defined-benefit pension plans. Moreover, recent irregularities in the insurance sector suggest that there may be a need to supervise systemically important entities on a national level.

18. ***As demonstrated by last year's framework agreement for the Doha Round, the United States has an important leadership role in the quest for global trade liberalization.*** The mission welcomes Administration proposals to reduce agricultural subsidies, as well as plans to offer and elicit stronger commitments for liberalization in services. At the same time, specific areas for U.S. leadership would be to ensure that bilateral free trade agreements complement the multilateral framework so as to minimize the potential costs of regionalism and to achieve significant increases in market access, particularly for agricultural products. It is also imperative to resist protectionist responses to the recent surge in Chinese imports, including those related to the expiry of the Agreement on Textiles and Clothing.

19. ***Recent increases in U.S. official development assistance (ODA) and progress on the Millennium Challenge Account are welcome.*** However, U.S. ODA relative to GNI remains among the lowest across industrial countries and argues for continued efforts to boost U.S. foreign assistance.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 26, 2005
JS-2478

Randal K. Quarles
U.S. Treasury Assistant Secretary for International Affairs
Institute for International Bankers
Washington, DC
May 26, 2005

I am delighted to be here again to share with you a brief overview of Treasury's international financial sector work. I'd like to begin with a just few comments on major regulatory matters that will be impacting financial markets in the years ahead. Then I'll give you an update on some of the issues we discussed last October: multilateral and bilateral financial services negotiations and our financial markets dialogues particularly with China, Japan and the European Union.

Before I begin, let me emphasize that the underlying goal of our financial sector work is to strengthen global economic growth and development prospects. Financial stability, financial sector openness and sound regulatory policy are essential financial pillars for growth. We work to strengthen these three pillars via a variety of means: from global and multilateral programs to bilateral engagement.

Basel II

One of the biggest contributors to financial stability has been adherence to the international standards on capital adequacy for banking institutions embodied in the Basel Accord. We anticipate that implementation of the revision of those standards, known as Basel II, will prove equally valuable. As you know, the U.S. banking regulators jointly announced on April 29 a delay in the publication of the joint notice of proposed rule-making (NPR) which will implement the Basel II risk-adjusted capital framework in the US. Originally targeted for June, our regulators agreed to delay the NPR to consider issues raised in a fourth impact study, which showed wide dispersion of impact with a drop in required capital levels for half of the 26 surveyed institutions. The goal is to issue the NPR at the earliest date possible, while allowing time to consider how to minimize these unintended consequences and thus get it right the first time. Our regulators remain committed to the Basel process and will continue to take the steps necessary to try and implement the revised Accord by their original 2008 target.

Consolidated Supervised Entity (CSE) Rule:

Regarding the CSE rules of the SEC, we are aware of a number of issues you have raised with respect to the application of the CSE regime. These include the alternative net capital treatment of broker-dealer subsidiaries, reporting and recording keeping for non-US holding companies and "deference" in supervisory regimes. These matters cut across a number of important supervisory and regulatory areas and are areas that I understand you are continuing to pursue with the SEC and Federal Reserve. As further experience is gained in implementing the rule, I trust that any misunderstandings regarding the rule and its application will be fully clarified. .

Financial Services Trade Negotiations

The next topic on our growth agenda is trade in financial services. As I've

discussed with this group before, liberalization of financial services is vital to the Doha Development Agenda. Research has shown that developing countries with open financial sectors experience higher economic growth.

WTO Financial Services Negotiations
This "growth" orientation has several implications for our WTO stance. For example, we have advocated to a large number of WTO Members--not just the big emerging markets--the adoption of fundamental openness, especially to foreign direct investment in this sector. We also have proposed the adoption of transparency principles in the regulation of financial services.

We are entering an important phase of these negotiations. WTO members will submit revised offers by the end of this month. Treasury and USTR held a series of meetings in February in Geneva to encourage improved offers and more talks will take place in June. We will continue to articulate the benefits of financial services liberalization in our bilateral meetings and other fora. We have no illusions that securing a WTO financial sector agreement will be quick or easy, but the importance of the issues and breadth of WTO participation merit our continued efforts.

Bilateral Free Trade Agreements
Since 2002, we have expanded the number of countries which with we are negotiating (or have completed) bilateral free trade agreements. Agreements are now in place with Chile, Singapore and Australia and negotiations have been concluded with Bahrain, Morocco, five Central American countries and the Dominican Republic. Negotiations are actively underway with Thailand, Oman, the UAE and three Andean countries. These agreements provide our financial institutions with key legal rights and increase regulatory transparency, contributing to an overall sounder financial sector and more sustainable economic growth.

Ongoing Dialogues in Financial Services

In addition to trade negotiations, we conduct informal financial dialogues with our counterparts from a number of countries, as we seek to: (1) encourage movement toward more competitive, better regulated financial systems; and (2) find ways to mitigate cross border friction.

In addition to our long running Japan financial sector dialogue, we now also hold financial dialogues with our NAFTA partners, as well as with China, Australia, India, Russia and the European Union. Before each of these meetings, Treasury officials reach out to U.S. private financial sector officials and trade associations for their input and expertise. Let me give you a brief update on what has been happening with some of these dialogues.

U.S.-China
As I'm sure most of you know, the Bush Administration has had an unprecedented level of engagement with the Chinese to encourage them to move to a market-based, flexible exchange rate regime as quickly as possible. While Secretary Snow, myself and others have been out front, publicly making the macro-economic case that a flexible exchange rate is in China's own best interest, we have also been working behind the scenes to help China prepare its financial sector for such a move.

In addition to our high level annual Joint Economic Committee meetings, Treasury has established a Technical Cooperation Program (TCP) to share our experiences on the regulatory and financial market underpinnings that support market-oriented reforms. The TCP's four session have covered a broad set of topics including: banking supervision, corporate governance, asset disposition, forex derivatives markets, treasury cash management and debt management operations. Another session, next week in Beijing, will cover deposit insurance. And a follow up on banking issues is under consideration. We believe that these efforts have helped the China prepare to move ahead and introduce flexibility in the exchange rate regime.

Of course, no financial sector is perfect, and despite their progress, the Chinese will still need more sophisticated financial technology and human capital to address coming competitive challenges. Since foreign banks and other financial institutions bring just such technology and know-how as well as much needed fresh capital, we've continued to push for market access. China's commitment under its WTO accession to open the banking sector to foreign banks by 2007 is on track, but we continue to advocate raising the cap on foreign ownership in banks, securities companies and asset management firms beyond their WTO commitments.

U.S - Japan
Notwithstanding all of the attention on China, we must remember that Japan is still the world's second largest economy. We have an active financial dialogue with Japan on a variety of issues and in a variety of forums, some on-going, and other ad hoc. The latter enables us to address issues as they arise.

Over recent years, a persistent subject of discussion has been banking sector stability. Significantly, Japan's banking sector seems to have stepped back from the brink thanks to an improved economy, and importantly, a tougher supervision regime. Japan's FSA has made remarkable progress by focusing on resolving NPLs, improving the quality of bank capital, and inspecting banks the major banks more thoroughly.

While more remains to be done, especially at regional banks, the major Japanese banks have cut reported bad debt to within the government target of 4 percent of total loans. That's a remarkable 50 percent decline over just three years. Less regulatory forbearance has raised the pressure on banks to restructure their bad debts, while stronger balance sheets have made the banks more willing, and able, to do so.

The privatization of Japan Post has also been a frequent topic of discussion --- especially with regard to its savings and life insurance businesses, which are the world's two largest financial institutions. We are watching closely to ensure that privatization does not disadvantage private firms, including foreign ones, that are already operating in Japan. It is also important to note that a successful privatization has the potential to significantly improve (1) the efficiency in Japan's financial markets, (2) the profitability and stability of bank earnings, and (3) ultimately the prospects for growth in Japan.

U.S. – EU
Three years ago, we launched the U.S-EU informal financial markets regulatory dialogue between Treasury, the US regulators and the European Commission. By promoting quiet discussion, this dialogue has contributed to stronger working relationships among regulators and is now moving beyond just problem solving to more forward looking issues.

The EU has fundamentally overhauled the legal framework of its financial markets, but still faces the difficult stage of implementation. The challenge is to have the new measures implemented, interpreted and enforced consistently across all 25 member states. This would be a big victory for growth, as various studies have shown that the integrated, efficient, open capital market envisioned by Europe's Financial Services Action Plan could boost annual economic growth by over one percentage point.

Moreover, this convergence within the EU has given impetus to convergence between the U.S. and EU and, indeed between other markets, most notably in accounting standards. The EU's requirement for listed EU firms to use IFRS beginning this financial year has encouraged the U.S. SEC staff to lay out roadmap by which they could recommend SEC acceptance of IFRS financial statements from US-listed firms by as early as 2007 (and no later than 2009). This roadmap has been well received in Europe, and would be a remarkable achievement, reducing costs for businesses on both sides of the Atlantic.

US-Mexico-Canada

Treasury and US regulators have been discussing financial sector issues with our NAFTA partners for the past eleven years since the trade agreement was signed. Much has been achieved but some issues in financial services and in many other areas pertaining to economic integration remain unresolved. In March of this year, Presidents Bush and Fox and Prime Minister Martin launched the Security and Prosperity Partnership of North America, which will entail wide-ranging discussions by officials of the three countries on economic and security issues under various working groups. I will chair the Financial Services Working Group (FSWG). Other US participants in this group will include representatives from the Department of Commerce, USTR and our financial regulators.

This group will address cross-border issues for banking, securities and insurance. All three parties agree that well-developed, efficient capital markets are essential for economic growth and national security. We will identify and discuss ways to facilitate the free flow of capital and the efficient provision of financial services throughout the three countries. Preparatory work for the FSWG has included outreach to private sectors and legislatures in the three countries to ensure that interests and concerns are appropriately being taken into account. On June 23, our Leaders will meet again and are expected to formally kick of the real work envisaged under SPP.

Conclusion:
As you can tell, Treasury has been busy promoting more robust financial policy regimes in many different fora around the globe. Close contact among U.S. and foreign regulators and financial institutions has led to better policy reform. We've worked together to improve the quality of financial regimes and to enhance opportunities for competition in each other's markets. To the extent we have been successful, the efficiency of capital markets will increase and the capacity for higher sustained economic growth will expand. Thank you.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 31, 2005
JS-2479

Statement of Under Secretary Levey Upon Conclusion of Meetings with Senior Latvian Officials

Riga, LATVIA - Stuart Levey, the Treasury Department's Under Secretary for Terrorism and Financial Intelligence, made the following statement upon the conclusion of meetings with senior Latvian officials:

"Both the United States Government and the Latvian Government are committed to working together to safeguard the international financial system from abuse. My meetings with senior officials from the Prosecutor General's Office, the Financial and Capital Markets Commission, the Bank of Latvia, the Latvian State Police, the commercial banking sector and notably with Prime Minister Kalvitis were positive and productive.

"Latvia has taken many important steps to combat money laundering and corruption in the financial sector. Prime Minister Kalvitis has shown strong leadership on this issue. I am also encouraged by the Saeima's recent passage of an anti-money laundering law. This is a vital move that will not only help protect Latvia's financial sector, but also reaffirms the Latvian Government's commitment to these issues.

"However, there is still important progress to be made. I encourage the Latvians to swiftly and credibly implement the new anti-money laundering law. I look forward to seeing significant results come to fruition as a result of both this legislation and the ongoing efforts of Latvian law enforcement and regulatory authorities.

"The U.S. Treasury Department's recent designation of two Latvian banks as "primary money laundering concerns" reflects the importance to the U.S. Government of having the systems and oversight in place to keep corrupt funds from flowing through the Latvian, as well as the international, financial system.

"The United States and Latvia have forged a strong partnership in many areas, including, notably, our commitment to combating money laundering and financial crime. Continued collaboration and cooperation will only enhance this relationship. The Bush Administration will continue to work with Latvia to help rid its financial sector of illicit funds as we continue to battle the scourge of money laundering worldwide," said Levey.

FROM THE OFFICE OF PUBLIC AFFAIRS

May 31, 2005
JS-2480

Statement of Treasury Secretary John W. Snow on the announced departure of Enrique V. Iglesias, President of the Inter-American Development Bank

With today's announcement that Enrique V. Iglesias intends to depart as President of the Inter-American Development Bank, I wanted to be among the first to praise him for the important contributions he has made to the international financial system and in leading development policy in the Americas.

It would be difficult to overstate the contribution that Enrique has made to the Inter-American Development Bank and to economic development in Latin American and Caribbean nations over the last eighteen years. The Bank, which now has over $100 billion in capital thanks to Enrique's leadership, remains the main source of multilateral development financing for the region. It has provided critical financial support and policy advice to emerging markets and poor countries in the region, helping them to increase productivity, raise economic growth and lift millions out of poverty. We are deeply indebted to Enrique for his visionary leadership and prodigious achievements over nearly two decades, and congratulate him on his new appointment the First Secretary General of the Ibero-American Summit. In this prestigious new role, I have no doubt that he will continue to serve with distinction to further our common interests in the hemisphere.

The process now begins for selecting President Iglesias' successor. I look forward to discussing with my fellow Governors from Latin American and the Caribbean, and other shareholders, the outstanding candidates who might be interested in serving as the next President of the IDB.