HIGHLIGHTS
OF THIS ISSUE

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

INCOME TAX

Final regulations under section 368 of the Code provide guidance on when and to what extent creditors of a corporation will be treated as proprietors of the corporation in determining whether continuity of interest is preserved in a potential reorganization.

T.D. 9435, page 333.
Final, temporary, and proposed regulations under section 355 of the Code narrow the reach of section 355(a)(3)(B) to harmonize its application with the application of section 355(b), consistent with the 2006 amendments to section 355(b), the 2007 proposed regulations under section 355(b), and the 2007 grant of authority that was provided in the Tax Technical Corrections Act of 2007. Rev. Ruls. 65–286 and 76–54 obsoleted by T.D. 9435.

REG–113462–08, page 379.
Proposed regulations under section 7701(1) of the Code clarify that a disregarded entity is a person for purposes of regulations section 1.881–3.

Notice 2009–2, page 344.
Weighted average interest rate update; corporate bond indices; 30-year Treasury securities; segment rates. This notice contains updates for the corporate bond weighted average interest rate for plan years beginning in January 2009; the 24-month average segment rates; the funding transitional segment rates applicable for January 2009; and the minimum present value transitional rates for December 2008.

EMPLOYEE PLANS

Notice 2009–8, page 347.
This notice provides interim guidance on recently enacted section 457A of the Code which became effective January 1, 2009. Section 457A generally provides that compensation deferred under a nonqualified deferred compensation plan of a nonqualified entity is includible in gross income when there is no substantial risk of forfeiture of the right to such compensation. For this purpose, the term nonqualified deferred compensation plan has the meaning provided under section 409A(d), subject to some modifications, and the term nonqualified entity means (a) any foreign corporation unless substantially all of its income is (i) effectively connected with the conduct of a trade or business in the U.S., or (ii) subject to a comprehensive foreign income tax, and (b) any partnership unless substantially all of its income is allocated to persons other than (i) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax, and (ii) tax-exempt organizations.

Section 305. This procedure provides temporary guidance regarding section 305 treatment of a stock distribution by a publicly traded regulated investment company (RIC) or real estate investment trust (REIT) in which the shareholders have an election to receive money or stock, subject to an aggregate limitation on the amount of money to be distributed. Rev. Proc. 2008–68 amplified and superseded.

(Continued on the next page)
Notice 2009–8, page 347.
This notice provides interim guidance on recently enacted section 457A of the Code which became effective January 1, 2009. Section 457A generally provides that compensation deferred under a nonqualified deferred compensation plan of a nonqualified entity is includible in gross income when there is no substantial risk of forfeiture of the right to such compensation. For this purpose, the term nonqualified deferred compensation plan has the meaning provided under section 409A(d), subject to some modifications, and the term nonqualified entity means (a) any foreign corporation unless substantially all of its income is (i) effectively connected with the conduct of a trade or business in the U.S., or (ii) subject to a comprehensive foreign income tax, and (b) any partnership unless substantially all of its income is allocated to persons other than (i) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax, and (ii) tax-exempt organizations.

EMPLOYMENT TAX

Proposed regulations under section 3402(t) of the Code have been issued relating to withholding. The regulations reflect changes in the law made by the Tax Increase Prevention and Reconciliation Act of 2005 that require federal, state, and local government entities to withhold income tax when making payments to persons providing property or services.

ADMINISTRATIVE

Final regulations under section 7216 of the Code provide rules relating to the disclosure and use of tax return information by tax return preparers. The regulations provide updated guidance regarding the disclosure of a taxpayer's social security number to a tax return preparer located outside of the United States.

Proposed regulations under section 6707 of the Code implement the amendments provided by the American Jobs Creation Act of 2004. The regulations provide the rules relating to the assessment of penalties against material advisors who fail to timely file a true and complete return required under section 6111(a).
The IRS Mission

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

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

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

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

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

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

The contents of this publication are not copyrighted and may be reprinted freely. A citation of the Internal Revenue Bulletin as the source would be appropriate.

Section 301.—Distributions of Property

26 CFR 1.301–10: Rules applicable with respect to distributions of money and other property.

This revenue procedure provides temporary guidance regarding certain stock distributions by publicly traded regulated investment companies (RICs) and real estate investment trust (REITs). See Rev. Proc. 2009-15, page 356.

Section 305.—Distributions of Stock and Stock Rights

26 CFR 1.305–1: Stock dividends.

This revenue procedure provides temporary guidance regarding certain stock distributions by publicly traded regulated investment companies (RICs) and real estate investment trust (REITs). See Rev. Proc. 2009-15, page 356.

Section 355.—Distribution of Stock and Securities of a Controlled Corporation


A temporary regulation narrows the reach of section 355(a)(3)(B) to harmonize its application with the application of section 355(b), consistent with the 2006 amendments to section 355(b). The proposed regulations under section 355(b), and the 2007 grant of authority that was provided in the Tax Technical Corrections Act of 2007. See T.D. 9435, page 333.


A proposed regulation narrows the reach of section 355(a)(3)(B) to harmonize its application with the application of section 355(b), consistent with the 2006 amendments to section 355(b), the 2007 proposed regulations under section 355(b), and the 2007 grant of authority that was provided in the Tax Technical Corrections Act of 2007. See REG-150670-07, page 378.


T.D. 9435

DEPARTMENT OF THE TREASURY
Internal Revenue Service 26 CFR Part 1

Guidance Regarding the Treatment of Stock of a Controlled Corporation Under Section 355(a)(3)(B)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations that provide guidance regarding the distribution of stock of a controlled corporation acquired in a transaction described in section 355(a)(3)(B) of the Internal Revenue Code (Code). This action is necessary in light of amendments to section 355(b). These temporary regulations will affect corporations and their shareholders. The text of these temporary regulations also serves as the text of the proposed regulations (REG–150670–07) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

DATES: Effective Date: These final and temporary regulations are effective on December 15, 2008.

Applicability Date: For dates of applicability, see §1.355–2T(i).

FOR FURTHER INFORMATION CONTACT: Russell P. Subin, (202) 622–7790 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background


Section 355(a) provides that, under certain circumstances, a corporation may distribute stock and securities in a corporation it controls to its shareholders and security holders without causing either the distributing corporation (distributing) or its shareholders and security holders to recognize income, gain, or loss. For this purpose, control is defined under section 368(c).

Sections 355(a)(1)(C) and 355(b)(1) generally require that distributing and the controlled corporation (controlled) each be engaged, immediately after the distribution, in the active conduct of a trade or business. Section 355(b)(2)(A) provides that a corporation shall be treated as engaged in the active conduct of a trade or business if and only if it is engaged in the active conduct of a trade or business.

Section 355(b)(2)(B) requires that the trade or business have been actively conducted throughout the five-year period ending on the date of the distribution (pre-distribution period). Section 355(b)(2)(C) provides that the trade or business must not have been acquired in a transaction in which gain or loss was recognized, in whole or in part (taxable transaction or taxable acquisition), within the pre-distribution period.

Section 355(b)(2)(D) provides that control of a corporation that (at the time of acquisition of control) was conducting the trade or business must not have been
directly or indirectly acquired by any distributee corporation or by distributing during the pre-distribution period in a taxable transaction. For purposes of section 355(b)(2)(D), all distributee corporations that are members of the same affiliated group (as defined in section 1504(a) without regard to section 1504(b)) shall be treated as one distributee corporation.

Section 355(b)(3)(A) provides that for purposes of determining whether a corporation meets the requirements of section 355(b)(2)(A), all members of such corporation’s separate affiliated group (SAG) shall be treated as one corporation. Section 355(b)(3)(B) provides that for purposes of section 355(b)(3), the term SAG means, with respect to any corporation, the affiliated group that would be determined under section 1504(a) if such corporation were the common parent and section 1504(b) did not apply. Section 355(b)(3)(C) provides that if a corporation became a SAG member as a result of one or more taxable transactions, any trade or business conducted by such corporation (at the time that such corporation became such a member) shall be treated for purposes of section 355(b)(2) as acquired in a taxable transaction. Section 355(b)(3)(A) through (C) are collectively referred to in this preamble as the SAG regime. In addition, for purposes of this preamble, the term DSAG and CSAG include a reference to this grant of authority, these temporary regulations modify the application of section 355(b)(3), in connection with the application of section 355(b)(3). Pursuant to this grant of authority, these temporary regulations modify the application of section 355(a)(3)(B) in order to harmonize the hot stock rule and section 355(b).

Explanation of Provisions

1. Hot Stock Rule Inapplicable Where Controlled is a DSAG Member

Congress enacted section 355(b)(3) because it was concerned that, prior to a distribution under section 355, corporate groups conducting business in separate corporate entities often had to undergo elaborate restructurings to place active businesses in the proper entities to satisfy the ATB requirement. See, for example, H.R. Rep. No. 109–304, at 53, 54 (2005). The effect of section 355(b)(3) is to treat a corporation’s SAG as a single corporation for purposes of the ATB requirement. Consistent with this treatment, Congress enacted the Technical Corrections to clarify:

that if a corporation became a member of a separate affiliated group as a result of one or more transactions in which gain or loss was recognized in whole or in part, any trade or business conducted by such corporation (at the time that such corporation became such a member) is treated for purposes of section 355(b)(2) as acquired in a transaction in which gain or loss was recognized in whole or in part. Accordingly, such an acquisition is subject to the provisions of section 355(b)(2)(C), and may qualify as an expansion of an existing active trade or business conducted by the distributing corporation or the controlled corporation, as the case may be.

The provision clarifies that the Treasury Department shall prescribe regulations that provide for the application of sections 355(b)(2)(B), (C), and (D) in the case of any corporation that is tested for active business under the separate affiliated group rule, and that modify the application of section 355(a)(3)(B) in the case of such a corporation in a manner consistent with the purposes of the provision.

153 Cong. Rec. S16057 (daily ed. Dec. 19, 2007) (Joint Committee on Taxation’s explanation of H.R. 4839, which explanation was printed in the Congressional Record at the request of Senator Baucus, who stated that the explanation expressed the Senate Finance Committee’s understanding of the bill).

Accordingly, the SAG regime affords a group a certain amount of flexibility regarding the satisfaction of the ATB requirement. For example, Congress indicated that, for purposes of section 355(b), in certain circumstances a stock acquisition will be treated in a manner comparable to an asset acquisition and, as such, may constitute an expansion of an existing trade or business. The IRS and Treasury Department have further interpreted the SAG regime to disregard acquisitions of additional stock of a current subsidiary SAG member for purposes of satisfying the ATB requirement. See proposed §1.355–3(b)(1)(ii).

Although the SAG regime is not applicable for purposes of section 355(a)(3)(B), the Technical Corrections provide a specific grant of regulatory authority indicating that the application of the hot stock rule may be modified to apply in a manner consistent with the SAG regime of section 355(b)(3). Toward that end, these temporary regulations reflect the fundamental conclusion that the hot stock rule should not apply to any acquisition of stock of controlled where controlled is a DSAG member at any time after the acquisition (but prior to the distribution of controlled).

Such a conclusion resolves conflicts that would otherwise arise under section 355(a)(3)(B) and section 355(b). For example, suppose distributing acquired all of
controlled’s stock in a taxable transaction that qualified as an expansion of distributing’s existing trade or business under the SAG regime, and later distributed all such stock within five years of the acquisition in an unrelated transaction. The distribution would satisfy the ATB requirement but, absent the rule reflected in these temporary regulations, could otherwise be fully taxable under the hot stock rule. Such a result seems inconsistent with Congressional intent. Similarly, to achieve consistency with the SAG regime, if controlled is a DSAG member and distributing acquires additional controlled stock, such acquisition should be disregarded for purposes of section 355(a)(3)(B).

Therefore, these temporary regulations generally provide that controlled stock acquired by the DSAG within the pre-distribution period in a taxable transaction constitutes hot stock, except if controlled is a DSAG member at any time after the acquisition (but prior to the distribution of controlled). Accordingly, each of Rev. Rul. 76–54, 1976–1 C.B. 96, and Rev. Rul. 65–286, 1965–2 C.B. 92, is obsolete.

2. Transfers Among DSAG Members

Consistent with the SAG regime, which treats the DSAG as a single corporation, transfers of controlled stock owned by DSAG members immediately before and immediately after the transfer are disregarded and are not treated as acquisitions for purposes of the hot stock rule. Compare proposed §1.355–3(b)(1)(ii) (applying a similar rule for purposes of the ATB requirement).

3. Hot Stock Rule Inapplicable to Acquisitions from Certain Affiliates

Former §1.355–2(g) provided that the hot stock rule did not apply to acquisitions of controlled stock in a transaction described in §1.355–3(b)(4)(iii) (affiliate exception). In other words, former §1.355–2(g) generally exempted from the hot stock rule an acquisition of controlled stock by distributing from a member of the affiliated group (as defined in §1.355–3(b)(4)(iv)) of which distributing was a member. Compare Notice 2007–60, 2007–2 C.B. 466 (IRS will not challenge applicability of §1.355–3(b)(4)(iii) to distributions effected on or before date temporary or final regulations modifying §1.355–3(b)(4)(iii) are published). These temporary regulations retain the affiliate exception of former §1.355–2(g) (including its treatment of stock described in section 1504(a)(4)). The IRS and Treasury Department, however, continue to study what impact transfers between affiliates should have on the satisfaction of the ATB requirement and the application of the hot stock rule and believe that, when finalized, the rules regarding the ATB requirement and the hot stock rule should generally be applied consistently with respect to transactions between affiliates.


The IRS and Treasury Department are considering issuing additional guidance under section 355(a)(3)(B), as described in this section 4 of the preamble. Such guidance would be in addition to, rather than in replacement of, these temporary regulations. In this issue of the Bulletin (REG–150670–07), comments are requested regarding these temporary regulations and the issues described in this preamble.

4.A. Dunn Trust and Predecessor Issues

Section 355(a)(3)(B) applies to controlled stock acquired by reason of any transaction during the pre-distribution period in which gain or loss is recognized in whole or in part. The primary types of transactions for which the IRS and Treasury Department are considering issuing additional guidance generally involve the effect of indirect acquisitions and the extent to which predecessor rules should apply for purposes of the hot stock rule. Although the IRS and Treasury Department are considering addressing in future guidance the issues arising in transactions described in this section 4.A. of the preamble, no inference should be drawn regarding the present application of section 355(a)(3)(B), including these temporary regulations, to such transactions.

For example, future guidance may address whether, in a situation where a corporation that owns controlled stock joins the DSAG in a taxable transaction, the DSAG is treated as acquiring the controlled stock in a taxable transaction. Compare section 355(b)(3)(B); proposed §1.355–3(b)(1)(ii) and (b)(4)(i). Similarly, guidance may address the treatment of taxable acquisitions of controlled stock during the pre-distribution period by a corporation that subsequently joins the DSAG in a nontaxable transaction.

The IRS and Treasury Department are also considering issuing additional guidance that treats the DSAG as making any acquisition made by a predecessor of a DSAG member. Compare H.R. Rep. No. 83–2543, at 38 (1954) (Conf. Rep.) (“by reason of” language of section 355(a)(3)(B) encompasses purchase of controlled stock by a corporation that is in control of distributing prior to “downstairs merger” by such purchaser into distributing). For this purpose, a predecessor of a corporation would be a corporation that transfers its assets to such corporation in a transaction to which section 381(a) applies. Such guidance would address the circumstances in which a predecessor of distributing (or predecessor of a DSAG member) effects an acquisition of controlled stock described in section 355(a)(3)(B).

Additionally, if a DSAG acquires stock of a corporation (target) during the pre-distribution period in a taxable transaction and such target is subsequently acquired by controlling in a section 381(a) transaction, the earlier taxable acquisition of target stock may implicate section 355(a)(3)(B). A conceptually similar issue was addressed in Dunn Trust v. Commissioner, 86 T.C. 745 (1986), acq. (1998–1 C.B. 5 n. 4 (acquiescing in result only)), except that in Dunn Trust the target that was acquired by distributing was not subsequently acquired by controlling in a section 381(a) transaction. Instead, in Dunn Trust, distributing acquired stock of target in a taxable transaction and subsequently contributed such target stock (which stock could not have been distributed without violating section 355(a)(3)(B)) to controlled in exchange for controlled stock in a nontaxable transaction. The Tax Court ruled that the controlled stock was not hot stock under section 355(a)(3)(B). Where distributing acquires target stock in a taxable transaction, and the target is subsequently either combined with controlled in a nontaxable section 381(a) transaction or (as in Dunn Trust) acquired by controlling in a nontaxable stock acquisition, the IRS and Treasury Department believe that such
acquisitions raise an issue as to whether target or controlled is the “real controlled” for purposes of section 355(a)(3)(B).

Identifying the “real controlled” might be illustrated by the following example. Assume that distributing owns an amount of stock in controlled that constitutes control within the meaning of section 368(c) but which does not meet the requirements of section 1504(a)(2). Controlled, in turn, owns stock of a target subsidiary that satisfies the requirements of section 1504(a)(2). Distributing acquires additional target stock in a taxable transaction, which stock is then contributed to controlled in exchange for additional controlled stock in a transaction to which section 351(a) applies. Assume that neither controlled nor target joins the DSAG section 351(a) applies. Assume that neither controlled nor target joins the DSAG after either step. The question under section 355(a)(3)(B) is whether a target whose stock is acquired by the DSAG in a taxable transaction should be treated as the “real controlled”, where such additional target stock is subsequently acquired by the actual controlled (or, in some cases, a CSAG member) in a nontaxable transaction. The IRS and Treasury Department are considering issuing guidance that would provide that a target whose stock is acquired by distributing in a taxable transaction may be treated as the “real controlled” for purposes of section 355(a)(3)(B) if, at the time of the distribution, the CSAG cannot satisfy the requirements of section 355(b) without taking into account an ATB conducted by the target at the time the DSAG acquired the stock of the target in the taxable transaction. In other words, section 355(a)(3)(B) could be implicated as a result of an acquisition of target stock if the target is engaged in an ATB at the time the DSAG acquires the target stock in a taxable transaction, the target stock is then acquired by controlled (or, in some cases, a CSAG member) prior to the distribution, and at the time of the distribution of the controlled stock the CSAG is not able to satisfy the requirements of section 355(b) without taking into account an ATB that was being conducted by the target at the time the DSAG acquired the target stock in the taxable transaction.

B. Issuances of controlled stock outside the Dunn Trust or predecessor context

The IRS and Treasury Department are considering additional guidance that would generally provide that issuances of controlled stock by controlling to distributing in a taxable transaction do not give rise to hot stock. For example, such an acquisition may occur where section 357(c) applies (see Rev. Rul. 78–442, 1978–2 C.B. 143) (transferring a business to wholly-owned controlled, which assumes distributing’s liabilities)). As noted in Rev. Rul. 78–442, the IRS and Treasury Department believe that section 355(b)(2)(C) was not intended to apply to such an acquisition of a trade or business by controlled from distributing under the facts of that ruling even if it is a taxable transaction because the acquisition was not from an “outside party”. “[F]or the same reasons, section 355(a)(3)(B) . . . is not applicable to the distribution” of controlled stock acquired in such a transaction.

The IRS and Treasury Department request comments regarding the extent to which issuances by controlled of controlled stock to distributing in taxable transactions should not give rise to hot stock, whether distributing must own some minimum percentage in controlled at the time of such issuance in order for such an acquisition to be excepted from section 355(a)(3)(B), and the extent to which such transactions are adequately addressed under section 355(a)(1)(B) (relating to device) and section 355(g) (relating to distributions involving disqualified investment corporations).

C. Redemptions of controlled stock

Finally, the IRS and Treasury Department request comments regarding the effect of redemptions of controlled stock under section 355(a)(3)(B). Generally, if the controlled shares distributed by distributing were not acquired by distributing during the pre-distribution period, such shares cannot be hot stock. Therefore, a redemption by controlled of its stock from unrelated parties generally should not cause any portion of distributing’s controlled stock to become hot stock. Such a rule may be distinguishable from the rule under section 355(b)(2)(D). See McLaulin v. Commissioner, 276 F.3d 1269 (11th Cir. 2001) (applying section 355(b)(2)(D) when distributing acquired control of a subsidiary through a redemption of subsidiary stock), and Rev. Rul. 57–144, 1957–1 C.B. 123 (same).

The distinction can be made based on the different focus of the provisions. Section 355(a)(3)(B) provides that controlled stock “acquired by the distributing corporation” during the pre-distribution period in a taxable transaction is hot stock, and is directed at the property distributed to the distributing shareholders. In a redemption, generally no additional shares of stock are acquired by distributing and generally no additional value is distributed to the distributing shareholders. In contrast, section 355(b)(2)(D) prohibits the acquisition of “control of a corporation.” Control is a requisite status in order for distributing to distribute the stock of controlled to its shareholders under section 355. A redemption can confer this status on distributing without distributing’s acquiring any additional shares of stock.

However, for purposes of section 355(a)(3)(B), the IRS and Treasury Department believe that a redemption of controlled stock from a shareholder other than distributing is the equivalent of distributing’s purchase of controlled stock from the redeemed shareholder to the extent distributing is the source of funds for the redemption. Further, the IRS and Treasury Department are studying whether there are other situations in which distributing’s increased percentage ownership in controlled resulting from redemptions of controlled stock from a shareholder other than distributing should be treated as hot stock.

5. Request for Comments

In this issue of the Bulletin (REG–150670–07), the IRS and Treasury Department are requesting comments regarding these temporary regulations, including comments on whether section 355(a)(3)(B) should use the same definition of taxable transaction as section 355(b), whether the exception for acquisitions from certain affiliates should be the same for both provisions, and the other issues described in this preamble.
Effective/Applicability Date

These temporary regulations are generally applicable for distributions occurring after December 15, 2008. However, unless taxpayers elect otherwise, these temporary regulations do not apply to any distribution occurring after December 15, 2008, that is pursuant to a transaction which is (1) made pursuant to an agreement which was binding on December 15, 2008, and at all times thereafter; (2) described in a ruling request submitted to the IRS on or before such date; or (3) described on or before such date in a public announcement or in a filing with the Securities and Exchange Commission. Furthermore, taxpayers may elect to apply these temporary regulations retroactively to distributions to which sec-

Drafting Information

The principal author of these temporary regulations is Russell P. Subin of the Office of Associate Chief Counsel (Corpo-
rate). However, other personnel from the IRS and Treasury Department participated in their development.

Availability of IRS Documents

Documents published in the IRB cited in this preamble are available from the Superintendent of Documents, U.S. Gov-

Effect on Other Documents

The following publications are obsolete as of the applicability of these temporary regulations:


Special Analyses

It has been determined that this Treas-

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.355–2T(g) and (i) are also issued under 26 U.S.C. 355(b)(3)(D). **

Par. 2. Section 1.355–0 is amended by amending the entry under §1.355–2 to paragraph (g) and add paragraph (i) to read as follows:

§1.355–0 Outline of sections.

§1.355–2 Limitations.

(g) [Reserved].

(i) [Reserved].

Par. 3. Section 1.355–0T is added to read as follows:

§1.355–0T Outline of sections (temporary).

This section lists the major paragraphs under §1.355–2T.

§1.355–2T Limitations (temporary).

(a) through (f)(2) [Reserved]. For further guidance, see the entries for §1.355–2(a) through (f)(2) in §1.355–0.

(g) Recently acquired controlled stock under section 355(a)(3)(B).

(1) Other property.

(2) Exceptions.

(3) DSAG.

(4) Taxable transaction.

(5) Examples.

(h) [Reserved]. For further guidance, see the entry for §1.355–2(h) in §1.355–0.

(i) Effective/applicability date.

(1) In general.

(2) Transition election.

(3) Retroactive election.

(4) Manner of election.

(5) Prior law.

(6) Expiration date.

Par. 4. Section 1.355–1 is amended by revising paragraph (a) to read as follows:

§1.355–1 Distribution of stock and securities of a controlled corporation.

(a) Effective/applicability date of certain sections. Except as otherwise provided, this section and §§1.355–2 through 1.355–4 apply to transactions occurring after February 6, 1989. For transactions occurring on or before that date, see 26 CFR 1.355–1 through 1.355–4 (revised as of April 1, 1987). This section and §§1.355–2 through 1.355–4, other than $1.355–2(g) and (i) and $1.355–2T, do not reflect the amendments to section 355 made by the Revenue Act of 1987, the Technical and Miscellaneous Revenue Act of 1988, and the Tax Technical Corrections Act of 2007. For the applicability date of §§1.355–2T(g), 1.355–5, 1.355–6, and 1.355–7, see §§1.355–2T(i), 1.355–5(e), 1.355–6(g), and 1.355–7(k), respectively.

Par. 5. Section 1.355–2 is amended by revising paragraph (g) and adding paragraph (i) to read as follows:

§1.355–2 Limitations.

(g) [Reserved]. For further guidance, see §1.355–2T(g).

(i) [Reserved]. For further guidance, see §1.355–2T(i).

Par. 6. Section 1.355–2T is added to read as follows:

Par. 7. Section 1.355–3 is amended by revising paragraph (g) and adding paragraph (i) to read as follows:

§1.355–3 Limitations.

(g) [Reserved]. For further guidance, see §1.355–3T(g).

(i) [Reserved]. For further guidance, see §1.355–3T(i).

Par. 8. Section 1.355–4 is added to read as follows:

Par. 9. Section 1.355–5 is amended by revising paragraph (g) and adding paragraph (i) to read as follows:

§1.355–5 Limitations.

(g) [Reserved]. For further guidance, see §1.355–5T(g).

(i) [Reserved]. For further guidance, see §1.355–5T(i).

Par. 10. Section 1.355–5T is added to read as follows:

§1.355–5T Limitations (temporary).

(a) through (f)(2) [Reserved]. For further guidance, see the entries for §1.355–5(a) through (f)(2) in §1.355–0.

(g) Recently acquired controlled stock under section 355(a)(3)(B).

(1) Other property.

(2) Exceptions.

(3) DSAG.

(4) Taxable transaction.

(5) Examples.

(h) [Reserved]. For further guidance, see the entry for §1.355–2(h) in §1.355–0.

(i) Effective/applicability date.

(1) In general.

(2) Transition election.

(3) Retroactive election.

(4) Manner of election.

(5) Prior law.

(6) Expiration date.

Par. 11. Section 1.355–6 is amended by revising paragraph (g) and adding paragraph (i) to read as follows:

§1.355–6 Limitations.

(g) [Reserved]. For further guidance, see §1.355–6T(g).

(i) [Reserved]. For further guidance, see §1.355–6T(i).

Par. 12. Section 1.355–6T is added to read as follows:

Par. 13. Section 1.355–7 is amended by revising paragraph (g) and adding paragraph (i) to read as follows:

§1.355–7 Limitations.

(g) [Reserved]. For further guidance, see §1.355–7T(g).

(i) [Reserved]. For further guidance, see §1.355–7T(i).

Par. 14. Section 1.355–7T is added to read as follows:

Par. 15. Section 1.355–8 is amended by revising paragraph (g) and adding paragraph (i) to read as follows:

§1.355–8 Limitations.

(g) [Reserved]. For further guidance, see §1.355–8T(g).

(i) [Reserved]. For further guidance, see §1.355–8T(i).

Par. 16. Section 1.355–8T is added to read as follows:

Par. 17. Section 1.355–9 is amended by revising paragraph (g) and adding paragraph (i) to read as follows:

§1.355–9 Limitations.

(g) [Reserved]. For further guidance, see §1.355–9T(g).

(i) [Reserved]. For further guidance, see §1.355–9T(i).

Par. 18. Section 1.355–9T is added to read as follows:

Par. 19. Section 1.355–10 is amended by revising paragraph (g) and adding paragraph (i) to read as follows:

§1.355–10 Limitations.

(g) [Reserved]. For further guidance, see §1.355–10T(g).

(i) [Reserved]. For further guidance, see §1.355–10T(i).

Par. 20. Section 1.355–10T is added to read as follows:
§1.355–2T Limitations (temporary).

(a) through (f)(2) [Reserved]. For further guidance, see §1.355–2(a) through (f)(2).

(g) Recently acquired controlled stock under section 355(a)(3)(B)—(1) Other property. Except as provided in paragraph (g)(2) of this section, for purposes of section 355(a)(1)(A), section 355(c), and so much of section 356 as relates to section 355, stock of a controlled corporation acquired by the DSAG in a taxable transaction (as defined in paragraph (g)(4) of this section) within the five-year period ending on the date of the distribution (pre-distribution period) shall not be treated as stock of the controlled corporation but shall be treated as “other property.” Transfers of controlled corporation stock that is owned by the DSAG immediately before and immediately after the transfer are disregarded and are not acquisitions for purposes of this paragraph (g)(1).

(2) Exceptions. Paragraph (g)(1) of this section does not apply to an acquisition of stock of the controlled corporation—

(i) If the controlled corporation is a DSAG member at any time after the acquisition (but prior to the distribution); or

(ii) Described in §1.355–3(b)(4)(iii).

(3) DSAG. For purposes of this paragraph (g), a DSAG is the distributing corporation’s separate affiliated group (the affiliated group which would be determined under section 1504(a) if such corporation were the common parent and section 1504(b) did not apply) that consists of the distributing corporation as the common parent and all corporations affiliated with the distributing corporation through stock ownership described in section 1504(a)(1)(B) (regardless of whether the corporations are includible corporations under section 1504(b)). For purposes of paragraph (g)(1) of this section, any reference to the DSAG is a reference to the distributing corporation if it is not the common parent of a separate affiliated group.

(4) Taxable transaction—(i) Generally. For purposes of this paragraph (g), a taxable transaction is a transaction in which gain or loss was recognized in whole or in part.

(ii) Dunn Trust and predecessor issues. [Reserved].

(5) Examples. The following examples illustrate this paragraph (g). Assume that C, D, P, and S are corporations, X is an unrelated individual, each of the transactions is unrelated to any other transaction and, but for the issue of whether C stock is treated as “other property” under section 355(a)(3)(B), the distributions satisfy all of the requirements of section 355. No inference is drawn from any of these examples as to whether any requirements of section 355 other than section 355(a)(3)(B), as specified, are satisfied. Furthermore, the following definitions apply:

(i) Purchase is an acquisition that is a taxable transaction.

(ii) Section 368(c) stock is stock constituting control within the meaning of section 368(c).

(iii) Section 1504(a)(2) stock is stock meeting the requirements of section 1504(a)(2).

Example 1. Hot stock. For more than five years, D has owned section 368(c) stock but not section 1504(a)(2) stock of C. In year 6, D purchases additional C stock from X. However, D does not own section 1504(a)(2) stock of C after the year 6 purchase. If D distributes all of its C stock within five years after the year 6 purchase, for purposes of section 355(a)(1)(A), section 355(c), and so much of section 356 as relates to section 355, the C stock purchased in year 6 would be treated as “other property.” See paragraph (g)(1) of this section.

Example 2. C becomes a DSAG member. For more than five years, D has owned section 368(c) stock but not section 1504(a)(2) stock of C. In year 6, D purchases additional C stock from X such that D’s total ownership of C is section 1504(a)(2) stock. If D distributes all of its C stock within five years after the year 6 purchase, the distribution of the C stock purchased in year 6 would not be treated as “other property” because C becomes a DSAG member. See paragraph (g)(2)(ii) of this section. The result would be the same if D did not own any C stock prior to year 6 and D purchased all of the C stock in year 6. See paragraph (g)(2)(i) of this section. Similarly, if D did not own any C stock prior to year 6, D purchased 20 percent of the C stock in year 6, and then acquired all of the remaining C stock in year 7, the C stock purchased in year 6 and the C stock acquired in year 7 (even if purchased) would not be treated as “other property” because C becomes a DSAG member. See paragraph (g)(2)(i) of this section.

Example 3. Intra-SAG transaction. For more than five years, D has owned all of the stock of S. D and S, in the aggregate, have owned section 368(c) stock but not section 1504(a)(2) stock of C. Therefore, D and S are DSAG members, but C is not. In year 6, D purchases S’s C stock. If D distributes all of its C stock within five years after the year 6 purchase, the distribution of the C stock purchased in year 6 would not be treated as “other property.” D’s purchase of the C stock from S is disregarded for purposes of paragraph (g)(1) of this section because that C stock was owned by the DSAG immediately before and immediately after the purchase. See paragraph (g)(1) of this section.

Example 4. Affiliate exception. For more than five years, P has owned 90 percent of the sole outstanding class of the stock of D and a portion of the stock of C, and X has owned the remaining 10 percent of the D stock. Throughout this period, D has owned section 368(c) stock but not section 1504(a)(2) stock of C. In year 6, D purchases P’s C stock. However, D does not own section 1504(a)(2) stock of C after the year 6 purchase. If D distributes all of its C stock to X in exchange for X’s D stock within five years after the year 6 purchase, the distribution of the C stock purchased in year 6 would not be treated as “other property” because the C stock was purchased from a member (P) of the affiliated group (as defined in §1.355–3(b)(4)(iv)) of which D is a member, and P did not purchase that C stock within the pre-distribution period. See paragraph (g)(2)(ii) of this section.

(h) [Reserved]. For further guidance, see §1.355–2(h).

(i) Effective/applicability date—(1) In general. Paragraphs (g)(1) through (g)(5) of this section apply to distributions occurring after December 15, 2008. However, except as provided in paragraph (i)(2) of this section, paragraphs (g)(1) through (g)(5) of this section do not apply to any distribution occurring after December 15, 2008, that is pursuant to a transaction which is—

(i) Made pursuant to an agreement which was binding on December 15, 2008, and at all times thereafter;

(ii) Described in a ruling request submitted to the Internal Revenue Service on or before such date; or

(iii) Described on or before such date in a public announcement or in a filing with the Securities and Exchange Commission.

(2) Transition election. In the case of any distribution described in the second sentence of paragraph (i)(1) of this section, taxpayers may elect to apply all of paragraphs (g)(1) through (g)(5) of this section. However, neither the distributing corporation nor any person related to the distributing corporation within the meaning of section 267(b) (determined immediately before or immediately after the distribution) may make such an election with respect to a distribution unless all such persons make such an election with respect to such distribution.

(3) Retroactive election. In the case of any distribution occurring on or before December 15, 2008, taxpayers may elect to apply all of paragraphs (g)(1) through (g)(5) of this section to distributions to which section 4(b) of the Tax Techni-
cal Corrections Act of 2007, Public Law 110–172 (121 Stat. 2473, 2476) applies (generally applicable to distributions made after May 17, 2006, as provided in section 4(d) of that act). However, neither the distributing corporation nor any person related to the distributing corporation within the meaning of section 267(b) (determined immediately before or immediately after the distribution) may make such an election with respect to a distribution unless all such persons make such an election with respect to such distribution.

(4) Manner of election. Taxpayers may make any election available under this paragraph (i) by applying the selected rule on its original or amended return.

(5) Prior law. For distributions to which paragraphs (g)(1) through (g)(5) of this section do not apply, see §1.355–2(g), as contained in 26 CFR part 1, revised as of April 1, 2008.

(6) Expiration date. The applicability of paragraph (i) of this section will expire on December 15, 2011.

Steve T. Miller,
(Acting) Deputy Commissioner for
Services and Enforcement.

Approved December 2, 2008.

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

Section 368.—Definitions Relating to Corporate Reorganizations

26 CFR 1.368–1: Purpose and scope of exception to reorganization exchanges.

T.D. 9434

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Creditor Continuity of Interest

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations providing guidance regarding when and to what extent creditors of a corporation will be treated as proprietors of the corporation in determining whether continuity of interest (“COI”) is preserved in a potential reorganization. These final regulations are necessary to provide clarity to parties engaging in reorganizations of insolvent corporations, both inside and outside of bankruptcy. These final regulations affect corporations, their creditors, and their shareholders.

DATES: Effective Date: These final regulations are effective on December 12, 2008.

Applicability Date: For dates of applicability, see §1.368–1(e)(9).


SUPPLEMENTARY INFORMATION:

Background

On March 10, 2005, the IRS and Treasury Department published a notice of proposed rulemaking (REG–163314–03, 2005–1 C.B. 835) in the Federal Register (70 FR 11903) proposing regulations that would provide guidance regarding the application of the nonrecognition rules of subchapter C of the Internal Revenue Code (Code) to transactions involving insolvent corporations and to other transactions that raise similar issues. No public hearing regarding the proposed regulations was requested or held. The IRS and Treasury Department have carefully considered the comments regarding the proposed regulations. The IRS and Treasury Department continue to consider the issues raised and to evaluate the complexity and necessity for valuation under the exchange of net value requirement. In the interim, these final regulations adopt the portion of the proposed regulations that deals with the circumstances in which (and the extent to which) creditors of a corporation will be treated as proprietors of the corporation in determining whether continuity of interest is preserved in a potential reorganization.

Explanation of Provisions

These final regulations provide that, in certain circumstances, stock received by creditors may count for continuity of interest purposes both inside and outside of bankruptcy proceedings. The expansion of the application of the G reorganization rules to reorganizations of insolvent corporations outside of bankruptcy is consistent with Congress’ intent to facilitate the rehabilitation of troubled corporations. S. Rep. No 96–1035, 96th Sess. 35 (1980). Accordingly, the final regulations adopt the rules proposed for creditors of an insolvent target corporation outside of a title 11 or similar case in new §1.368–1(e)(6) with only minor modifications and clarifications. The final regulations treat claims of the most senior class of creditors to receive a proprietary interest in the issuing corporation and claims of all equal classes of creditors (together, the senior claims) differently from the claims of classes of creditors junior to the senior claims (the junior claims). The final regulations treat such senior claims as representing proprietary interests in the target corporation. While such senior claims, and all junior claims, are treated as representing a proprietary interest in the target corporation, the determination of the value of proprietary interests in the target corporation represented by the senior claims is made by calculating the average treatment for all senior claims. The final regulations provide that the value of a proprietary interest in the target corporation represented by a senior claim is determined by multiplying the fair market value of the creditor’s claim by a fraction, the numerator of which is the fair market value of the proprietary interests in the issuing corporation that are received in the aggregate in exchange for the senior claims, and the denominator of which is the sum of the amount of money and the fair market value of all other consideration (including the proprietary interests in the issuing corporation) received in the aggregate in exchange for such claims. In contrast to the treatment of the senior creditor class that receives stock of the issuing corporation, the value of the proprietary interest in the target corporation represented by a junior claim is the fair market value of the junior claim. The effect of this rule is that there is 100 percent continuity of interest if each senior claim is sat-
satisfied with the same ratio of stock to nonstock consideration and no junior claim is satisfied with nonstock consideration. An example was added to the COI rule in response to a suggestion that the final regulations demonstrate the bifurcation of senior claims when the creditors of the class receive disproportionate amounts of acquiring corporation stock and other property. Also, in response to comments, a rule was added to the final regulations requiring that in the situation where there is only one class of creditors receiving stock, more than a de minimis amount of issuing corporation stock must be exchanged for the creditors’ proprietary interests relative to the total consideration received by the insolvent target corporation, its shareholders, and its creditors, before the stock will be counted for purposes of COI.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these final regulations and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Jean Brenner, Douglas Bates, and Bruce Decker of the Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows: Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.368–1 is amended by:
1. Adding a sentence after the fifth sentence of paragraph (e)(1)(i).
2. Adding a sentence at the end of paragraph (e)(1)(ii).
3. Revising paragraph (e)(3).
4. Redesignating paragraphs (e)(6), (e)(7), and (e)(8) as paragraphs (e)(7), (e)(8), and (e)(9) respectively, and adding a new paragraph (e)(6).
5. Adding Example 10 to the end of newly designated paragraph (e)(8).
6. Adding a sentence at the end of newly designated paragraph (e)(9)(i).

The additions and revisions read as follows:

§1.368–1 Purpose and scope of exception to reorganization exchanges.

* * * * *

(e) * * *

(1) * * * See paragraph (e)(6) of this section for rules related to when a creditor’s claim against a target corporation is a proprietary interest in the corporation. * * *

(ii) * * * A proprietary interest in the target corporation is not preserved to the extent that creditors (or former creditors) of the target corporation that own a proprietary interest in the corporation under paragraph (e)(6) of this section (or would be so treated if they had received the consideration in the potential reorganization) receive payment for the claim prior to the potential reorganization and such payment would be treated as other property or money received in the exchange for purposes of section 356 had it been a distribution with respect to stock.

(3) Related person acquisitions. A proprietary interest in the target corporation is not preserved if, in connection with a potential reorganization, a person related to the issuing corporation acquires, for consideration other than stock of the issuing corporation, either a proprietary interest in the target corporation or stock of the issuing corporation that was furnished in exchange for a proprietary interest in the target corporation. The preceding sentence does not apply to the extent those persons who were the direct or indirect owners of the target corporation prior to the potential reorganization maintain a direct or indirect proprietary interest in the issuing corporation.

* * * * *

(6) Creditors’ claims as proprietary interests—(i) In general. A creditor’s claim against a target corporation may be a proprietary interest in the target corporation if the target corporation is in a title 11 or similar case (as defined in section 368(a)(3)) or the amount of the target corporation’s liabilities exceeds the fair market value of its assets immediately prior to the potential reorganization. In such cases, if any creditor receives a proprietary interest in the issuing corporation in exchange for its claim, every claim of that class of creditors and every claim of all equal and junior classes of creditors (in addition to the claims of shareholders) is a proprietary interest in the target corporation immediately prior to the potential reorganization to the extent provided in paragraph (e)(6)(ii) of this section.

(ii) Value of proprietary interest—(A) Claims of most senior class of creditor receiving stock. A claim of the most senior class of creditors receiving a proprietary interest in the issuing corporation and a claim of any equal class of creditors will be treated as a proprietary interest in accordance with the rules of this paragraph (e)(6)(ii). For a claim of the most senior class of creditors receiving a proprietary interest in the issuing corporation and a claim of any equal class of creditors, the value of the proprietary interest in the target corporation represented by the claim is determined by multiplying the fair market value of the claim by a fraction, the numerator of which is the fair market value of the proprietary interests in the issuing corporation that are received in the aggregate in exchange for the claims of those classes of creditors, and the denominator of which is the sum of the amount of money and the fair market value of all other consideration (including the proprietary interests in the issuing corporation) received in the aggregate in exchange for such claims. If only one class (or one set of equal classes) of creditors receives stock, such class (or set of equal classes) is treated as the most senior class of creditors receiving stock.
Example 10. Creditors treated as owning a proprietary interest. (i) More than one class of creditor receives issuing corporation stock. T has assets with a fair market value of $150x and liabilities of $200x. T has two classes of creditors: two senior creditors with claims of $25x each; and one junior creditor with a claim of $150x. T transfers all of its assets to P in exchange for $95x in cash and shares of P stock with a fair market value of $55x. Each T senior creditor receives $20x in cash and P stock with a fair market value of $55x in exchange for his claim. The T junior creditor receives $55x in cash and P stock with a fair market value of $45x in exchange for his claim. The T shareholders receive no consideration in exchange for their T stock. Under paragraph (e)(6) of this section, because the amount of T’s liabilities exceeds the fair market value of its assets immediately prior to the potential reorganization, the claims of the creditors of T are proprietary interests in T immediately prior to the transaction. Under paragraph (e)(6)(ii)(A) of this section, the value of the proprietary interest of each of the senior creditors’ claims is $55x (the fair market value of the senior creditor’s claim, $25x, multiplied by a fraction, the numerator of which is $10x, the fair market value of the proprietary interests in the issuing corporation, P, received in the aggregate in exchange for the claims of all the creditors in the senior class, and the denominator of which is $50x, the sum of the amount of money and the fair market value of all other consideration (including the proprietary interests in P) received in the aggregate in exchange for such claims). Accordingly, $55x of the stock that each of the senior creditors receives is counted in measuring continuity of interest. Under paragraph (e)(6)(ii)(B) of this section, the value of the junior creditor’s proprietary interest in T immediately prior to the transaction is $100x, the value of his claim. Thus, the value of the creditors’ proprietary interests in total is $110x and the creditors received $55x worth of P stock in total in exchange for their proprietary interests. Therefore, P acquired 50 percent of the value of the proprietary interests in T in exchange for P stock. Because a substantial part of the value of the proprietary interests in T is preserved, the continuity of interest requirement is satisfied. (ii) One class of creditor receives issuing corporation stock and cash in disproportionate amounts. T has assets with a fair market value of $80x and liabilities of $200x. T has one class of creditor with two creditors, A and B, each having a claim of $100x. T transfers all of its assets to P for $60x in cash and shares of P stock with a fair market value of $20x. A receives $40x in cash in exchange for its claim. B receives $20x in cash and P stock with a fair market value of $20x in exchange for its claim. The T shareholders receive no consideration in exchange for their T stock. The P stock is not de minimis in relation to the total consideration received. Under paragraph (e)(6) of this section, because the amount of T’s liabilities exceeds the fair market value of its assets immediately prior to the potential reorganization, the claims of the creditors of T may be proprietary interests in T. Because the creditors of T received proprietary interests in P in the transaction in exchange for their claims, their claims and the T stock are treated as proprietary interests in T immediately prior to the transaction. Under paragraphs (e)(6)(ii)(A) and (b) of this section, the value of the proprietary interest of each of the senior creditors’ claims is $55x (the fair market value of the senior creditor’s claim, $25x, multiplied by a fraction, the numerator of which is $10x, the fair market value of the proprietary interests in the issuing corporation, P, received in the aggregate in exchange for the claims of all the creditors in the senior class, and the denominator of which is $50x, the sum of the amount of money and the fair market value of all other consideration (including the proprietary interests in P) received in the aggregate in exchange for such claims). Accordingly, $55x of the stock that was received by B are counted in measuring continuity of interest. Thus, the value of the creditors’ proprietary interests in total is $20x and the creditors received $10x worth of P stock in total in exchange for their proprietary interests. Therefore, P acquired 50 percent of the value of the proprietary interests in T in exchange for P stock. Because a substantial part of the value of the proprietary interests in T is preserved, the continuity of interest requirement is satisfied.

Section 7216—Disclosure or Use of Information by Preparers of Returns

26 CFR 301.7216–3: Disclosure or use permitted only with the taxpayer’s consent.

T.D. 9437

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 301

Amendments to the Section 7216 Regulations—Disclosure or Use of Information by Preparers of Returns

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and removal of temporary regulations.

SUMMARY: This document contains final regulations that provide rules relating to the disclosure and use of tax return information by tax return preparers. These regulations affect tax return preparers and provide updated guidance regarding the disclosure of a taxpayer’s social security number to a tax return preparer located outside of the United States.

DATES: Effective Date: These regulations are effective on December 16, 2008.

Applicability Date: See §301.7216–3(d), which states that the regulations apply to disclosures or uses of tax return information occurring on or after January 1, 2009.

FOR FURTHER INFORMATION CONTACT: Molly K. Donnelly, (202) 622–4940 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document amends 26 CFR part 301. On December 8, 2005, the Treasury Department and the IRS published a notice of proposed rulemaking (REG–137243–02, 2006–1 C.B. 317) in the Federal Register proposing amendments to the regulations under section 7216 (regarding the use or disclosure of tax return information by income tax return preparers). On January 3, 2008, the Treasury Department and the IRS issued final regulations under section 7216 (T.D. 9375, 2008–5 I.R.B. 344) applicable to disclosures or uses of tax return information occurring on or after January 1, 2008. Thus, T.D. 9375 replaced previously issued final regulations that remain applicable to disclosures or uses of tax return information occurring prior to January 1, 2009.

T.D. 9375 included a revision of §301.7216–3(b)(4) which, for disclosures and uses of tax return information occurring on or after January 1, 2009, provided that an income tax return preparer located in the United States may not disclose the taxpayer’s social security number (SSN) to a tax return preparer located outside of the United States even if the taxpayer consents to the disclosure.

On July 1, 2008, a temporary regulation (T.D. 9409, 2008–29 I.R.B. 118) was published in the Federal Register that created a limited exception to the rule prohibiting the disclosure of a taxpayer’s SSN outside of the United States. This temporary regulation modified the rules under §301.7216–3(b)(4). A notice of proposed rulemaking (REG–121698–08, 2008–29 I.R.B. 163) cross-referencing the temporary regulations was published in the Federal Register for the same day (73 FR 37910), requesting comments and setting a public hearing date.

Summary of Comments and Explanation of Revisions

The IRS and the Treasury Department requested written or electronic comments by September 30, 2008. Persons wishing to present oral comments at the public hearing scheduled for October 6, 2008, were to submit an outline of the topics to be discussed at the hearing by September 15, 2008, and written or electronic comments by September 30, 2008. No written or electronic comments or requests to speak at the hearing, together with the required outline of topics, were submitted, and the hearing was cancelled (73 FR 56534).

The final regulations adopt the rules published in the proposed regulations without substantial change. The final regulations maintain the general rule in §301.7216–3(b)(4) providing that an income tax return preparer located in the United States may not disclose the taxpayer’s SSN to a tax return preparer located outside of the United States even if the taxpayer consents to the disclosure. The final regulations create a limited exception to the general rule providing that a tax return preparer located within the United States, including any territory or possession of the United States, may obtain consent to disclose the taxpayer’s SSN to a tax return preparer located outside of the United States only if the tax return preparer discloses the SSN through the use of an adequate protection safeguard as described in guidance published in the Internal Revenue Bulletin and verifies the maintenance of the adequate data protection safeguards in the request for the taxpayer’s consent pursuant to the specifications described in guidance published in the Internal Revenue Bulletin.

Drafting Information

The principal author of these regulations is Molly K. Donnelly, Office of the Associate Chief Counsel (Procedure and Administration). * * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 301 is amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

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

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

Paragraph 2. Section 301.7216–3 is amended by revising paragraph (b)(4) to read as follows:

§301.7216–3 Disclosure or use permitted only with the taxpayer’s consent.

* * * * *

(b) * * *
No consent to the disclosure of a taxpayer’s social security number to a return preparer outside of the United States with respect to a taxpayer filing a return in the Form 1040 Series—(i) In general. Except as provided in paragraph (b)(4)(ii) of this section, a tax return preparer located within the United States, including any territory or possession of the United States, may not obtain consent to disclose the taxpayer’s social security number (SSN) with respect to a taxpayer filing a return in the Form 1040 Series, for example, Form 1040, Form 1040NR, Form 1040A, or Form 1040EZ, to a tax return preparer located outside of the United States or any territory or possession of the United States. Thus, if a tax return preparer located within the United States (including any territory or possession of the United States) obtains consent from an individual taxpayer to disclose tax return information to another tax return preparer located outside of the United States, as provided under §§301.7216–2(c) and 301.7216–2(d), the tax return preparer located in the United States may not disclose the taxpayer’s SSN, and the tax return preparer must redact or otherwise mask the taxpayer’s SSN before the tax return information is disclosed outside of the United States. If a tax return preparer located within the United States initially receives or obtains a taxpayer’s SSN from another tax return preparer located outside of the United States, however, the tax return preparer within the United States may, without consent, retransmit the taxpayer’s SSN to the tax return preparer located outside the United States that initially provided the SSN to the tax return preparer located within the United States. For purposes of this section, a tax return preparer located outside of the United States does not include a tax return preparer who is continuously and regularly employed in the United States or any territory or possession of the United States and who is in a temporary travel status outside of the United States. (ii) Exception. A tax return preparer located within the United States, including any territory or possession of the United States, may obtain consent to disclose the taxpayer’s SSN to a tax return preparer located outside of the United States only if the tax return preparer located within the United States discloses the SSN to a tax return preparer located outside of the United States through the use of an adequate data protection safeguard as defined by the Secretary in guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(b) of this chapter) and verifies the maintenance of the adequate data protection safeguards in the request for the taxpayer’s consent pursuant to the specifications described by the Secretary in guidance published in the Internal Revenue Bulletin.

§301.7216–3T [Removed]

Paragraph 3. Section 301.7216–3T is removed.

Linda E. Stiff,
Deputy Commissioner for Services and Enforcement.

Approved December 10, 2008.

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

(Filed by the Office of the Federal Register on December 15, 2008, 8:45 a.m., and published in the issue of the Federal Register for December 16, 2008, 73 F.R. 76216)

Part III. Administrative, Procedural, and Miscellaneous

Update for Weighted Average Interest Rates, Yield Curves, and Segment Rates

Notice 2009–2

This notice provides guidance as to the corporate bond weighted average interest rate and the permissible range of interest rates specified under § 412(b)(5)(B)(ii)(II) of the Internal Revenue Code as in effect for plan years beginning before 2008. It also provides guidance on the corporate bond monthly yield curve (and the corresponding spot segment rates), the 24-month average segment rates, and the funding transitional segment rates under § 430(h)(2). In addition, this notice provides guidance as to the interest rate on 30-year Treasury securities under § 417(e)(3)(A)(ii)(II), and the minimum present value segment rates under § 417(e)(3)(D) as in effect for plan years beginning after 2007.

CORPORATE BOND WEIGHTED AVERAGE INTEREST RATE

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

Notice 2004–34, 2004–1 C.B. 848, provides guidelines for determining the corporate bond weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability. That notice establishes that the corporate bond weighted average is based on the monthly composite corporate bond rate derived from designated corporate bond indices. The methodology for determining the monthly composite corporate bond rate as set forth in Notice 2004–34 continues to apply in determining that rate. See Notice 2006–75, 2006–2 C.B. 366.

The composite corporate bond rate for December 2008 is 6.64 percent. Pursuant to Notice 2004–34, the Service has determined this rate as the average of the monthly yields for the included corporate bond indices for that month.

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

<table>
<thead>
<tr>
<th>For Plan Years</th>
<th>Corporate Bond Weighted</th>
<th>Permissible Range</th>
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<tbody>
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<td>90% to 100%</td>
</tr>
<tr>
<td>Month</td>
<td></td>
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</tr>
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<td>6.29</td>
<td>5.67 to 6.29</td>
</tr>
<tr>
<td>2009</td>
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<td></td>
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</table>

YIELD CURVE AND SEGMENT RATES

Generally for plan years beginning after 2007 (except for delayed effective dates for certain plans under sections 104, 105, and 106 of PPA), § 430 of the Code specifies the minimum funding requirements that apply to single employer plans pursuant to § 412. Section 430(h)(2) specifies the interest rates that must be used to determine a plan’s target normal cost and funding target. Under this provision, present value is generally determined using three 24-month average interest rates (“segment rates”), each of which applies to cash flows during specified periods. However, an election may be made under § 430(h)(2)(D)(ii) to use the monthly yield curve in place of the segment rates. For plan years beginning in 2008 and 2009, a transitional rule under § 430(h)(2)(G) provides that the segment rates are blended with the corporate bond weighted average as specified above. An election may be made under § 430(h)(2)(G)(iv) to use the segment rates without applying the transitional rule.

Notice 2007–81, 2007–44 I.R.B. 899, provides guidelines for determining the monthly corporate bond yield curve, the 24-month average corporate bond segment rates, and the funding transitional segment rates used to compute the target normal cost and the funding target. Pursuant to Notice 2007–81, the monthly corporate bond yield curve derived from December 2008 data is in Table I at the end of this notice. The spot first, second, and third segment rates for the month of December 2008 are, respectively, 6.72, 7.12, and 6.36. The three 24-month average corporate bond segment rates applicable for January 2009 under the election of § 430(h)(2)(G)(iv) are as follows:

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<tr>
<th>First Segment</th>
<th>Second Segment</th>
<th>Third Segment</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.32</td>
<td>6.45</td>
<td>6.69</td>
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</table>
The transitional segment rates under § 430(h)(2)(G) applicable for January 2009, taking into account the corporate bond weighted average of 6.29 stated above, are as follows:

<table>
<thead>
<tr>
<th>For Plan Years Beginning in</th>
<th>First Segment</th>
<th>Second Segment</th>
<th>Third Segment</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>5.97</td>
<td>6.34</td>
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</tr>
<tr>
<td>2009</td>
<td>5.64</td>
<td>6.40</td>
<td>6.56</td>
</tr>
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</table>

30-YEAR TREASURY SECURITIES INTEREST RATES

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

The rate of interest on 30-year Treasury securities for December 2008 is 2.87 percent. The Service has determined this rate as the monthly average of the daily determination of yield on the 30-year Treasury bond maturing in May 2038.

Generally for plan years beginning after 2007, § 431 specifies the minimum funding requirements that apply to multiemployer plans pursuant to § 412. Section 431(c)(6)(B) specifies a minimum amount for the full-funding limitation described in section 431(c)(6)(A), based on the plan’s current liability. Section 431(c)(6)(E)(ii)(I) provides that the interest rate used to calculate current liability for this purpose must be no more than 5 percent above and no more than 10 percent below the weighted average of the rates of interest on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year. Notice 88–73, 1988–2 C.B. 383, provides guidelines for determining the weighted average interest rate. The following rates were determined for plan years beginning in the month shown below.

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<th>For Plan Years Beginning in</th>
<th>30-Year Treasury Weighted Average</th>
<th>Permissible Range</th>
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</tr>
<tr>
<td>January</td>
<td>2009</td>
<td>4.59</td>
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MINIMUM PRESENT VALUE SEGMENT RATES

Generally for plan years beginning after December 31, 2007, the applicable interest rates under § 417(e)(3)(D) are segment rates computed without regard to a 24-month average. For plan years beginning in 2008 through 2011, the applicable interest rate is the monthly spot segment rate blended with the applicable rate under § 417(e)(3)(A)(ii)(II) as in effect for plan years beginning in 2007. Notice 2007–81 provides guidelines for determining the minimum present value segment rates. Pursuant to that notice, the minimum present value transitional segment rates determined for December 2008, taking into account the December 2008 30-year Treasury rate of 2.87 stated above, are as follows:

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<tr>
<th>For Plan Years Beginning in</th>
<th>First Segment</th>
<th>Second Segment</th>
<th>Third Segment</th>
</tr>
</thead>
<tbody>
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<td>2008</td>
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<td>2009</td>
<td>4.41</td>
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</table>

DRAFTING INFORMATION

The principal author of this notice is Tony Montanaro of the Employee Plans, Tax Exempt and Government Entities Division. Mr. Montanaro may be e-mailed at RetirementPlanQuestions@irs.gov.
Table I

Monthly Yield Curve for December 2008

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<th>Maturity</th>
<th>Yield</th>
<th>Maturity</th>
<th>Yield</th>
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Interim Guidance Under Section 457A

Notice 2009–8

PURPOSE

This notice provides interim guidance on the application of § 457A to nonqualified deferred compensation plans of nonqualified entities. Section 457A generally provides that any compensation that is deferred under a nonqualified deferred compensation plan of a nonqualified entity is includable in gross income when there is no substantial risk of forfeiture of the rights to such compensation. For purposes of § 457A, the term nonqualified deferred compensation plan has the same meaning as provided under § 409A(d), subject to certain modifications. For purposes of § 457A, the term nonqualified entity means (a) any foreign corporation unless substantially all of its income is (i) effectively connected with the conduct of a trade or business in the United States, or (ii) subject to a comprehensive foreign income tax, and (b) any partnership unless substantially all of its income is allocated to persons other than (i) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax, and (ii) organizations which are exempt from tax under Title 26 of the United States Code. Section 457A is a provision of the Tax Expenditures and Alternative Minimum Tax Relief Act of 2008, Div. C of Pub. L. No. 110–343 (TEAMTRA), which was enacted on October 3, 2008.

This guidance is intended as interim guidance to assist taxpayers in applying § 457A while the Treasury Department and the IRS consider further guidance on the application of § 457A. The Treasury Department and the IRS anticipate issuing further guidance on issues not addressed by this notice. Future guidance may also modify the guidance provided in this notice, for example by expanding upon the definition of a nonqualified entity as set forth in this notice. In addition, certain provisions of this notice refer to interim guidance under Notice 2008–115, 2008–52 I.R.B. 1367 (Dec. 29, 2008) (reporting and withholding obligations under § 409A for taxable years beginning on and after January 1, 2008), and proposed regulations under § 409A (proposed § 1.409A–3, REG–148326–05, 2008–51 I.R.B. 1325 [73 Fed. Reg. 74380] (Dec. 8, 2008)). Future guidance under § 457A may need to be adapted to any future changes to the guidance provided in Notice 2008–115 and the proposed § 409A regulations. However, as provided in the section entitled “EFFECTIVE DATE,” any future guidance under § 457A that would expand the coverage of § 457A will be prospective and will not apply to a service provider’s taxable year beginning before the issuance of such guidance.

Comments are requested on all aspects of this notice. See the section entitled “REQUEST FOR COMMENTS” for information on how to submit comments.

INTERIM GUIDANCE ON APPLICATION OF § 457A

A. Section 457A — In General

Q–1 When is compensation includible in gross income under § 457A?

A–1 As a general rule, § 457A provides that any compensation that is deferred under a nonqualified deferred compensation plan of a nonqualified entity is includable in gross income when there is no substantial risk of forfeiture of the rights to such compensation. However, deferred compensation is not includible in gross income if the amount of the compensation is not determinable, in which case additional taxes apply to such compensation at the time the amount of such compensation becomes determinable and is includible in gross income. Section B of this notice (Q&A–2 through Q&A–4) addresses the definition of the term nonqualified deferred compensation plan. Section C (Q&A–5 through Q&A–14) addresses which service providers are covered by § 457A and the definition of the term nonqualified entity. Section D (Q&A–15 through Q&A–18) addresses the calculation of the amount includible in income under § 457A. Section E (Q&A–19 through Q&A–21) addresses when deferred amounts are considered to be not determinable. Section F (Q&A–22 through Q&A–23) addresses the application of the effective dates. Section G (Q&A–24 through Q&A–27) addresses issues related to the coordination of § 457A with § 409A.

B. Definition of a Nonqualified Deferred Compensation Plan

Q–2 What is a nonqualified deferred compensation plan for purposes of § 457A?

A–2 (a) General rule. Except as otherwise provided in this A–2, for purposes of § 457A, the term nonqualified deferred compensation plan has the meaning given such term under § 409A(d) and § 1.409A–1(a). With respect to an arrangement between a partner and a partnership, taxpayers may rely upon the applicable guidance under § 409A, which as of January 9, 2008, included Notice 2005–1, Q&A–7, 2005–1 C.B. 274, § II.E of the preamble to the proposed § 409A regulations published on October 4, 2005 (REG–158080–04, 2005–2 C.B. 786 [70 Fed. Reg. 57930]) and § III.G of the preamble to the final § 409A regulations published on April 17, 2007 (T.D. 9321, 2007–1 C.B. 1123[72 Fed. Reg. 19234]). However, see Q&A–3 through Q&A–4 of this notice regarding the definition of substantial risk of forfeiture and the application of the short-term deferral rule for purposes of § 457A.

(b) Equity appreciation rights. As provided in § 457A(d)(3)(A), the term nonqualified deferred compensation plan also includes any plan that provides a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient. Accordingly, except as otherwise provided in this paragraph A–2(b), § 1.409A–1(b)(5)(i)(B) (exception for certain stock appreciation rights) does not apply for purposes of determining whether an arrangement provides for deferred compensation for purposes of § 457A. However, the exceptions from coverage under § 1.409A–1(b)(5)(i)(A) (exception for nonstatutory stock options on service recipient stock issued with an exercise price not less than fair market value at the date of grant and with no other deferral feature) and § 1.409A–1(b)(5)(i)(C) (exception for statutory stock options) apply. Solely for purposes of this paragraph A–2(b), the exception from coverage under § 1.409A–1(b)(5)(i)(B) may be applied so that a stock appreciation right which by its terms at all times must be settled in service recipient stock, and is settled in service recipient stock (and otherwise
meets the requirements of that section), will be excluded from coverage under § 457A. In addition, for purposes of applying the exception from coverage under § 1.409A–1(b)(5)(i)(A) to an equity interest in a non-corporate entity (meaning a right to purchase actual equity in such entity, and not a mere right to an amount equal to the appreciation in such equity), the rules of § 1.409A–1(b)(5)(i)(A) are applied by analogy.

(c) Short-term deferral exception. In applying § 1.409A–1(b)(4) (exception from the definition of deferred compensation for purposes of § 409A for certain short-term deferrals), the definition of substantial risk of forfeiture in Q&A–3 of this notice is applied in lieu of the definition in § 1.409A–1(d). In addition, deferred compensation for purposes of § 457A does not include a § 457A short-term deferral (as defined in Q&A–4).

Q–3 What is a substantial risk of forfeiture for purposes of § 457A?

A–3 (a) General rule. For purposes of § 457A, the rights of a person to compensation are subject to a substantial risk of forfeiture only if such person’s rights to such compensation are conditioned upon the future performance of substantial services by such person. Thus, for example, the rights of a person to compensation (including a stock right) are not subject to a substantial risk of forfeiture merely because those rights are subject to the occurrence of a condition related to a purpose of the compensation, or are conditioned, directly or indirectly, upon the refraining from the performance of services. The addition of any risk of forfeiture after the legally binding right to compensation arises, or any extension of a period during which compensation is subject to a risk of forfeiture is disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture. However, an amount may be considered subject to a substantial risk of forfeiture beyond the date or time at which the recipient otherwise could have elected to receive the compensation if the present value of such amount (disregarding in determining the present value, the risk of forfeiture) is materially greater than the present value of the amount the recipient otherwise could have elected to receive absent such risk of forfeiture. For purposes of determining whether an amount that is subject to a risk of forfeiture is materially greater than the amount the recipient otherwise could have elected to receive absent such risk of forfeiture, compensation, such as salary, that the service provider would receive for continuing to perform services is not taken into account. For example, if a bonus plan provides an election between a cash payment or restricted stock units with a present value that is materially greater (disregarding the risk of forfeiture) than the present value of such cash payment and that will be forfeited absent continued services for a period of years, the right to the restricted stock units generally is treated as subject to a substantial risk of forfeiture.

(b) Stock rights. For the application of the definition of a substantial risk of forfeiture to a stock right (as defined in § 1.409A–1(l)), see § 1.409A–1(d)(2).

(c) Enforcement of forfeiture condition. For rules on the determination of whether the risk of forfeiture is substantial with respect to the rights of a service provider that owns a significant amount of the total voting power or value of the service recipient, see § 1.409A–1(d)(3).

Q–4 What is a short-term deferral for purposes of § 457A (a § 457A short-term deferral)?

A–4 (a) General rule. Deferred compensation for purposes of § 457A does not include a short-term deferral as provided under § 457A(d)(3)(B) (a § 457A short-term deferral). The term § 457A short-term deferral refers to compensation that is paid not later than 12 months after the end of the service recipient’s taxable year during which the right to the payment of the compensation is first no longer subject to a substantial risk of forfeiture. For purposes of this special rule, the service recipient is the person for whom the service provider is directly providing services at the time the right to the payment of such compensation is first no longer subject to a substantial risk of forfeiture. In addition, as provided in Q&A–2(c), any amount qualifying as a short-term deferral under § 1.409A–1(b)(4), applied using the definition of substantial risk of forfeiture for § 457A purposes as described in Q&A–3, does not constitute deferred compensation for purposes of § 457A.

(b) Example. If on January 1, 2009, an employee is provided a right to a future payment of $10,000 if the employee continues providing services to his or her employer through January 1, 2011, and the amount is paid out not later than 12 months after the end of the employer’s taxable year that includes January 1, 2011, the arrangement is not subject to § 457A. However, if the amount is not paid to the employee before the end of that 12-month period, the arrangement is subject to § 457A and $10,000 is includible in the employee’s gross income on January 1, 2011.

C. Nonqualified Entities

Q–5 To which types of service providers does § 457A apply?

A–5 A service provider subject to § 457A may include an individual, corporation, subchapter S corporation, partnership, personal service corporation (as defined in § 269A(b)(1)), noncorporate entity that would be a personal service corporation if it were a corporation, qualified personal service corporation (as defined in § 448(d)(2)), and noncorporate entity that would be a qualified personal service corporation if it were a corporation. A service provider may be subject to § 457A regardless of whether such person accounts for gross income from the performance of services under the cash receipts and disbursements method of accounting or under the accrual method of accounting. However, an independent contractor is not a service provider subject to § 457A if an arrangement with respect to the independent contractor would be excluded from coverage under § 1.409A–1(f)(2) (generally excluding arrangements with independent contractors having multiple unrelated clients, but not excluding arrangements with such independent contractors that provide management services).

Q–6 What is a nonqualified entity for purposes of § 457A?

A–6 For purposes of § 457A, as provided in § 457A(b), the term nonqualified entity means—(1) any foreign corporation unless substantially all of its income is (A) effectively connected with the conduct of a trade or business in the United States, or (B) subject to a comprehensive foreign income tax; and (2) any partnership unless substantially all of its income is allocated to persons other than (A) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax, and (B) organizations which are exempt from tax under Title 26 of the United States Code.

Q–7 How is it determined whether an entity is a foreign corporation or a partner-
ship for purposes of determining whether an entity is a nonqualified entity under § 457A?

A–7 For purposes of § 457A, the term foreign corporation means a corporation as defined in § 7701(a)(3) that is not domestic as defined in § 7701(a)(4). For purposes of § 457A, the term partnership has the meaning given that term in § 7701(a)(2).

Q–8 How is it determined whether substantially all of a foreign corporation’s income is subject to a comprehensive foreign income tax?

A–8 (a) In general. For purposes of § 457A, substantially all of the income of a foreign corporation is subject to a comprehensive foreign income tax if, for the taxable year of the foreign corporation ending with or within the service provider’s relevant taxable year (as determined in accordance with Q&A–13)—

(i) either (A) the foreign corporation is eligible for the benefits of a comprehensive income tax treaty between its country of residence and the United States (as determined in accordance with Q&A–10), or (B) the foreign corporation demonstrates to the satisfaction of the Secretary that it is resident for tax purposes in a foreign country that has a comprehensive income tax; and

(ii) the foreign corporation is not taxed by the foreign corporation’s country of residence under any regime or arrangement that is materially more favorable than the corporate income tax otherwise generally imposed by such country.

(b) Exception where nonresidence source income is excluded. Notwithstanding paragraph A–8(a), substantially all of the income of a foreign corporation will not be treated as subject to a comprehensive foreign income tax if—

(i) the foreign corporation’s taxable income determined under the laws of its country of residence excludes an item of nonresidence source income if the foreign corporation’s taxable income does not include such income, or excludes such income by means of exemption, exclusion (including an exclusion from gross income), deduction (including a dividends received deduction or dividends paid deduction (or similar provision)), by means of taxation of such income at a rate of less than 50 percent of the generally applicable rate, or by other means;

(ii) the foreign corporation’s gross income is defined as the foreign corporation’s gross income as determined under the income tax laws of the foreign corporation’s country of residence plus all nonresidence source income of the foreign corporation to the extent not otherwise included in the foreign corporation’s gross income;

(iii) the term nonresidence source income means any items of income that would be included in gross income, determined under the principles of § 61, from sources outside the foreign corporation’s country of residence, including dividends distributed by corporations that are not resident in the foreign corporation’s country of residence; and

(iv) an item of nonresidence source income is not included in the excluded amount to the extent that such item of nonresidence source income is—(A) effectively connected with the conduct of a trade or business in the United States in force as of January 9, 2009, other than the income tax treaty with Bermuda and the income tax treaty with the Netherlands Antilles. To be eligible for the benefits of such a comprehensive income tax treaty for purposes of § 457A, a foreign person must be a resident within the meaning of such term under the relevant treaty and must satisfy any other relevant requirements of that treaty, including the requirements under any applicable limitation on benefits provision.

Q–9 How is it determined whether substantially all of a partnership’s income for a taxable year is allocated to persons other than (A) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax and (B) organizations which are exempt from tax under Title 26 of the United States Code?

A–11 (a) In general. Under § 457A(b)(2), a partnership is not a nonqualified entity with respect to a taxable year if it has income and substantially all of its income for the taxable year is allocated to persons not described in § 457A(b)(2)(A) or (B) (a person not described in § 457A(b)(2)(A) or (B) is referred to herein as an eligible person). Substantially all of a partnership’s income is treated for purposes of § 457A(b)(2) as allocated to eligible persons with respect to a taxable year only if at least 80 percent of the gross income of the partnership for such taxable year is allocated to eligible persons, as provided in paragraph A–11(e) below. The paragraphs of this A–11 below
provide guidance on whether substantially all of the income of a partnership that is the sponsor (see Q&A–14) of a nonqualified deferred compensation plan is allocated to eligible persons, including determining—(i) the gross income of such a partnership; (ii) which persons may be treated as receiving allocations of such gross income; and (iii) which allocations of gross income will be treated as made to eligible persons. An item or portion of an item of gross income may be treated for purposes of this Q&A–11 as allocated to any one of (and only one of) the following: (i) a partnership, if the partnership is the sponsor (see Q&A–14) of the nonqualified deferred compensation plan and subject to a comprehensive foreign income tax with respect to such income as provided in paragraph A–11(f), (ii) a partner of the partnership, or (iii) any direct or indirect owner of the partner.

(b) Gross income and allocations for U.S. relevant partnerships. With respect to a U.S. relevant partnership that is the sponsor (see Q&A–14) of a nonqualified deferred compensation plan, the term gross income of the partnership has the same meaning as for purposes of § 702(c) (see also §§ 1.702–1(c) and 1.704–1(b)(1)(vii)). A partnership is a U.S. relevant partnership if it either (i) is required to file a return of partnership income under § 6031 or (ii) determines the distributive share of income of any partner in accordance with § 704. If a U.S. relevant partnership allocates any income net of deductions, gross income is treated as being allocated to the partner who received the related allocation of net income to the extent such net income is derived from gross income (determined under § 702(c) principles). Allocations of income to the partners are the actual tax allocations of the partnership determined under § 704 for the partnership’s relevant taxable year under Q&A–13 of this notice. Gross income of a foreign partnership, or a domestic partnership that is treated under the laws of a foreign country as resident in that country for tax purposes, that is the sponsor (see Q&A–14) of the nonqualified deferred compensation plan may be treated as allocated to the partnership.

(c) Gross income and allocations for partnerships that are not U.S. relevant partnerships. Gross income of a partnership that is the sponsor (see Q&A–14) of a nonqualified deferred compensation plan that is not a U.S. relevant partnership is determined for the partnership’s relevant taxable year under Q&A–13 of this notice using any reasonable method that incorporates the principles of § 61. Further, for purposes of this Q&A–11, gross income of a partnership that is the sponsor (see Q&A–14) of a nonqualified plan and is not a U.S. relevant partnership is deemed allocated to a partner to the extent that the partner includes such income in its gross income on a current basis under the income tax laws of the country of which such partner is a resident (except if included in income solely by reason of an anti-deferral regime, for example, §§ 951 et seq., §§ 1293 et seq., or comparable provisions of foreign law), whether or not such income is distributed to such person. Gross income of a partnership that is not a U.S. relevant partnership and that is the sponsor (see Q&A–14) of a nonqualified deferred compensation plan may be treated as allocated to the partnership.

(d) Tiered ownership. (i) An item or portion of an item of gross income of the partnership that is the sponsor (see Q&A–14) of a nonqualified deferred compensation plan that is allocated to a partner pursuant to paragraph A–11(b) or (c) may be treated as income allocated to any one direct or indirect owner of such partner that takes such income into account on a current basis under the income tax laws of the country of which such owner is a resident (except if included in income solely by reason of an anti-deferral regime, for example, §§ 951 et seq., §§ 1293 et seq., or comparable provisions of foreign law), whether or not such income is distributed to such owner.

(ii) An item or portion of an item of gross income of the partnership that is the sponsor (see Q&A–14) of a nonqualified deferred compensation plan that is allocated to a partner pursuant to paragraph A–11(b) or (c) to a partner that is a trust or estate that is a United States person, as defined in § 7701(a)(30) (a foreign person), is deemed to include for these purposes and for purposes of paragraph A–11(f) below a domestic partnership that is the sponsor (see Q&A–14) of the nonqualified deferred compensation plan and that is treated under the laws of a foreign country as resident in that country for tax purposes), who is subject to a comprehensive foreign income tax with respect to such income as provided in paragraph A–11(f) below.

(f) Comprehensive Foreign Income Tax. For purposes of this A–11 a foreign person is subject to a comprehensive foreign income tax with respect to an item of income of the partnership only if both—

(i) The foreign person takes such income into account on a current basis under the income tax laws of the country in which the foreign person is resident (except if included in income solely by reason of an anti-deferral regime, for example, §§ 951 et seq., §§ 1293 et seq., or comparable provisions of foreign law), whether or not such income is distributed to such foreign person; and

(ii) gross income that is effectively connected with the conduct of a trade or business in the United States, within the meaning of § 871(b) or § 882(a), as applicable (effectively connected income), is allocated to a person subject to U.S. federal income tax on such income under § 871(b) or § 882(a), as applicable, and not exempt from U.S. federal income tax pursuant to a treaty obligation of the United States;
(ii)(A) In the case of a foreign person that is not a nonresident alien individual—(I) the foreign person is an entity that is not fiscally transparent under the law of the entity’s jurisdiction (as defined in § 1.894–1(d)(3)(ii)) with respect to such income; (II) the foreign person satisfies the requirements of Q&A–8(a)(i) and (ii) treating the foreign person as the “foreign corporation” for this purpose; and (III) such income is not excluded from such foreign person’s taxable income by means of exemption, exclusion, dividends paid deduction or dividends received deduction (or similar provision), by means of taxation of such income at a rate less than 50 percent of the generally applicable rate, or by other means; or

(B) In the case of a foreign person that is a nonresident alien individual—(I) such nonresident alien individual is eligible for the benefits of a comprehensive income tax treaty with the United States, or such nonresident alien individual demonstrates to the satisfaction of the Secretary that such nonresident alien individual is subject to a comprehensive foreign income tax; and (II) such income is not excluded from such foreign person’s taxable income by means of exemption, exclusion (including an exclusion from gross income), deduction (including a dividends paid deduction or dividends received deduction (or similar provision)), by means of taxation of such income at a rate less than 50 percent of the generally applicable rate, or by other means.

(g) Examples. The following examples illustrate the rules in this A–11. For purposes of Examples 1 through 3, assume the following. PRS is a domestic partnership. PRS has two partners, A, a domestic corporation that is not an organization exempt from tax under Title 26 of the United States Code, and B, an entity exempt from tax pursuant to § 501(a). Under the PRS partnership agreement, A is allocated the first $700 of net income, and any remaining net income is allocated 75% to A and 25% to B. Net losses are allocated 75% to A and 25% to B. Assume that B’s distributive share of income of PRS does not constitute unrelated business taxable income to B and that all of PRS’ allocations of income, gain, loss and deduction satisfy the requirements of § 704.

Example 1. For the taxable year ending on December 31, 2009, PRS has $1,500 in gross income and no other gains, losses or deductions. Under the PRS partnership agreement, A is allocated the first $700 of net income, and the remaining $800 of net income is allocated $600 to A (75% x $800) and $200 to B (25% x $800). In 2009, PRS is not a nonqualified entity under § 457A(b)(2) and this Q&A–11 because $1,300 of gross income is allocated to A, which is at least 80% of the gross income of PRS (80% x $1,500 = $1,200).

Example 2. For its taxable year ending December 31, 2009, PRS has $1,000 in ordinary income, $300 of deductions (or net ordinary income of $700), and no losses. Under the PRS partnership agreement, A is allocated the first $700 of net income, and the $800 of gain is allocated $6,000 to A (75% x $8,000) and $2,000 to B (25% x $8,000). In 2009, PRS is a nonqualified entity under § 457A(b)(2) and this Q&A–11 because $7,000 of gross income is allocated to A, which is less than 80% of the gross income of PRS (80% x $9,000 = $7,200).

Example 3. For its taxable year ending December 31, 2009, PRS has a $1,400 net loss ($100 of gross income, $1,500 of deductions, and no other gains or losses). Under the PRS partnership agreement, A is allocated $1,050 of the net loss (75% x $1,400). B is allocated $350 of the net loss (25% x $1,400). Under § 702(c), A’s share of gross income of PRS is $750 (75% x $1,000). In 2009, PRS is a nonqualified entity under § 457A(b)(2) and this Q&A–11 because less than 80% of PRS’ gross income is allocated to A (80% x $100 = $80).

Example 4. In 2009, K and B are partners in KB partnership, a partnership organized under the laws of foreign country 1 that is fiscally transparent under the laws of foreign country 1. KB is a partnership for U.S. federal income tax purposes and a U.S. relevant partnership hereunder. K is an entity organized under the laws of foreign country 2, and K is fiscally transparent under the laws of foreign country 2 and has in effect an election to be treated as a corporation for U.S. federal tax purposes. B is a domestic corporation that is not an organization exempt from tax under Title 26 of the United States Code. The owners of K are S, an individual who is a citizen and resident of foreign country 3, and J, a foreign corporation. S is eligible for the benefits of a comprehensive income tax treaty with the United States and takes into account under the income tax laws of country 3 her share of gross income of K on a current basis, whether or not such income is distributed to S. S’s share of such income is taxed under the laws of country 3 at a rate not less than the generally applicable rate, and not otherwise excluded from S’s income and is not included in income by reason of an anti-deferral regime. J is subject to a comprehensive foreign income tax with respect to such income.

Q–12 Does § 457A apply to deferred compensation that would have been deductible against income of a foreign corporation which is taxable under § 882 if the compensation had been paid in cash on the date that such compensation ceased to be subject to a substantial risk of forfeiture?

A–12 In the case of a foreign corporation with income which is taxable under § 882, § 457A does not apply to compensation that, had such compensation been paid in cash on the date of the date that such compensation ceased to be subject to a substantial risk of forfeiture, would have been deductible under the principles of § 882 and the regulations thereunder by such foreign corporation against such income. If such compensation expense would not have been part of the corporation’s cost of goods sold, the compensation will be considered to have been deductible by the foreign corporation against such income only to the extent that the compensation would be properly allocated and apportioned to such income under the principles of § 1.861–8 et seq. If such compensation expense would have been part of the corporation’s cost of goods sold, the compensation will be considered to have been deductible by the corporation against such income using any reasonable method that is satisfactory to the Secretary based on all facts and circumstances.

Q–13 When is the determination made whether an entity is a nonqualified entity?

A–13 (a) General rule. The determination of whether an entity is a nonqualified entity is made as of the last day of each of the service provider’s taxable years in which the nonqualified deferred compensation is no longer subject to a substantial risk of forfeiture and remains de-
ferred. Accordingly, if the plan sponsor becomes a nonqualified entity during a service provider’s taxable year and is a nonqualified entity as of the last day of the service provider’s taxable year, amounts deferred under the plan are subject to § 457A for that taxable year of the service provider and the amounts are includible in income to the extent that the amounts are not subject to a substantial risk of forfeiture and have not previously been included in income. Similarly, if the plan sponsor ceases to be a nonqualified entity during a service provider’s taxable year, and is not a nonqualified entity as of the last day of the service provider’s taxable year, amounts deferred under the plan are not subject to § 457A for that taxable year of the service provider. Comments are requested regarding alternative approaches to determine whether it is a nonqualified entity. Whether a partnership is a nonqualified entity is determined as described entity in a subsequent taxable year. See the section below entitled “Request for Comments” for information on the submission of comments.

(b) Special rule for partnerships. Whether a partnership is a nonqualified entity as of the last day of the service provider’s taxable year is determined based on the allocations (or deemed allocations) of gross income by the partnership for the partnership’s taxable year ending with or within the service provider’s taxable year. If a partnership does not yet have a taxable year that has ended or ends on the last day of the service provider’s taxable year, a reasonable, good faith estimate of such allocation (or deemed allocation) of the partnership for its current taxable year must be used to determine whether it is a nonqualified entity.

Q–14 How is it determined whether a nonqualified deferred compensation plan is a plan of a nonqualified entity?

A–14 The determination of whether a nonqualified deferred compensation plan is a plan of a nonqualified entity (for purposes of this notice, whether a nonqualified entity is the “sponsor”, or one of the “sponsors”, of the plan) is determined as of the last day of the service provider’s relevant taxable year as determined under Q&A–13. For this purpose, with respect to any amount deferred under a plan, the sponsor of the plan is any entity or entities which, if the entity paid the amount deferred in cash to the service provider in the relevant taxable year (as determined under Q&A–13), would be entitled to a compensation deduction under U.S. federal income tax principles.

D. Amount Includible in Income

Q–15 Does § 457A apply to a right to earnings on deferred compensation that is subject to § 457A?

A–15 Yes. For purposes of § 457A and this notice, references to deferred compensation include references to income (whether actual or notional) attributable to such compensation or such income. When the right to earnings is specified under the terms of the plan, the legally binding right to earnings arises at the time of the deferral of the compensation to which the earnings relate. Accordingly, rights to reasonable earnings credited on at least an annual basis are includible in gross income under § 457A when the right to the earnings credited is no longer subject to a substantial risk of forfeiture (as defined in Q&A–3 of this notice). The right to earnings that are not reasonable earnings, or that are not credited at least annually, will result in some or all of the earnings being treated as currently deferred amounts in accordance with rules analogous to the rules set forth in proposed § 1.409A–6(b)(2)(iii) (crediting of earnings and losses), § 1.409A–6(b)(2)(ii)(B) (use of an unreasonable actuarial assumption or method), and § 1.409A–6(b)(3)(ii) (account balance plans — unreasonable rate of return).

Q–16 How is the amount includible in income under § 457A determined?

A–16 Except as provided in Q&A–19 and Q&A–20, for purposes of § 457A, the amount includible in income is determined under the rules applicable to the determination of amounts includible in income under § 409A(a). For the currently applicable rules, see Notice 2008–115, which provides certain rules including a rule permitting taxpayers to rely upon proposed § 1.409A–4.

Q–17 If an amount is included in gross income under § 457A before the amount is paid to the service provider, is the amount also includible in income when the amount is paid to the service provider?

A–17 To the extent a deferred amount is included in income under § 457A before the amount is paid to the service provider, the amount is not includible in income when the amount is paid to the service provider. However, after such amount is included in income by the service provider, § 457A may continue to apply to the right to future reasonable earnings on such previously included amounts (see Q&A–15). For purposes of determining the amount previously included in income that is not includible in income at the time of the payment, taxpayers may rely upon rules that are the same as the rules of proposed § 1.409A–4(f).

Q–18 If an amount is included in income under § 457A before the amount is paid to the service provider and, before such amount is paid, the right to the amount is forfeited or otherwise permanently lost, is the service provider entitled to a loss?

A–18 Yes. If an amount is included in income under § 457A before the amount is paid to the service provider and, before such amount is paid, the right to the amount is forfeited or otherwise permanently lost, the service provider may rely upon rules that are the same as the rules of proposed § 1.409A–4(g) for purposes of determining the availability of any loss.

E. Deferred Amounts that are not Determinable

Q–19 When is the deferred amount to which a service provider is entitled treated as not determinable for purposes of § 457A?

A–19 (a) In general. For purposes of § 457A, the deferred amount to which a service provider is entitled is treated as not determinable if the deferred amount would be calculated under proposed § 1.409A–4(b)(2)(iv) (application of the general calculation rules to formula amounts), if such rule were effective. Under proposed § 1.409A–4(b)(2)(iv), for a plan that is not an account balance plan, an amount payable in a future taxable year is a formula amount (and thus not determinable) to the extent that the amount payable in a future taxable year is dependent upon factors that, after applying the assumptions and other rules set out in the proposed regulations, are not determinable.
as of the end of the service provider’s taxable year. This generally occurs where the amount of the payment (and not the timing of the payment) is unknown at the end of the taxable year because it is based upon factors that remain variable as of the end of the taxable year. For example, an annual bonus based on annual profits as of December 31, 2010 is a formula amount (and thus an indeterminable amount) at all times prior to December 31, 2010. However, the deferred amount is determinable as of December 31, 2010 because the information necessary to calculate the bonus exists, regardless of whether the calculation of the annual profits is readily available.

Q–20 When is a deferred amount that is treated as not determinable at the time that the compensation is otherwise includable in gross income under § 457A required to be included in income?

A–20 A deferred amount that is treated as not determinable at the time that the compensation is otherwise includable in gross income under § 457A is required to be included in gross income when the deferred amount becomes determinable. For purposes of calculating the amount includable in gross income at such time, the rules of Q&A–16 apply.

Q–21 What additional taxes apply to a deferred amount that is treated as not determinable at the time that the compensation is otherwise includable in gross income under § 457A?

A–21 When a deferred amount that is treated as not determinable at the time that the compensation is otherwise includable in gross income under § 457A becomes determinable and must be included in gross income, the tax for the taxable year in which the compensation is includable in gross income is increased by the sum of (a) an amount equal to 20 percent of the amount of the compensation and (b) the premium interest tax on the compensation.

For purposes of this A–21, the premium interest tax is the amount of interest at the underpayment rate under § 6621 plus 1 percentage point on the underpayments that would have occurred had the deferred compensation been includable in gross income for the taxable year in which first deferred or, if later, the first taxable year in which the deferred compensation is not subject to a substantial risk of forfeiture (as defined in Q&A–3 of this notice). For purposes of calculating the premium interest tax, rules analogous to the rules provided in proposed § 1.409A–4(d) apply, if such rule were effective.

F. Effective Dates for Application of § 457A

Q–22 What is the effective date of § 457A?

A–22 Section 457A applies to amounts deferred that are attributable to services performed after December 31, 2008. In the case of any amount deferred to which § 457A would not otherwise apply solely by reason of the fact that the amount is attributable to services performed before January 1, 2009, to the extent the amount deferred is not included in gross income in a taxable year beginning before 2018, that amount deferred is includible in gross income in the later of (a) the last taxable year beginning before January 1, 2018 or (b) the first taxable year in which there is no substantial risk of forfeiture of the right to the amount deferred (as defined in Q&A–3 of this notice).

Q–23 For purposes of applying the effective date, how are the periods of service to which the compensation is attributable determined?

A–23 (a) Services to which compensation is attributable.

(1) General rule: compensation attributable to a service period based on plan formula. If a service provider obtains a legally binding right to compensation under a plan on or before December 31, 2008, and as of December 31, 2008 that plan provides for benefit payments under a formula that relates to a specific period of service in a year (such as relating to compensation paid during that period), the compensation is attributable to that specific period, except as otherwise provided in this A–23.

To the extent that, based on the terms of the plan as of December 31, 2008, compensation is not attributable to services performed in a particular period, then the compensation generally is attributable to services performed during the year in which the employee obtains the legally binding right to the compensation. If a service provider is entitled to compensation only upon an involuntary separation from service, the amount attributable to services performed on or before December 31, 2008 is the amount the service provider would be entitled to based upon the years of service and compensation earned as of December 31, 2008 (disregarding any requirement to perform further services). Any additional amount to which the service provider becomes entitled after December 31, 2008 due solely to additional services performed after December 31, 2008 is attributable to service performed after December 31, 2008. A right to reasonable earnings on amounts deferred attributable to services performed before December 31, 2008 is treated as attributable to services performed before December 31, 2008, but only to the extent further services were not required after December 31, 2008 to retain the right to the earnings.

(2) Legally binding right. Compensation is not attributable to a period of services prior to the date the service provider obtains a legally binding right to the compensation. A service provider does not have a legally binding right to compensation to the extent that compensation may be reduced unilaterally or eliminated by the service recipient or other person after the services creating the right to the compensation have been performed. However, if the facts and circumstances indicate that the discretion to reduce or eliminate the compensation is available or exercisable only upon a condition, or the discretion to reduce or eliminate the compensation lacks substantive significance, then the employee has a legally binding right to the compensation. For this purpose, compensation is not considered subject to unilateral reduction or elimination merely because it may be reduced or eliminated by operation of the objective terms of the plan, such as the application of a nondiscretionary, objective provision creating a substantial risk of forfeiture. (See §§ 1.409A–1(b)(1) and 31.3121(v)(2)–1(b)(3)(i) for additional rules regarding when an employee obtains a legally binding right to compensation.)

(3) Substantial risk of forfeiture. To the extent that under a plan’s terms as of December 31, 2008, a service provider’s right to compensation is subject to a substantial risk of forfeiture (as defined in Q&A–3) in the form of a requirement to continue to perform substantial future services for the service recipient after December 31, 2008, the compensation generally is for services performed over the period of time
that the service provider is required to continue to perform substantial future services for the service recipient and is attributed to that period on a pro rata basis, unless the compensation is attributable to a different period under the rule in paragraph A–23(b)(1). For purposes of applying the effective date, if the substantial risk of forfeiture lapses after December 31, 2008, but before the substantial risk of forfeiture would otherwise have lapsed under the terms of the plan as of December 31, 2008 if the service provider had continued providing services (such as due to death, disability or an acceleration of the vesting requirement), the allocation remains prorated over the period from when the service provider obtained the legally binding right to the payment to the date that the substantial risk of forfeiture would otherwise have lapsed under the terms of the plan as of December 31, 2008 if the service provider had continued providing services.

(4) Plan terms as of December 31, 2008. A plan’s terms as of December 31, 2008, include only the plan’s terms as in effect on December 31, 2008, and do not include any amendment to such plan terms after December 31, 2008, even if the amendment to such plan terms is made effective retroactively to a date earlier than January 1, 2009. Notwithstanding the foregoing, the terms of a plan may be amended retroactively to provide that a substantial risk of forfeiture would otherwise lapse on or after January 1, 2009 will be treated as having lapsed effective before January 1, 2009, provided that the amendment is made in writing and effective before July 1, 2009, and provided further that any shortening of the period during which a deferred amount was subject to a substantial risk of forfeiture must be applied consistently to every service provider participating in that arrangement or a substantially similar arrangement.

(b) Examples. For purposes of these examples, the description of the terms of the relevant plan refers to the terms of the plan as of December 31, 2008, except where otherwise provided.

Example 1. Employee A obtains on January 1, 2006 a legally binding right to be paid $400,000 at the end of December, 2014, but only if A continues to be employed on December 31, 2010. In this case, a pro rata portion of the compensation is attributable to services performed during 2006, 2007, 2008, 2009, and 2010, so that 60% of the amount deferred is attributable to services performed before 2009.

Example 2. Employee C obtains on December 31, 2007 a legally binding right to be paid on February 1, 2014 an amount equal to 10% of employee C’s salary during the period from January 1, 2008 through December 31, 2009, and employee C’s salary is $400,000 for each of 2008 and 2009. In this case, the compensation is attributable pro rata to services performed in 2008 and 2009, so that 50% of the amount deferred is attributable to services performed in 2008.

Example 3. Employee D obtains on December 31, 2007 a legally binding right to be paid on January 1, 2014 an amount equal to 20% of D’s highest annual salary times the number of years of service completed by D before January 1, 2010, but only if D remains employed through December 31, 2009. Employee D remains employed through December 31, 2009 and has an annual salary of $400,000 in 2008. Under the terms of the plan in this case, under the rule in paragraph A–23(a)(1), the compensation attributable to services performed in 2008 is the present value of $80,000 (20% of Employee D’s annual salary in 2008 times 1 year of service) payable on January 1, 2014.

Example 4. Employee E obtains on December 31, 2008 a legally binding right to be paid $400,000 on February 1, 2010 (without any requirement of continued employment). Under these facts and circumstances, the compensation is not attributable to services performed in a period of time after December 31, 2008.

Example 5. Employee F obtains on December 31, 2008 a stock appreciation right with a 10-year term and an exercise price equal to the fair market value of the stock on December 31, 2008 (without any requirement of continued employment in order to be able to exercise the right and receive payment). The compensation is not attributable to services performed in a period of time after December 31, 2008.

Example 6. Employee G obtains on January 1, 2008 a stock appreciation right with a 10-year term and an exercise price equal to the fair market value of the stock on January 1, 2008, but the stock appreciation right can be exercised only after the employee has continued his or her employment for three more years (through December 31, 2010). In this case, the amount deferred under the stock appreciation right is attributable to services performed from January 1, 2008 through December 31, 2010, so that one-third of the amount deferred is attributable to services performed before January 1, 2009.

Example 7. Employee H obtains on January 1, 2000 a right to a retirement benefit payable solely upon separation from service (including separation from service due to death or disability) if a life annuity equal to a monthly payment of 3% multiplied by the average of the highest three years of compensation multiplied again by the number of years of service Employee H had completed with the service recipient. As of December 31, 2008, Employee H had completed 15 years of service and the average of the highest three years of compensation was $250,000. The deferred amount attributable to services performed on or before December 31, 2008 equals the present value of the life annuity calculated using the years of service completed and the compensation earned as of December 31, 2008. Any increase in the deferred amount due to an additional year of service or an increase in compensation after December 31, 2008 would be a deferred amount attributable to services performed after December 31, 2008.

Example 8. Employee J obtains on January 1, 2008 a right to a bonus equal to 10% of the increase in the value of a pool of assets, calculable and payable one year after Employee J’s separation from service. Because any increase in the value through the date of payment would not be due to Employee J’s continued services, the entire deferred amount is attributable to services performed during 2008.

Example 9. Employee K obtains on January 1, 2008 a right to an amount payable on January 1, 2014, but only if Employee K continues to provide services through December 31, 2010, or dies or becomes disabled before December 31, 2010. On July 1, 2010, Employee K dies. Because under the terms of the plan as of December 31, 2008, Employee K was required to continue to provide services through December 31, 2010, one-third of the deferred amount continues to be attributable to services performed before January 1, 2009.

Example 10. Employee L obtains on January 1, 2008 a right to a amount payable on January 1, 2014, but only if Employee L continues to provide services through December 31, 2010, or dies or becomes disabled before December 31, 2010. On January 1, 2010, the arrangement is amended so that Employee L is entitled to payment of the amount regardless of whether Employee L continues to provide services after December 31, 2009. For purposes of the effective date of § 457A, this amendment is disregarded and only one-third of the amount deferred is treated as attributable to services performed on or before December 31, 2008.

Example 11. Employee M obtains on January 1, 2008 a right to an amount payable on January 1, 2014, but only if Employee M continues to provide services through December 31, 2010, or dies or becomes disabled before December 31, 2010. On March 15, 2009, the arrangement is amended so that Employee M is entitled to payment of the amount regardless of whether Employee M continues to provide services after December 31, 2008. Provided that the same amendment is made and applied consistently to every service provider participating in the same or a substantially similar arrangement sponsored by the same service recipient, the amendment is not disregarded for purposes of the effective date under § 457A and all of the amount deferred is treated as attributable to services performed on or before December 31, 2008.

G. Coordination with § 409A

Q–24 How does § 457A coordinate with § 409A?

A–24 Sections 457A and 409A may both apply to amounts deferred under the same arrangement. For purposes of applying § 409A to arrangements covered by § 457A, rules similar to those addressing arrangements subject to § 457(f) apply. Accordingly, an inclusion in income under § 457A is treated as a payment for purposes of the short-term deferral rule under § 1.409A–1(b)(4). In addition, until further guidance, the inclusion in income
under § 457A of earnings on amounts subject to § 457A is treated as a payment in accordance with a fixed schedule of payments if the earnings are reasonable, are credited at least annually, and are included in income under § 457A for the later of the taxable year in which such earnings are credited or when such amounts would otherwise be includible in income under § 457A. However, the right to an amount that is not subject to § 457A because it is a § 457A short-term deferral under Q&A–4 is subject to § 409A unless the arrangement also qualifies as a short-term deferral under § 1.409A–1(b)(4).

Q–25 What transition rules apply under § 409A with respect to amounts covered by § 457A that are attributable to services performed before January 1, 2009? A–25 Solely with respect to a deferred amount attributable to services performed before January 1, 2009, a change in the time and form of payment to conform the date of distribution to the date the amount may be required to be included in income under § 457A is treated as an impermissible modification under § 409A(a)(3) and § 1.409A–3(j)(1), provided that such change in the time and form of payment is established in writing and effective on or before December 31, 2011. To the extent a deferred amount attributable to services performed before January 1, 2009 was earned and vested before December 31, 2004 and is not otherwise covered by § 409A due to the application of the effective date rules under § 1.409A–6, a change in the time and form of payment to conform the date of payment to the date the amount is includible in income under § 457A will not be treated as a material modification of such arrangement under § 1.409A–6(a)(4), provided that such change in the time and form of payment is established in writing and effective on or before December 31, 2011.

Q–26 What transition rules apply under § 409A with respect to certain back-to-back arrangements attributable to services performed before January 1, 2009? A–26 In general, the right to a deferred amount attributable to services performed after December 31, 2008 subject to a substantial risk of forfeiture.

Accordingly, a plan provision stating that an amount will be payable in cash at the time the amount is includible in income under § 457A will not be required because the right to payment of such amount will not be subject to § 409A. However, payment timing issues under § 409A may arise if the right to a deferred amount becomes subject to § 457A in a future year (for example, because the plan sponsor becomes a nonqualified entity), or ceases to be subject to § 457A in a future year (because the plan sponsor ceases to be a nonqualified entity before the right to the substantial risk of forfeiture lapses). In addition, payment timing issues may arise if earnings on deferred compensation become includible in gross income under § 457A, to the extent such earnings would otherwise have been accumulated and paid at a deferred date. To address these issues, until further guidance the payment of a deferred amount during the service provider’s taxable year in which such amount becomes includible in income under § 457A will not constitute an impermissible acceleration of a payment under § 409A(a)(3) or § 1.409A–3(j). However, plan provisions will still be necessary to address use of the § 457A short-term deferral rule (see Q&A–4).

Q–27 What transition rules apply under § 409A with respect to certain back-to-back arrangements attributable to services performed before January 1, 2009? A–27 (a) If the service provider is also a service recipient (the intermediate service recipient) and maintains one or more nonqualified deferred compensation arrangements attributable to services performed by § 457A under which any amount is attributable to services performed before January 1, 2009, a change in the time and form of payment of such amount solely to conform the date of payment to the date the amount is required to be included in income will not be treated as an impermissible acceleration under § 409A(a)(3) and § 1.409A–3(j)(1), provided that such change in the time and form of payment is established in writing and effective on or before December 31, 2011. To the extent a deferred amount covered by § 457A was earned and vested before December 31, 2004 and is not otherwise subject to § 409A due to the application of the effective date rules under § 1.409A–6, a change in the time and form of payment solely to conform the date of distribution to the date the amount is required to be included in income under § 457A will not be treated as a material modification of such arrangement under § 1.409A–6(a)(4), provided that such change in the time and form of payment is established in writing and effective on or before December 31, 2011.

(b) With respect to a back-to-back arrangement under which a service provider provides services to a service recipient (the intermediate service recipient) that in turn provides services to another service recipient (the ultimate service recipient), to the extent the arrangement is covered by § 409A, all potential times and forms of payment under which the service provider may be paid a deferred amount by the intermediate service recipient must comply with the requirements of § 409A and § 1.409A–3. This means that the service provider must be payable upon a permissible payment event, which may include the service provider’s separation from service. However, a nonqualified deferred compensation arrangement that provides for the service provider to be paid when the intermediate service recipient separates from service in the ultimate service recipient is not a permissible payment event. Nothing in this A–27 should be interpreted as changing this requirement. In addition, no opinion is expressed as to whether such an arrangement would satisfy the requirements of the transition guidance for periods before the effective date of the final § 409A regulations (January 1, 2009). For the applicable transition rules, see Notice 2007–86, 2007–46 I.R.B. 990.

REQUEST FOR COMMENTS

The Treasury Department and the IRS anticipate issuing additional guidance with respect to § 457A. The Treasury Department and the IRS request comments on the topics addressed in this notice, and any other issues arising under § 457A. The Treasury Department and the IRS specifically request comments regarding the following topics:

1. Whether and to what extent a limitation on benefits provision or exchange of information program is relevant to the determination of what is a “comprehensive income tax treaty.”
2. The extent to which a reimbursement arrangement with respect to a domestic taxpayer arrangement recipient and a non-qualified entity that has agreed to share or reimburse the domestic taxpayer service recipient’s compensation costs should result in the domestic taxpayer service recipient also being treated as a nonqualified entity.

3. The potential scope of the exception to the definition of substantial risk of forfeiture that may be provided by regulation under § 457A(d)(1)(B), relating to the single investment asset.

4. The proper treatment of trusts that are partners in a partnership and beneficiaries of these trusts for purposes of determining to whom income of a partnership is allocated under § 457A(b)(2).

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

Comments may be submitted to Internal Revenue Service, CC:PA:LPD:PR (Notice 2009–8), Room 5203, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may also be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to the Courier’s Desk at 1111 Constitution Avenue, NW, Washington, DC 20224, Attn: CC:PA:LPD:PR (Notice 2009–8), Room 5203. Submissions may also be sent electronically via the internet to the following email address: Notice.comments@irs.counsel.treas.gov. Include the notice number (Notice 2009–8) in the subject line.

EFFECTIVE DATE

Until further guidance is issued, taxpayers may rely on the rules in this notice for purposes of § 457A effective from October 3, 2008 (the date of enactment of TEAMTRA). Further guidance that would expand the coverage of § 457A will be prospective and will not apply to a service provider’s taxable years beginning before the issuance of such guidance.

CONTACT INFORMATION

For further information regarding this notice, contact Stephen Tackney of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt & Government Entities) at (202) 927–9639 (not a toll-free call).

26 CFR 601.601: Rules and regulations. (Also: Part I, §§ 301, 305.)


SECTION 1. PURPOSE


SECTION 2. BACKGROUND

.01 Section 305(a) of the Internal Revenue Code (“Code”) provides that, except as otherwise provided in section 305, gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock.

.02 Section 305(b)(1) provides that section 305(a) shall not apply to a distribution by a corporation of its stock, and the distribution shall be treated as a distribution of property to which section 301 applies if the distribution is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either in its stock or in property.

.03 Section 305(b)(2) provides that section 305(a) shall not apply to a distribution by a corporation of its stock, and the distribution shall be treated as a distribution of property to which section 301 applies, if the distribution (or a series of distributions of which such distribution is one) has the result of the receipt of property by some shareholders, and an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation.

.04 Section 1.305–2(a) of the Income Tax Regulations provides that under section 305(b)(1), if any shareholder has the right to an election or option with respect to whether a distribution shall be made either in money or any other property, or in stock or rights to acquire stock of the distributing corporation, then, with respect to all shareholders, the distribution of stock or rights to acquire stock is treated as a distribution of property to which section 301 applies regardless of—

(1) Whether the distribution is actually made in whole or in part in stock or in stock rights;

(2) Whether the election or option is exercised or exercisable before or after the declaration of the distribution;

(3) Whether the declaration of the distribution provides that the distribution will be made in one medium unless the shareholder specifically requests payment in the other;

(4) Whether the election governing the nature of the distribution is provided in the declaration of the distribution or in the corporate charter or arises from the circumstances of the distribution; or

(5) Whether all or part of the shareholders have the election.

.05 Section 1.305–1(b)(2) provides that where a corporation which regularly distributes its earnings and profits, such as a regulated investment company, declares a dividend pursuant to which the shareholders may elect to receive either money or stock of the distributing corporation of equivalent value, the amount of the distribution of the stock received by any shareholder electing to receive stock will be considered to equal the amount of the money which could have been received instead.

SECTION 3. SCOPE AND APPLICATION

The Internal Revenue Service will treat a distribution of stock by a corporation that qualifies as a RIC or as a REIT under part I or II, respectively, of subchapter M of the Code as a distribution of property to which section 301 applies by reason of section 305(b), and the amount of such distribution of stock will be considered to equal the amount of the money which could have been received instead.

(1) The distribution is made by the corporation to its shareholders with respect to its stock;

(2) Stock of the corporation is publicly traded on an established securities market in the United States;

(3) The distribution is declared with respect to a taxable year ending on or before December 31, 2009;

(4) Pursuant to such declaration each shareholder may elect to receive the share-
holder’s entire entitlement under the declaration in either money or stock of the distributing corporation of equivalent value subject to a limitation on the amount of money to be distributed in the aggregate to all shareholders (the “Cash Limitation”), provided that—

(a) such Cash Limitation is not less than 10% of the aggregate declared distribution, and

(b) if too many shareholders elect to receive money, each shareholder electing to receive money will receive a pro rata amount of money corresponding to the shareholder’s respective entitlement under the declaration, but in no event will any shareholder electing to receive money receive less than 10% of the shareholder’s entire entitlement under the declaration in money;

(5) The calculation of the number of shares to be received by any shareholder will be determined, as close as practicable to the payment date, based upon a formula utilizing market prices that is designed to equate in value the number of shares to be received with the amount of money that could be received instead. For purposes of applying subsection (4) of this Section 3, the value of the shares to be distributed shall be determined by using the formula described in the preceding sentence; and

(6) With respect to any shareholder participating in a dividend reinvestment plan (“DRIP”), the DRIP applies only to the extent that, in the absence of the DRIP, the shareholder would have received the distribution in money under subsection (4) of this Section 3.

SECTION 4. EFFECT ON OTHER DOCUMENTS


SECTION 5. EFFECTIVE DATE

This revenue procedure is effective with respect to distributions declared on or after January 1, 2008.

SECTION 6. DRAFTING INFORMATION

The principal author of this revenue procedure is T. Ian Russell of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue procedure, contact T. Ian Russell at (202) 622–7550 (not a toll-free call).
Part IV. Items of General Interest

Notice of Proposed Rulemaking

Section 6707 and the Failure to Furnish Information Regarding Reportable Transactions

REG–160872–04

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under section 6707 of the Internal Revenue Code (Code), which provide the rules relating to the assessment of penalties against material advisors who fail to timely file a true and complete return required under section 6111(a). The regulations implement the amendments to section 6707 by the American Jobs Creation Act and promote material advisors’ compliance with the regulations under section 6111. These regulations affect material advisors responsible for disclosing reportable transactions under section 6111.

DATES: Written or electronic comments and request for a public hearing must be received by March 23, 2009.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–160872–04), room 5205, 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–160872–04), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC, 20224, or sent electronically via the Federal eRulemaking Portal at http://www.regulations.gov (IRS REG–160872–04).

FOR FURTHER INFORMATION CONTACT: Matthew S. Cooper, (202) 622–4940 (not a toll-free number); concerning submissions of comments and requests for a public hearing, Oluwafumilayo Taylor of the Publications and Regulation Branch at (202) 622–7180 (not a toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Procedure and Administration Regulations (26 CFR Part 301) under section 6707 of the Internal Revenue Code. Section 6707 was originally added to the Code by section 141(b) of the Tax Reform Act of 1984, Public Law 98–369, 98 Stat. 494. At that time, section 6707 imposed a penalty for failing to timely register a tax shelter or for filing false or incomplete information with respect to the tax shelter registration. Treasury Regulations §301.6707–1T was issued shortly after section 6707 became law.

The American Jobs Creation Act of 2004, Public Law 108–357, 118 Stat. 1418, (AJCA) was enacted on October 22, 2004. AJCA section 816 amended section 6707 to impose a penalty on a material advisor who is required to file a return under section 6111(a) with respect to any reportable transaction, and who fails to file a timely return or who files a return with false or incomplete information with respect to the reportable transaction. Section 6707, as amended, is effective for returns due after October 22, 2004. The amount of the penalty for failing to timely file or filing a return with false or incomplete information with respect to any reportable transaction other than a listed transaction is $50,000. For listed transactions, the amount of the penalty is the greater of (1) $200,000, or (2) 50 percent of the gross income derived by the material advisor with respect to aid, assistance, or advice that the material advisor provides with respect to any listed transaction before the date the return is filed under section 6111. If the penalty is imposed with respect to a listed transaction and the failure or action subject to the penalty was intentional, the penalty is the greater of (1) $200,000, or (2) 75 percent of the gross income derived by the material advisor with respect to aid, assistance, or advice that the material advisor provides with respect to the listed transaction before the date the return is filed under section 6111. The provisions of section 6707A(d) regarding rescission of the penalty apply to any penalty assessed under section 6707.

To implement the pertinent provisions of the AJCA, the IRS and Treasury Department issued interim guidance on section 6111 in Notice 2004–80, 2004–2 C.B. 963, December 13, 2004; Notice 2005–17, 2005–1 C.B. 606, February 22, 2005; Notice 2005–22, 2005–1 C.B. 756, March 21, 2005; and Notice 2006–6, 2006–1 C.B. 385, January 30, 2006 (see §601.601(d)(2)(ii)(b)). These notices provided guidance to a material advisor required to file a return under section 6111, including rules regarding the date by which the material advisor must file the return and the information the material advisor must include on the return. Subsequently, the IRS and Treasury Department proposed amendments to the rules relating to the disclosure of reportable transactions by material advisors under section 6111 (see Prop. Treas. Reg. §301.6111–3, 71 FR 64501) and finalized those proposed regulations as T.D. 9351, 2007–38 I.R.B. 616, in the Federal Register (72 FR 43157). The IRS and Treasury Department are now proposing rules relating to the AJCA amendments to section 6707.

Rev. Proc. 2007–21, 2007–9 I.R.B. 613, which was published on February 26, 2007, provides guidance to persons against whom a penalty under section 6707 or 6707A is assessed regarding procedures for requesting that the Commissioner of the Internal Revenue Service rescind all or a portion of these penalties with respect to a reportable transaction other than a listed transaction.

Explanation of Provisions

These proposed regulations provide rules reflecting the AJCA amendments to the section 6707 penalty for the failure to timely file a return under section 6111 or for filing a return with false or incomplete information regarding reportable transactions. The scope of the changes to the section 6707 penalty provisions by the AJCA necessitates a change to the temporary regulations promulgated under former section 6707.
Under these proposed revisions, a penalty under section 6707 may be assessed against each material advisor required to file a return under section 6111 who fails to file a timely return in accordance with §301.6111–3(e) or files a return with false or incomplete information. Accordingly, if more than one material advisor is responsible for filing a return under section 6111 with respect to the same reportable transaction, a separate penalty under section 6707 may be assessed against each material advisor who fails to timely file a return or files a return with false or incomplete information.

Additionally, §301.6707–1(b)(4) of these proposed regulations provides that “incomplete information” means a Form 8918, “Material Advisor Disclosure Statement” (or successor form), filed with the IRS that does not provide the information required under §301.6111–3(d). A return will not be considered incomplete when the information not provided on the Form 8918 (or successor form) is immaterial or was not provided due to mistake or accident after the exercise of reasonable care. The proposed regulations also provide that material advisors who complete the form to the best of their ability and knowledge after the exercise of reasonable efforts to obtain the information will not be considered to have filed an incomplete form within the meaning of this section. A Form 8918 (or successor form), however, will be considered intentionally incomplete (and, in the case of a listed transaction, subject to the increased penalty imposed by section 6707(b)) when it omits information required to be provided under §301.6111–3(d) and contains a statement that the omitted information will be provided upon request.

False information under proposed §301.6707–1(b)(5) means information provided on a Form 8918 (or successor form) to the IRS that is untrue or incorrect when the Form 8918 (or successor form) was filed. Information filed with the IRS will not be considered false when the return contains untrue or incorrect information by mistake or accident after the exercise of reasonable care or when the untrue or incorrect information is immaterial.

Under proposed §301.6707–1(b)(6), the failure to timely file or the submission of false or incomplete information is intentional if the material advisor knew of the obligation to file a return under section 6111, and knowingly did not timely file a return with the IRS; or filed a return knowing that it was false or incomplete. In the case of a listed transaction, the failure to timely file a true and complete return will not be considered intentional if the material advisor remedies this failure by filing a true and complete return with the IRS prior to the earlier of the date that any taxpayer files a Form 8886 identifying the material advisor with respect to the reportable transaction in question or the date the IRS contacts the material advisor concerning the reportable transaction. This rule is intended to encourage material advisors to correct material defects in their compliance with section 6111, and recognizes that by voluntarily correcting material defects the material advisors demonstrate an intent to comply with section 6111.

The proposed regulations in §301.6707–1(c)(2) state that a separate penalty may be assessed against each material advisor for its own failure to timely file the required return. If multiple material advisors (all with filing obligations under section 6111) enter into a designation agreement (within the meaning of §301.6111–3(f)) designating one material advisor to file the required return on behalf of all parties to the agreement, the section 6707 penalty may be imposed upon each party to the agreement if the material advisor designated to file the return either fails to timely file a return or files a return with false or incomplete information. In the case of a listed transaction, if the designated material advisor fails to timely file a true and complete return, a non-designated material advisor will not be considered to have intentionally violated its obligations under section 6111 unless the non-designated material advisor knew or should have known that the designated material advisor would fail to timely file a true and complete return.

Section 301.6707–1(d) of these proposed regulations provides several examples illustrating the potential application of the section 6707 penalty. Included are examples showing that the gross income derived by the material advisor will be determined in accordance with §301.6111–3(b)(3)(ii) for purposes of calculating the amount of the penalty with respect to a listed transaction.

Section 301.6707–1(e) of these proposed regulations restates the existing authority of the Secretary to prescribe the procedures to request rescission of a section 6707 penalty with respect to a non-listed reportable transaction by revenue procedure or other guidance published in the Internal Revenue Bulletin. Rev. Proc. 2007–21 describes the procedures for requesting rescission of a penalty assessed under section 6707, including the deadline by which a person must request rescission; the information the person must provide in the rescission request; the factors that weigh in favor of and against granting rescission; where the person must submit the rescission request; and the rules governing requests for additional information from the person requesting rescission.

These proposed regulations provide factors that the Commissioner (or the Commissioner’s delegate) should take into account during the determination whether to rescind all or a portion of any penalty imposed under section 6707. The proposed regulations generally adopt the list of factors stated in Rev. Proc. 2007–21, which factors are consistent with the legislative history of section 6707. See H.R. Conf. Rep. No. 755, 108th Cong., 2d Sess. at 599 (2004). The factors identified in these proposed regulations do not represent an exclusive list, and no single factor will be determinative of whether to grant rescission in any particular case. Rather, the Commissioner (or the Commissioner’s delegate) will consider and weigh all relevant factors, regardless of whether the factor is included in this list, and will generally favor rescission when the relevant factors and circumstances suggest that sustaining assessment of the penalty is against equity and good conscience.

One additional factor identified in the temporary regulations recently promulgated under section 6707A as weighing in favor of granting rescission that is not proposed to be adopted for purposes of rescission of the penalty under section 6707 is the extent to which the penalty assessed is disproportionately larger than the tax benefit received. The material advisor does not receive a tax benefit from the reportable transaction, but rather benefits from the transaction through the gross
income derived for aiding, assisting, or advising on the transaction. The threshold of gross income for status as a material advisor under section 6111 in the case of a reportable transaction is $50,000 if substantially all of the tax benefits from the transaction are provided to natural persons (looking through any partnerships, S corporations, or trusts). For all other nonlisted reportable transactions, the threshold amount is $250,000. The gross income levels necessary to be treated as a material advisor substantially ensure that any penalty imposed upon a material advisor under section 6707 will not be disproportionate to the benefit received by the material advisor.

Because it is the policy of the IRS to administer penalties in a manner that promotes voluntary compliance with the tax laws, the fact that a material advisor voluntarily files the form required under section 6111 prior to the earlier of: (i) the date that any taxpayer files a Form 8886 identifying the material advisor with respect to the reportable transaction in question or (ii) the date the IRS contacts the material advisor concerning the reportable transaction will weigh strongly in favor of rescission. See IRS Policy Statement 20–1 (June 29, 2004).

The proposed regulations mirror Rev. Proc. 2007–21 in providing that a rescission request is not the appropriate forum to contest whether the elements necessary to support a penalty under section 6707 exist. That question is for the examining agent, the IRS Office of Appeals, and the courts. A rescission determination is based on the premise that a violation of section 6707 exists but, nonetheless, the penalty should be rescinded (or abated). Accordingly, the proposed regulations provide that the Commissioner (or the Commissioner’s delegate) will not consider whether the material advisor in fact failed to comply with section 6111. Furthermore, these regulations provide that the Commissioner (or the Commissioner’s delegate) will not take into consideration doubt as to liability for, or collectibility of, the penalties in determining whether to rescind the penalty.

Proposed Effective Date

These regulations are proposed to apply to returns the due date of which is after the date the Treasury decision adopting these rules as final regulations is published in the Federal Register.

Special Analyses

It has been determined that these regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to this regulation and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on the impact on small business.

Comments and Requests for a Public Hearing

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

Drafting Information

The principal author of these regulations is Matthew S. Cooper of the Office of the Associate Chief Counsel (Procedure and Administration).

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Proposed Amendments to the Regulations

Accordingly, 26 CFR Part 301 is proposed to be amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

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

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

Par. 2. Section 301.6707–1 is added to read as follows:

§301.6707–1 Failure to furnish information regarding reportable transactions.

(a) In general. A material advisor who is required to file a return under section 6111(a) with respect to any reportable transaction, who fails to file a timely return in accordance with §301.6111–3(e) or who files a return with false or incomplete information with respect to the reportable transaction, will be subject to a penalty. The amount of the penalty for failing to timely file or filing a false or incomplete return with respect to any reportable transaction other than a listed transaction is $50,000. The amount of the penalty with respect to a failure relating to any listed transaction is the greater of $200,000 or 50 percent of the gross income derived by the material advisor with respect to aid, assistance, or advice that is provided with respect to the listed transaction before the date the return is filed under section 6111. If the failure or action subject to the penalty is with respect to a listed transaction and is intentional, the penalty is the greater of $200,000 or 75 percent of the gross income derived by the material advisor with respect to aid, assistance, or advice that is provided with respect to the listed transaction before the date the return is filed under section 6111. For purposes of calculating the amount of the penalty with respect to a listed transaction, the gross income derived by the material advisor will be determined in accordance with §301.6111–3(b)(3)(ii).

(b) Definitions.—(1) Reportable transaction. The term “reportable transaction” is defined in §1.6011–4(b)(1) of this chapter.

(2) Listed transaction. The term “listed transaction” is defined in section 6707A(c) of the Code and §1.6011–4(b)(2) of this chapter.

(3) Material Advisor. The term “material advisor” is defined in sec-
tion 6111(b)(1) of the Code and §301.6111–3(b).

(4) Incomplete information. For purposes of this section, incomplete information means a Form 8918, “Material Advisor Disclosure Statement” (or successor form), filed with the IRS that does not provide the information required under §301.6111–3(d). Information filed with the IRS will not be considered incomplete when the information not provided on the Form 8918 (or successor form) is immaterial or was not provided due to mistake or accident after the exercise of reasonable care. A material advisor who completes the form to the best of their ability and knowledge after the exercise of reasonable effort to obtain the information will not be considered to have filed incomplete information within the meaning of this section. A Form 8918 (or successor form) will be considered to provide incomplete information when it omits information required to be provided under §301.6111–3(d) and contains a statement that the omitted information will be provided upon request. For listed transactions, a Form 8918 (or successor form) that omits information required to be provided under §301.6111–3(d) and contains a statement that the omitted information will be provided upon request will be considered an intentional submission of a return with incomplete information within the meaning of paragraph (b)(6) of this section.

(5) False information. For purposes of this section, false information means information provided on a Form 8918 (or successor form) filed with the IRS that is untrue or incorrect when the Form 8918 (or successor form) was filed. False information does not include information provided on a Form 8918 (or successor form) filed with the IRS that is immaterial or that is untrue or incorrect due to a mistake or accident after the exercise of reasonable care.

(6) Intentional. For purposes of this section, the failure to timely file a return or the submission of a return with false or incomplete information is intentional if—

(i) The material advisor knew of the obligation to file a return and knowingly did not timely file a return with the IRS; or

(ii) The material advisor filed a return knowing that it was false or incomplete.

(7) Derive. The term “derive” is defined in §301.6111–3(c)(3).

(c) Assessment of penalty—(1) Individual liability. If there is more than one material advisor who is responsible for filing a return under section 6111 with respect to the same reportable transaction, a separate penalty under section 6707 may be imposed against each material advisor who fails to timely file or files a false or incomplete return. The determination of whether the failure or action subject to the penalty is intentional will also be made individually for each material advisor with respect to the same reportable transaction. The higher penalty will not apply to any material advisor whose failure to file timely or whose furnishing of false or incomplete information is unintentional. The failure to timely file a return, or filing a return with false or incomplete information, will be considered unintentional if the material advisor subsequently files a true and complete return prior to the earlier of the date that any taxpayer files a Form 8886, “Reportable Transaction Disclosure Statement” (or successor form), identifying the material advisor with respect to the reportable transaction in question or the date the IRS contacts the material advisor concerning the reportable transaction.

(2) Designation agreements. A material advisor who is required to file a return under section 6111 and who is a party to a designation agreement within the meaning of §301.6111–3(f) is subject to a penalty under section 6707 if the designated material advisor fails to timely file a return or files a return with false or incomplete information. In the case of a listed transaction, if the designated material advisor fails to timely file a return, or files a return with false or incomplete information, the nondesignated material advisor who is a party to the designation agreement will not be treated as intentionally failing to file the return, or intentionally filing a return with false or incomplete information, unless the nondesignated material advisor knew or should have known that the designated material advisor would fail to timely file a true and complete return.

(d) Examples. The rules of paragraphs (a) through (c) of this section are illustrated by the following examples:

Example 1. Advisor A becomes a material advisor as defined under section 6111(b) and §301.6111–3(b) in the fourth quarter of 2009 with respect to a reportable transaction other than a listed transaction, and Advisor B also becomes a material advisor in the same quarter with respect to the same reportable transaction. Subsequently, Advisors A and B fail to timely file the Form 8918. Because the section 6707 penalty applies to each material advisor independently, Advisors A and B each are subject to a penalty of $50,000.

Example 2. Same as Example 1, except that Advisor B timely filed the Form 8918 with the IRS Office of Tax Shelter Analysis (OTSA). Advisors A and B did not enter into a designation agreement. Accordingly, only Advisor A is subject to a $50,000 penalty.

Example 3. Advisor C becomes a material advisor to Client X on January 5, 2009, with respect to a listed transaction. Advisor C derives $400,000 in gross income from his advice to Client X because he expects to receive that amount from Client X, even though he has not yet received that amount. Advisor C unintentionally does not file a Form 8918. On January 5, 2010, Advisor C becomes a material advisor to Client Y with respect to the same type of listed transaction. The gross income Advisor C expects to receive from his advice to Client Y is $100,000. Advisor C does not become a material advisor with respect to any other client and unintentionally does not file a Form 8918. Advisor C is subject to a penalty of $250,000 (50 percent of the gross income he derived) under section 6707.

Example 4. Same as Example 3, except that Advisor C files the Form 8918 on November 15, 2009, which is beyond the date prescribed for filing the disclosure statement. Advisor C is subject to a $200,000 penalty under section 6707 because, as of the date he filed the Form 8918, the gross income Advisor C had received or expected to receive with respect to advice relating to the listed transaction did not include gross income for advice to Client Y.

Example 5. Same as Example 3, except that Advisor C files the Form 8918 on February 15, 2010, which is beyond the date prescribed for filing the disclosure statement. Advisor C is subject to a $250,000 penalty under section 6707 because, as of the date he filed the Form 8918, the gross income Advisor C had received or expected to receive with respect to advice to Client X on January 5, 2009, with respect to the same type of listed transaction did not include gross income for advice to Client X and Client Y.

Example 6. Advisor D becomes a material advisor as defined under section 6111(b) and §301.6111–3(b) in the first quarter of 2009 with respect to a reportable transaction other than a listed transaction. Advisor D does not file a Form 8918 by April 30, 2009. The transaction is then identified as a listed transaction in published guidance on July 7, 2009. Advisor D knew that it had a new obligation to file a Form 8918 by October 31, 2009, and intentionally failed to file the Form 8918. Advisor D is subject to only one penalty, in the amount of the greater of $200,000 or 75 percent of the gross income he derived from the transaction, for intentionally failing to disclose the listed transaction in accordance with §301.6111–3(d)(1) and (e).

(e) Rescission authority—(1) In general. The Commissioner (or the Commissioner’s delegate) may rescind the section 6707 penalty if—

(i) The violation relates to a reportable transaction that is not a listed transaction and
(ii) Rescinding the penalty would promote compliance with the requirements of the Internal Revenue Code and effective tax administration.

(2) Requesting rescission. The Secretary may prescribe the procedures for a material advisor to request rescission of a section 6707 penalty by revenue procedure or other guidance published in the Internal Revenue Bulletin.

(3) Factors that weigh in favor of granting rescission. In determining whether rescission would promote compliance with the requirements of the Code and effective tax administration, the Commissioner (or the Commissioner’s delegate) will take into account the following list of factors that weigh in favor of granting rescission. This is not an exclusive list and no single factor will be determinative of whether to grant rescission in any particular case. Rather, the Commissioner (or the Commissioner’s delegate) will consider and weigh all relevant factors, regardless of whether the factor is included in this list.

(i) The material advisor, upon becoming aware that it failed to properly disclose a reportable transaction, filed a complete and proper, albeit untimely, Form 8918 (or successor form). This factor will weigh strongly in favor of rescission provided that the material advisor files the form required under section 6111 prior to the earlier of the date that any taxpayer files a Form 8886 identifying the material advisor with respect to the reportable transaction in question or the date the IRS contacts the material advisor concerning the reportable transaction.

(ii) The material advisor’s failure to properly disclose the reportable transaction was due to an unintentional mistake of fact that existed despite the material advisor’s reasonable attempts to ascertain the correct facts with respect to the transaction.

(iii) The material advisor has an established history of properly disclosing other reportable transactions and complying with other tax laws, including compliance with any requests made by the IRS under section 6112, if applicable.

(iv) The material advisor demonstrates that the failure to include on any return or statement any information required to be disclosed under section 6111 arose from events beyond the material advisor’s control.

(v) The material advisor cooperates with the IRS by providing timely information with respect to the transaction at issue that the Commissioner (or the Commissioner’s delegate) may request in consideration of the rescission request. In considering whether a material advisor cooperates with the IRS, the Commissioner (or the Commissioner’s delegate) will take into account whether the material advisor meets the deadlines described in Rev. Proc. 2007–21 (or successor document) (see §601.601(d)(2)(ii)(b)) for complying with requests for additional information.

(vi) Assessment of the penalty weighs against equity and good conscience, including whether the material advisor demonstrates that there was reasonable cause for, and the material advisor acted in good faith with respect to, the failure to timely file or to include on any return any information required to be disclosed under section 6111. An important factor in determining reasonable cause and good faith is the extent of the material advisor’s efforts to determine whether there was a requirement to file the return required under section 6111. The presence of reasonable cause, however, will not necessarily be determinative of whether to grant rescission.

(4) Absence of favorable factors weighs against rescission. The absence of facts establishing the factors described in paragraph (e)(3) of this section weighs against granting rescission. The absence of any one of these factors, however, will not necessarily be determinative of whether to grant rescission.

(5) Factors not considered. In determining whether to grant rescission, the Commissioner (or the Commissioner’s delegate) will not consider doubt as to liability for, or collectibility of, the penalties.

(f) Effective/applicability date. The rules of this section apply to returns the due date for which is after the date the Treasury decision adopting these rules as final regulations is published in the Federal Register.
SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR Part 31 under section 3402(t) of the Code. This document also contains proposed amendments to 26 CFR Part 31 under sections 3406, 6011, 6051, 6071, and 6302 of the Code.

Section 3402(t) of the Code was added by section 511 of the Tax Increase Prevention and Reconciliation Act of 2005, Public Law 109–222 (TIPRA), 120 Stat. 345, which was enacted into law on May 17, 2006. Section 3402(t)(1) provides that the Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multi-State agencies) making any payment to any person providing any property or services (including any payment made in connection with a government voucher or certificate program which functions as a payment for property or services) shall deduct and withhold from such payment a tax in an amount equal to 3 percent of such payment. Under the statute, section 3402(t) applies to payments made after December 31, 2010.

Exceptions to section 3402(t) withholding are contained in section 3402(t)(2). Section 3402(t)(2) provides that section 3402(t) withholding shall not apply to any payment—

(A) Except as provided in section 3402(t)(2)(B), which is subject to withholding under any other provision of chapter 24 (Collection of Income Tax at Source on Wages, sections 3401 through 3406) or chapter 3 (Withholding of Tax on Nonresident Aliens and Foreign Corporations, sections 1441 through 1464) of the Code;

(B) Which is subject to withholding under section 3406 (backup withholding) and from which amounts are being withheld under such section;

(C) Of interest;

(D) For real property;

(E) To any government entity subject to the requirements of section 3402(t)(1), any tax-exempt entity, or any foreign government;

(F) Made pursuant to a classified or confidential contract described in section 6050M(e)(3);

(G) Made by a political subdivision of a State (or any instrumentality thereof) which makes less than $100,000,000 of such payments annually;

(H) Which is in connection with a public assistance or public welfare program for which eligibility is determined by a needs or income test; and

(I) To any government employee not otherwise attributable with respect to his or her services as an employee.

Section 3402(t)(3) provides for the coordination of section 3402(t) with other Code sections. Section 3402(t)(3) provides that, for purposes of sections 3403 and 3404 and for purposes of so much of subtitle F (except section 7205) as relates to chapter 24, payments to any person for property or services which are subject to withholding shall be treated as if such payments were wages paid by an employer to an employee.

The legislative history in connection with section 3402(t) indicates that “[t]he withholding requirement applies regardless of whether the government entity making such payment is the recipient of the property or services.” H.R. Conf. Rep. No. 109–455, 109th Cong., 2d Sess. at 300 (2006). Further, the conference report also provides, with respect to the exception provided by section 3402(t)(2)(H), that “payments under government programs to provide health care or other services that are not based on the needs or income of the recipients are subject to withholding, including programs where eligibility is based on the age of the beneficiary.” H.R. Conf. Rep. No. 109–455 at page 301. In addition, with respect to section 3402(t)(2)(A), the conference report states that section 3402(t) withholding “does not apply to payments of wages or to any other payment with respect to which mandatory (e.g., U.S.-source income of foreign taxpayers) or voluntary (e.g., unemployment benefits) withholding applies under present law.” H.R. Conf. Rep. No. 109–455 at page 301. The origins of the provision indicate that it was conceived to address tax noncompliance. See also, “Options to Improve Tax Compliance and Reform Tax Expenditures” (JCS–2–05), Joint Committee on Taxation, Jan. 27, 2005.

Notice 2008–38, 2008–13 I.R.B. 683, published by the IRS on March 31, 2008, invited public comments regarding guidance under section 3402(t). In particular, Notice 2008–38 requested comments on the application of section 3402(t) to credit cards and payment cards, payments to payees not subject to United States taxation, passthrough entities in which a government entity is a partner or owner, government contractors and subcontractors, and de minimis payments. The notice also requested comments on when and how amounts withheld under section 3402(t) should be transmitted to the IRS. See §601.601(d)(2)(ii)(b).

Many comments were received in response to Notice 2008–38, and the comments were taken into consideration in developing the proposed regulations.

Explanation of Provisions

The proposed regulations provide rules about which government entities are subject to the requirement of section 3402(t) withholding, which payments are subject to section 3402(t) withholding (and which are excepted from such withholding), when withholding is required on such payments, and how government entities pay and report the tax to the IRS. The proposed regulations also include transition rules providing relief from liability for the tax imposed by section 3402(t) with respect to payments under existing contracts. The proposed regulations also provide temporary relief from penalties and interest if a government entity makes a good faith effort but fails to withhold on payments as required under section 3402(t).

The regulations provide guidance primarily on what government entities need to do to comply so that they can make timely preparations. The Treasury Department and IRS anticipate issuing further guidance to address questions raised by taxpayers who expect to receive payments subject to section 3402(t) withholding from government entities including, but not limited to, how to claim credits and how to claim the benefit of statutory exemptions from withholding under section 3402(t). Although some commenters requested that the Treasury Department and IRS issue guidance exempting payments from withholding where the 3-percent rate for withholding prescribed under section 3402(t) is expected to exceed either the profit margin in the taxpayer’s industry or the income tax the taxpayer will owe for
reasons particular to the taxpayer’s business, the Treasury Department and IRS have determined that exemptions of this type would be contrary to the requirements of the statute. Commenters also requested that they be permitted to credit amounts withheld under section 3402(t) against Federal taxes other than income taxes, such as employment taxes. Consistent with the statute’s purpose of addressing income tax noncompliance, the Treasury Department and IRS propose to allow credits to be claimed only against income tax.

**Government Entities Subject to Section 3402(t)**

Section 3402(t)(1) applies to “the Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing.” Section 3402(t) does not restrict the term the Government of the United States in any manner. Therefore, the entire Federal government, including the executive branch, the legislative branch, and the judicial branch, is subject to the requirements of section 3402(t). Thus, Congress, the Administrative Office of the United States Courts, the Executive Office of the President, Federal agencies, and all other components of the Federal government are included in the definition of Government of the United States and are required to withhold under section 3402(t).

The term State includes the District of Columbia. See section 7701(a)(10) of the Code. For purposes of section 3402(t), the term State does not include Indian tribal governments. Section 7871(a) prescribes when an Indian tribal government is to be treated as a State under the Code, and section 7871(a) does not provide that Indian tribal governments will be treated as States for purposes of section 3402(t). Consequently, the term political subdivision also does not include a subdivision of an Indian tribal government. See section 7871(a) and (d). Accordingly, because Indian tribal governments and their subdivisions are not among the listed government entities subject to section 3402(t), payments by Indian tribal governments and their subdivisions are not subject to the withholding requirements of section 3402(t).

The definition of political subdivision in the proposed regulations follows the definition in the section 103 regulations. Section 1.103–1(b) of the Income Tax Regulations provides, in part, that the term political subdivision denotes any division of any State or local government unit that is a municipal corporation or that has been delegated the right to exercise part of the sovereign power of the unit.

Although the Code makes references to government instrumentalities in multiple sections, the Code and regulations do not currently provide a definition of instrumentality. In Rev. Rul. 57–128, 1957–1 C.B. 311, the IRS adopted a six-factor test for use in determining what is an instrumentality of a State or a political subdivision thereof for purposes of an exception from the requirement to pay tax under the Federal Insurance Contributions Act (FICA). The factors are: (1) whether the organization is used for a government purpose and performs a government function; (2) whether performance of its function is on behalf of one or more States or political subdivisions; (3) whether there are any private interests involved, or whether the States or political subdivisions involved have the powers and interests of an owner; (4) whether control and supervision of the organization is vested in public authority or authorities; (5) if express or implied statutory or other authority is necessary for the creation and/or use of such an instrumentality, and whether such authority exists; and (6) the degree of financial autonomy and the source of its operating expenses. A number of revenue rulings published by the IRS illustrate the application of this test. See, for example, Rev. Rul. 65–26, 1965–1 C.B. 444; Rev. Rul. 65–196, 1965–2 C.B. 388; and Rev. Rul. 69–453, 1969–2 C.B. 182. See §601.601(d)(2)(ii)(b). The Treasury Department and IRS invite comments on use of the same or a similar test for purposes of section 3402(t).

**Persons Subject to Withholding Under Section 3402(t)**

Section 3402(t) applies to government payments to “persons” providing any property or services. Section 7701(a)(1) of the Code provides that, when used in the Code, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof, the term person shall be construed to mean and include an individual, a trust, estate, partnership, association, company, or corporation. Because no alternative definition of person is provided in section 3402(t), the definition in section 7701(a)(1) and the regulations under section 7701(a)(1) applies. Therefore, section 3402(t) withholding can apply to payments for property or services to individuals, trusts, estates, partnerships, associations, companies, or corporations.

**Payments Subject to Section 3402(t) Withholding**

The proposed regulations provide that a payment subject to withholding arises when the government entity or its payment administrator pays a person for providing property or services. Under the proposed rules, the withholding requirements of section 3402(t) will not apply to any payment that is less than the payment threshold amount, which is $10,000. The Treasury Department and IRS are proposing this payment threshold of $10,000 because the burden of withholding on smaller transactions is likely to be substantial and outweigh the benefits of increased withholding. This threshold corresponds to a minimum withholding of $300.

Under the proposed rules, multiple payments made by a government entity to any person generally would not be aggregated in determining whether the payment threshold amount has been met. However, the proposed regulations provide an anti-abuse rule to ensure that the payment threshold is not manipulated to avoid the required withholding. If a government entity divides a payment into two or more separate payments primarily to avoid the payment threshold for one or more payments, the separate payments would be treated as one payment made on the date that the first payment was made for purposes of this rule. For example, if a government entity is scheduled to make a contractual payment to a person for landscaping services of $15,000 on July 2, 2011, but divides the payment into payments of $7,000 and $8,000 made on July 1, 2011, and July 2, 2011, respectively, the government entity would be treated as having made a single payment of $15,000 on July 1, 2011. This anti-abuse rule would not apply if the primary reason for division into separate payments is unrelated to section 3402(t).
If a government entity makes a single payment of $10,000 or more to any person for more than one property or service provided by that person, the government entity would be required to withhold on the payment. For example, if a person bills a government entity $5,000 each day for seven days for services provided each day, but the government entity makes one payment of $35,000 in satisfaction of these bills, the payment threshold is applied to the $35,000 payment.

Many commenters requested guidance on how the requirements of section 3402(t) apply to prime contractors and subcontractors. Under the proposed rules, if a government entity or its payment administrator makes a payment to a person that is subject to withholding under section 3402(t), no subsequent transfer of cash or property by that person to another person is treated as a payment for section 3402(t) purposes. Thus, if the government entity enters into a contract with a prime contractor for property and services, and that prime contractor separately contracts with subcontractors for delivery of certain property and services, then withholding under section 3402(t) applies only to payments by the government entity or its payment administrator to the prime contractor, and does not apply to successive payments by the prime contractor to its subcontractors.

The proposed regulations apply to payments made by the government entity or its payment administrator. For purposes of the proposed regulations, a payment administrator is any person that acts with respect to a payment solely as an agent for a government entity by making the payment on behalf of the government entity to a person providing property or services, or on behalf of the government entity. Transfers of funds from a government entity to a payment administrator to be used by the payment administrator, on the government entity’s behalf, to pay persons for providing property or services are not payments subject to withholding under section 3402(t). However, if the government entity pays the payment administrator a fee for its services, the government entity would treat the fee as a payment subject to withholding. The government entity is liable for the withholding required and responsible for all related reporting regardless of whether the government entity or its payment administrator makes the payment and regardless of when the payment for property or services is made under this section.

Credit Card Payments

Many commenters questioned how the requirements of section 3402(t) apply to payments made by government credit card or payment card. Under the proposed regulations, when a government entity or its payment administrator uses a credit card or payment card to pay a person for providing property or services, payment occurs at the point of sale when the government credit card or payment card is tendered and not when the government entity pays the credit card company. The government entity is liable for the withholding and reporting associated with the payment, and this liability is not transferred to any other party involved in the credit card or payment card transaction, including, but not limited to, the acquiring bank, the issuing bank, or the credit card association. (The acquiring bank may be separately required to report amounts it pays under new section 6050W, which was enacted as part of the Housing Assistance Tax Act of 2008, Div. C of Public Law 110–289.)

Section 3402(t)(2)(A)—Payments Subject to Withholding Under Chapter 3 or Chapter 24 and Section 3402(t)(2)(B)—Payments from Which Backup Withholding Is Withheld

Section 3402(t)(2)(A) provides an exception from the requirement of section 3402(t) for amounts that are subject to withholding under some other provision of chapter 3 or chapter 24 (other than section 3406). Thus, payments that are subject to withholding under the wage withholding regime or the regime for withholding of tax on nonresident aliens and foreign corporations are exempt from withholding under section 3402(t). Furthermore, consistent with the legislative history, amounts for which the payee may elect withholding are exempt from withholding under section 3402(t), regardless of whether the payee in fact makes such an election. These payments include: (1) unemployment compensation as defined in section 85(b) (section 3402(p)(2)); (2) social security benefits as defined in section 86(d) (section 3402(p)(1)(C)(i)); and (3) any payment referred to in the second sentence of section 451(d) that is treated as insurance proceeds, relating to certain disaster payments received under the Agricultural Act of 1949, as amended, or Title II of the Disaster Assistance Act of 1988 (section 3402(p)(1)(C)(ii)); (4) any amount that is includible in gross income under section 77(a), relating to amounts received as loans from the Commodity Credit Corporation that the taxpayer has elected to treat as income (section 3402(p)(1)(C)(iii)); and (5) any payment of an annuity to an individual.

A special rule applies for payments subject to backup withholding. Section 3402(t)(2)(B) provides that a payment that is subject to 28 percent withholding under section 3406 (backup withholding) is not excepted from the requirement of 3 percent withholding under section 3402(t) unless backup withholding is actually being deducted from the payment. Thus, if backup withholding is required with respect to a payment made by a government entity and the government entity performs backup withholding on the payment, section 3402(t) does not apply. If the government entity fails to backup withhold on such a payment, the government entity would remain liable for backup withholding regardless of whether it imposed withholding under section 3402(t) while backup withholding is actually being deducted from the payment. Under the proposed regulations, payments made to nonresident aliens or foreign individuals that are exempt from United States taxation pursuant to a treaty would be exempt from withholding under section 3402(t) because such payments are subject to withholding absent application of the treaty. Specifically, absent a treaty, United States source fixed or determinable, annual or periodic (FDAP) income paid to a nonresident alien individual or foreign corporation is subject to withholding under chapter 3, except for income that is effectively connected with a U.S. trade or business (other than compensation for personal services) pursuant to sections 1441 and 1442. Relevant examples of FDAP include salaries, compensation and emoluments.

Imposing a new withholding requirement on nonresident aliens and foreign...
corporations that owe no United States tax would serve no purpose. Foreign persons that are exempt from withholding under sections 1441 and 1442 by reason of an income tax treaty are not the source of the tax noncompliance problem that section 3402(t) was enacted to address. Further, our existing documentation procedures are intended to ensure that those claiming treaty benefits are in fact entitled to treaty benefits. See, for example, Form W–8BEN, “Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding,” and Form 8233, “Exemption From Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual.” Accordingly, the proposed regulations under section 3402(t) provide that the “subject to withholding under chapter 3” exception in section 3402(t)(2)(A) applies to payments with respect to which a foreign person claims a zero rate of tax under an income tax treaty. Thus, if a foreign person furnishes documentation establishing entitlement to an exemption from withholding under chapter 3 by reason of an income tax treaty, government entities would not be required to withhold under section 3402(t) from payments to such person.

Section 3402(t)(2)(C)—Interest

Section 3402(t)(2)(C) provides that payments of interest are exempt from withholding. The proposed regulations do not provide a definition of interest. The Treasury Department and IRS request comments concerning whether a definition of interest is needed and if so, what that definition should be.

Section 3402(t)(2)(D)—Payments for Real Property

Section 3402(t)(2)(D) provides that payments for real property are not subject to section 3402(t). Because the exception is not limited to payments for fee ownership, the proposed regulations provide that payments for real property include payments for leasing real property and leasehold improvements.

Commenters asked whether real property included payments made under contracts for the construction of buildings or other public works. Neither the statute itself nor the legislative history defines “real property” for purposes of section 3402(t).

The proposed regulations adopt the position that payments for the construction of buildings or public works are not payments for real property excepted by section 3402(t)(2)(D). Payments for the construction of a building are payments for services to build the building and personal property to be used in the construction of the building rather than payments for real property. This position is consistent with statutes governing construction contracts of the Federal government. See, for example, 40 USC 3131–3134 (the “Miller Act”).

Section 3402(t)(2)(E)—Payments to Government Entities Subject to Section 3402(t), Tax-Exempt Organizations, and Foreign Governments

Section 3402(t)(2)(E) provides exceptions from section 3402(t) withholding for payments to any government entity subject to the requirements of section 3402(t)(1), payments to any tax-exempt entity, and payments to any foreign government. The determination of whether an entity is a government entity such that payments it receives are exempt parallels the determination whether the entity is a government entity required to withhold on payments it makes. Thus, if a government entity is required to withhold under section 3402(t)(1), payments to that government entity are not subject to withholding under section 3402(t). The proposed regulations also clarify that, even if no withholding is required on payments from a government entity because the government entity qualifies for the exception of section 3402(t)(2)(G) for political subdivisions and instrumentalities making total payments of less than $100 million (discussed later in this preamble), payments to that government entity are not subject to withholding.

The proposed regulations define the term tax-exempt entity for purposes of section 3402(t)(2)(E) as any organization exempt from federal income tax under section 501(a) as an organization described in section 501(c), 501(d), or section 401(a).

Section 3402(t)(2)(F)—Payments Made Pursuant to a Classified or Confidential Contract

Section 3402(t)(2)(F) provides an exception from section 3402(t) withholding for payments made pursuant to a classified or confidential contract described in section 6050M(e)(3). Section 6050M(e)(3) describes a contract between a Federal executive agency and another person if—

(A) The fact of the existence of such contract or the subject matter of such contract has been designated and clearly marked or clearly represented, pursuant to the provisions of Federal law or an Executive order, as requiring a specific degree of protection against unauthorized disclosure for reasons of national security, or

(B) The head of such Federal executive agency (or his designee), pursuant to regulations issued by such agency, determines, in writing, that filing the required return under section 6050M (related to information returns required to be filed by any Federal executive agency with respect to persons receiving contracts) would interfere with the effective conduct of a confidential law enforcement or foreign counterintelligence activity.

Section 3402(t)(2)(G)—The Exception for Political Subdivisions and Instrumentalities Making Total Payments Under $100,000,000

Section 3402(t)(2)(G) provides that payments made by certain smaller government entities are not subject to withholding under section 3402(t). Specifically, a political subdivision of a State (or any instrumentality thereof) that makes less than $100,000,000 of payments for property or services annually (other than for payroll or of another type exempt from withholding under these proposed regulations) is not required to withhold under section 3402(t) on any of its payments. The proposed regulations provide a simple rule for determining before each year starts whether the exception provided by section 3402(t)(2)(G) applies to a given political subdivision or instrumentality. The determination would be based on the payments made during the accounting year of the political subdivision or instrumentality ending with or within the second preceding calendar year. For ex-
ample, to determine whether the political subdivision or instrumentality is subject to withholding with respect to payments made in 2011, the proposed regulations would look to whether payments made by the political subdivision or instrumentality for its accounting year ending with or within the calendar year 2009 equaled or exceeded $100,000,000. For this purpose, the accounting year is considered to be the year used by the political subdivision or instrumentality to keep its accounting books and determine budgets. In most cases, political subdivisions and instrumentalities would be able to make a reasonably accurate estimate whether the exception applies before the end of the accounting year ending in 2009 based on budgetary projections. However, in cases where the payments are expected to be near the $100,000,000 threshold, the time between the end of the accounting year in 2009, when a definitive determination could be made, and December 31, 2010, should give the political subdivision or instrumentality sufficient time to prepare for withholding under section 3402(t) for payments made in 2011.

In determining whether the political subdivision or instrumentality has made $100,000,000 of total payments, the proposed regulations would require that all payments for property and services made during the accounting year be considered with the exception of those payments qualifying for any of the exceptions provided by §§31.3402(t)–4(a) through (l) of the proposed regulations. For this purpose, payments that are less than the $10,000 payment threshold count toward the $100,000,000 test.

This exception provided by section 3402(t)(2)(G) does not apply to the United States Government, States, or instrumentalities of the United States Government or States.

The Treasury Department and IRS request comments on the application of section 3402(t)(2)(G), particularly with regard to whether the rules for determining whether the exception applies would provide adequate time to modify systems for compliance with section 3402(t), whether a special rule should be considered allowing the averaging of multiple accounting years for political subdivisions and instrumentalities that have unusually high expenditures in a given accounting year, and whether the determination of total payments under the proposed regulations is practicable.

Section 3402(t)(2)(H)—Payments in Connection with a Public Assistance Plan

Section 3402(t)(2)(H) provides an exception from section 3402(t) withholding for any payment in connection with a public assistance or public welfare program for which eligibility is determined by a needs or income test. The proposed regulations adopt a broad definition of in connection with to include payments made to third parties under a public assistance or public welfare program for the benefit of the recipient of benefits under the program. The proposed regulations also are consistent with the legislative history in providing that a program for which eligibility is determined under a needs or income test does not include a program under which eligibility is based on age only (for example, Medicare). The proposed regulations provide that, for purposes of this exception, a program providing disaster relief to victims of a natural or other disaster is considered to be a program for which eligibility is determined under a needs test.

Section 3402(t)(2)(I)—Payments to a Government Employee with Respect to Services as an Employee

Section 3402(t)(2)(I) provides an exception from section 3402(t) withholding for payments to any government employee not otherwise excludable with respect to the employee’s services as an employee. The proposed regulations broadly interpret this exception to exclude from section 3402(t) withholding any form of compensation that is paid to the employee or on the employee’s behalf. For example, the proposed regulations exclude employer contributions to employee benefit and deferred compensation plans as well as employee contributions to such plans. This exception applies to any payments by an employer for fringe benefits or deferred compensation to, or for the benefit of, an employee.

The proposed regulations provide that the section 3402(t)(2)(I) exclusion from section 3402(t) withholding also applies to: (a) travel reimbursements paid by a government entity to a government employee under accountable plans within the meaning of section 62(c) for the individual employee’s travel, lodging, and meal expenses; and (b) the government employee’s payments to third parties that provide travel, lodging, and meals that are reimbursable under such travel reimbursement plans. Most payments for individual travel, lodging, and meal expenses would fall beneath the $10,000 payment threshold. Nevertheless, this exception may be significant in determining whether the government entity making the payments qualifies for the exception under section 3402(t)(2)(G) for political subdivisions of a State (or their instrumentalities) making payments under $100,000,000, as payments under section 3402(t)(2)(I) are excluded when calculating the total amount of payments.

Section 31.3401(a)–4(a) of the Employment Tax Regulations provides that if a reimbursement or other expense allowance arrangement meets the requirements of section 62(c) and §1.62–2 and the expenses are substantiated within a reasonable period of time, payments made under the arrangement that do not exceed the substantiated expenses are treated as paid under an accountable plan and are not wages. Thus, these payments would qualify for the exception under section 3402(t)(2)(I).

By comparison, if the travel reimbursement or payment by the employer is not paid under an accountable plan, the reimbursement would be treated as paid under a nonaccountable plan. Payments to the employee under a nonaccountable plan are includible in gross income and wages and subject to income tax withholding under section 3402(a). Thus, such payments would be excepted from withholding under section 3402(t) by section 3402(t)(2)(A).

Exception for Certain Payments Received by Nonresident Alien Individuals and Foreign Corporations

In general, in the case of a nonresident alien individual or a foreign corporation (foreign person), sections 872(a) and 882(b) provide that gross income for United States income tax purposes consists of (1) gross income derived from sources within the United States; and
(2) gross income derived from sources outside the United States (foreign source income), but only if it is effectively connected with a trade or business within the United States. The source of income is determined under sections 861 through 865. The source of income derived from the performance of services is the place where the services are performed as provided in sections 861(a)(3) and 862(a)(3), whereas the source of income from the purchase and sale of inventory property (other than unprocessed timber) is the location where the sale takes place as described in §1.861–7(c) of the Income Tax Regulations (see also sections 861(a)(6) and 862(a)(6)). Therefore, if a foreign person provides services or sells inventory property in a foreign country, it will have no United States income tax liability with respect to the income earned from providing the services or selling the property—even to a United States government entity—provided that the income is not effectively connected with the conduct of a trade or business within the United States.

Accordingly, the proposed regulations exclude such payments made to foreign persons from 3-percent withholding under section 3402(t). For administrative reasons, subjecting these foreign source payments to withholding under section 3402(t) would be unduly burdensome to the foreign persons receiving such payments and the IRS. The foreign persons, most of whom are not presently United States income tax filers, would have to get taxpayer identification numbers (TINs) and file refund claims. Likewise, the IRS would have to issue TINs, process the claims, and refund all of the funds collected. Withholding on foreign source payments to foreign persons has no potential to reduce tax noncompliance because the potential income resulting from the payments is not subject to United States income taxation. Procedures to be followed by government entities and foreign persons for purposes of claiming this exception from section 3402(t) withholding will be issued at a later date.

Exception for Payments to Indian Tribal Governments

Indian tribal governments are not subject to United States income tax. Subjecting payments made by government entities to Indian tribal governments to withholding under section 3402(t) would be unduly burdensome for the same reasons discussed above with respect to certain payments made to foreign persons. Therefore, the proposed regulations except these payments from 3-percent withholding under section 3402(t).

Deposits and Reporting of Amounts Withheld Under Section 3402(t)

In determining rules for reporting amounts withheld under section 3402(t), the Treasury Department and IRS have considered the administrative burden on government entities imposed by reporting, the need for payees to receive timely and accurate information about the amounts withheld, and the need for IRS systems to process the information reported. Many comments reflected a preference for using an existing system and adapting current forms and procedures to accommodate section 3402(t) withholding, rather than creating a new system and forms for such withholding. The commenters indicated that using an existing system would ease compliance by government entities and would ease the processing of the payment and reporting of such tax.

The Treasury Department and IRS believe the existing procedure for reporting nonwage withholding on Form 945, “Annual Return of Withheld Federal Income Tax,” and reporting payments subject to withholding on Form 1099–MISC, “Miscellaneous Income,” with slight modifications to existing forms, would provide the most satisfactory method of payment and reporting. Because most government entities have a system for issuing Form 1099–MISC, using this system with modifications for reporting section 3402(t) withholding should ease compliance. Additionally, using Form 1099–MISC would give payees the information they need to timely file their income tax returns claiming credit for the withholding. Because this system would be similar to the system used currently for reporting and paying nonwage income tax withholding, the IRS would be able to process the withholding timely and on a cost-effective basis.

Accordingly, the proposed amendments to the regulations under section 6011 provide that payors required to withhold amounts under section 3402(t) must file Form 945 reporting the amounts withheld. Proposed amendments to the regulations under section 6302 further provide that the amounts withheld under section 3402(t) must be deposited and reported in the same manner as other nonwage withheld amounts, such as withholding on gambling winnings and pensions. Pursuant to existing regulations, such amounts are treated as if they were employment taxes for purposes of the deposit rules, but are subject to special rules for determining the payor’s deposit schedule, as provided in §31.6302–4.

Additionally, proposed amendments to regulations under section 6051 provide that payors required to withhold amounts under section 3402(t) must file information returns and furnish payee statements on Form 1099–MISC reporting such payments and tax withheld. Because this reporting would be done pursuant to regulations under section 6051, the exceptions provided in the regulations under section 6041 relating to Form 1099 would not apply (for example, the exception for payments to corporations).

Payments for Jury Duty, Utilities, and Fuel Surcharges

Commenters asked whether jury duty pay is subject to withholding under section 3402(t). Jury duty pay generally will not meet the $10,000 payment threshold provided in the proposed regulations. No special rule for jury duty pay is provided.

Commenters also requested guidance about utility payments. Rates for utility services are generally prescribed through a State regulatory process. Commenters expressed concern about the consequences of paying something less than the regulatorily prescribed rate to the utility. In fact, utility companies—like all persons receiving payments subject to withholding under section 3402(t)—would be paid the full amount charged, albeit in the form of a combination of a cash payment and a deposit of tax made to the IRS. Therefore, unless otherwise excepted, utility payments are subject to withholding under section 3402(t) on the same basis as payments for other property and services.

Commenters also requested that fuel surcharges be exempted from withholding, arguing that a fuel surcharge provided
under a contract is merely a cost recovery mechanism used to garner the lowest possible rates for the government by controlling volatile cost components in bid calculations. Although the use of separately stated charges for certain costs may well serve this purpose in contracting, section 3402(t) provides no exception for fuel surcharges or any other separately stated cost item. Section 3402(t) requires withholding on payments made regardless of how the payee may apply them against costs. Therefore, the proposed regulations do not provide an exception for payments allocated to fuel surcharges or any other separately stated costs.

**Application of Section 3402(t) to Passthrough Entities**

Commenters requested guidance with respect to the application of section 3402(t) where either the payor or the payee is a partnership or S corporation (“passthrough entities”). With respect to payments from a passthrough entity, the proposed regulations provide that such payments are not generally subject to withholding under section 3402(t) unless 80 percent or more of the passthrough entity is owned by government entities that are required to withhold under section 3402(t)(1). With respect to payments to a passthrough entity, the proposed regulations provide that such payments are generally subject to withholding under section 3402(t) unless 80 percent or more of the passthrough entity is owned by persons described in section 3402(t)(2)(E) (government entities required to withhold under section 3402(t)(1), tax-exempt entities, and foreign governments). An 80-percent threshold is consistent with similar thresholds in various areas of the tax law. See, for example, section 775(b)(3) and §§1.414(c)–2(b)(2) and 301.7701(i)–1(d)(3)(i)(A). The proposed regulations also provide that, as a general rule, whether a passthrough entity is subject to section 3402(t) is determined on the first day of the entity’s taxable year. The Treasury Department and IRS believe that this general rule simplifies compliance and administration by requiring one annual determination of whether a passthrough entity’s payments are subject to withholding under section 3402(t). However, the proposed regulations provide that any manipulation of the ownership percentage with an intent to avoid application of section 3402(t) would be recharacterized as appropriate to reflect the actual ownership percentage.

**Effective Date and Transition Relief for Existing Contracts**

The proposed regulations provide that the regulations will generally be effective for payments made after the later of December 31, 2010, or the date that is 6 months after the publication of final regulations. Commenters questioned whether section 3402(t) would apply to payments made under contracts in existence prior to the effective date of section 3402(t). They noted that many government entities are party to multi-year contracts. These contracts did not contemplate the withholding of income tax from payments under the contracts. Future contracts can address the withholding requirement and its effect on the contractor’s cash flow. Accordingly, the proposed regulations provide that payments made under written binding contracts in effect on the later of December 31, 2010, or the date that is 6 months after the publication of final regulations are not subject to withholding under section 3402(t), unless such contract is materially modified. Payments pursuant to contracts entered into after the later of December 31, 2010, or the date that is 6 months after the publication of final regulations will be subject to section 3402(t).

Under the proposed regulations, if there is a material modification to an existing contract after the later of the effective date of the legislation or six months after the issuance of final regulations under section 3402(t), the contract would cease to be an existing contract for purposes of this transition relief and payments under the contract would become subject to the withholding requirements of section 3402(t). The Treasury Department and IRS are considering whether contracts that contain the option of renewal should be considered new contracts as of the date of renewal. The final regulations may provide that a contract that is renewable as of a certain date is treated as a new contract on the first date the contract is renewed. The Treasury Department and IRS request comments on how option terms in contracts, including, but not limited to, options to renew, should affect the transition relief for payments under written binding contracts.

**Credit Against Income Tax**

The Treasury Department and IRS received numerous comments from taxpayers expecting to receive payments subject to section 3402(t) withholding. Most of these comments asked how taxpayers would take the credit for the section 3402(t) withholding. Section 31 provides the general crediting rule for withholding of income tax. Specifically, section 31(a)(1) provides that “[t]he amount withheld as tax under chapter 24 shall be allowed to the recipient of the income as a credit against the tax imposed by this subtitle.” Chapter 24 includes section 3402(t), and section 31(a)(1) is in subtitle A, income taxes. Thus, by its terms, section 31(a)(1) applies to persons who have had income tax withheld from a payment pursuant to section 3402(t) and allows a credit against income tax only.

Section 31(a)(2) provides the general rule on the timing of the allowance of the credit: “The amount so withheld during any calendar year shall be allowed as a credit for the taxable year beginning in such calendar year. If more than one taxable year begins in a calendar year, such amount shall be allowed as a credit for the last taxable year so beginning.” Thus, absent a special rule, the rule of section 31(a)(2) generally applies for purposes of withholdings required under chapter 24, which includes section 3402(t).

Section 31(c) provides a special rule solely for backup withholding. Under section 31(c), any credit allowed by section 31(a) for backup withholding under section 3406 must be allowed for the taxable year of the recipient of the income in which the income is received. Congress did not provide a similar exception for the timing of the credit for section 3402(t) withholding. Section 31(c) is limited by its terms to section 3406 withholding only. Thus, the general rule of section 31(a)(2) applies to section 3402(t) withholding rather than the special rule of section 31(c).

The effect of section 31(a)(2) is that fiscal year taxpayers may be entitled to take credit for withholding under section 3402(t) only in a taxable year subsequent to the taxable year in which the amount was withheld. For example, if amounts
were withheld under section 3402(t) from a June 30 fiscal year taxpayer during the period from January 1, 2011, to June 30, 2011, the taxpayer will be entitled to take credit for the withheld tax on its income tax return for the fiscal year ending June 30, 2012, rather than its income tax return for the fiscal year ending June 30, 2011.

The Treasury Department and IRS recognize that, in the case of fiscal year taxpayers, the application of the rule in section 31(a)(2) requiring that the credit be taken in the second of two possible taxable years may be burdensome for taxpayers. The Treasury Department and IRS request comments on what impact the timing rule in section 31(a)(2) described above for income tax credits will have on taxpayers that have tax withheld under section 3402(t).

Crediting Against Estimated Income Tax Liability

Taxpayers may take into account the income tax withheld under section 3402(t) and allowed as a credit under section 31 in determining estimated tax liability pursuant to sections 6654 and 6655. With respect to individual taxpayers, section 6654(g)(1) provides that, for purposes of determining the application of the penalty for an individual’s failure to pay estimated tax, the amount of the credit allowed under section 31 for the taxable year shall be deemed a payment of estimated tax. As with other income tax withheld, an individual recipient may account for income tax withheld in computing estimated income tax liability on Form 1040–ES, “Estimated Tax for Individuals.” Because most individuals are calendar year taxpayers, the section 3402(t) withholding would generally be treated as a payment of estimated tax for the same calendar year, and the individual’s liability for other payments of estimated tax for that year would be reduced. However, if the individual is a fiscal year taxpayer, the individual may not take into account the withholding for estimated tax purposes until the fiscal year that begins in the calendar year in which the tax is withheld.

Similar rules apply to corporate taxpayers. In determining the amount of estimated tax required to be paid to avoid the section 6655 penalty applicable to corporations for failure to pay estimated tax, section 6655(g)(1)(B) provides in effect that credits against tax under section 31 are taken into account. Thus, corporate taxpayers can also take into account the amount of credit allowed under section 31(a) in determining income tax liability and in computing estimated income tax liability. As with individual taxpayers, corporate taxpayers on a fiscal year could have the problem of delay in taking account of the credit if withholding occurs in the part of the calendar year before the beginning of the fiscal year that begins in that calendar year.

Credit Against Employment Taxes or Other Taxes

Many commenters requested that taxpayers be allowed to take credit for section 3402(t) withholding with respect to employment taxes or other taxes. The statute directs that crediting follow the rules under section 31(a), which provide for crediting against income tax. Where the statute permits income tax payments to be treated as employment tax payments, or vice versa, it makes specific provision for that treatment. See, for example, section 3507(d) (providing for the treatment of advance payments of the earned income credit as payments of the income tax withholding and FICA liability of the employer); section 3510(b) (providing that domestic employment taxes are treated as taxes due for estimated tax purposes under section 6654); and section 31(b) (providing for the crediting against income tax of the special refund of social security tax under section 6413(c) applicable when an employee receives wages from two or more employers in excess of the social security tax contribution and benefit base). The Code does not provide for withholding under section 3402(t) to be treated as payments of the taxpayer’s employment tax liability.

Rate of Income Tax Withholding

Some taxpayers requested that the Treasury Department and IRS provide for lower withholding rates for taxpayers with lower profit margins or lower marginal income tax rates. The statute provides for a uniform 3-percent rate of withholding. Thus, the proposed regulations apply withholding at the 3-percent rate to all payments for services and property from which withholding under section 3402(t) is required to be made.

Liability for Section 3402(t) Withholding in the Event of Failure to Withhold

If a government entity fails to withhold the tax imposed by section 3402(t), section 3403 applies. Under section 3402(t)(3) and section 3403, the government entity is generally liable for the payment of the tax to the IRS unless it can prove that the payee has paid its income tax liability.

Section 3403 provides that the employer shall be liable for the payment of tax required to be deducted and withheld under chapter 24, and shall not be liable to any person for the amount of any such payment.

Section 31.3403–1 of the Employment Tax Regulations provides that every employer required to deduct and withhold the tax under section 3402 from the wages of an employee is liable for the payment of such tax whether or not it is collected from the employee by the employer. If, for example, the employer deducts less than the correct amount of tax, or if the employer fails to deduct any part of the tax, the employer is nevertheless liable for the correct amount of the tax. Section 3402(t)(3) provides that for purposes of section 3403, payments to any person for property or services that are subject to withholding under section 3402(t) are treated as if such payments were wages paid by an employer to an employee.

Thus, sections 3402(t)(3) and 3403 establish the liability of the government entity for the amount of the tax imposed by section 3402(t) if it fails to withhold.

However, section 3402(d) provides an exception to the entity’s liability for income tax withholding in certain cases. Under this exception, if the entity required to withhold fails to do so, and thereafter the tax is paid, the tax will not be collected from the entity that failed to withhold. Thus, for purposes of section 3402(t), the government entity generally will be liable if it fails to withhold unless it is able to demonstrate, consistent with IRS procedures, that the taxpayer reported the amounts that were subject to withholding on its income tax return and paid the income tax due.
Transition Rule for Penalties and Interest on Underpayments

The proposed regulations provide a special transition rule for a government entity’s liability for interest and penalties with respect to the failure to pay the tax on payments for property and services made before January 1, 2012. Under the transition rule, a government entity would not be liable for penalties and interest with respect to liability for withholding imposed by section 3402(t), on payments for property or services made before January 1, 2012, if the entity made a good faith effort to comply with the requirements of section 3402(t). However, this transition rule would not provide relief from liability for the amount of tax required to be withheld under section 3402(t).

Proposed Effective Date

These regulations are proposed to apply to payments made after the later of December 31, 2010, or six months after the date of publication of final regulations. In addition, the regulations will not apply to payments under contracts existing on the later of December 31, 2010, or six months after the date of publication of final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to this regulation, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8 copies) or electronic comments that are timely submitted to the IRS. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written or electronic comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the Federal Register.

Drafting Information

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

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 31 is proposed to be amended as follows:

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

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

Authority: 26 U.S.C. 7805 * * *
Par. 2. The following §§31.3402(t)–0, 31.3402(t)–1, 31.3402(t)–2, 31.3402(t)–3, 31.3402(t)–4 and 31.3402(t)–5 are added, §31.3402(t)–6 is added and reserved, and 31.3402(t)–7 is added to read as follows:

§31.3402(t)–0 Outline of the Government withholding regulations.

This section lists paragraphs contained in §§31.3402(t)–1 through 31.3402(t)–5, and §31.3402(t)–7.

§31.3402(t)–1 Withholding requirement on certain payments made by government entities.

(a) In general.
(b) Special rules.
(c) Deposit and reporting requirements.
(d) Effective/applicability date.

§31.3402(t)–2 Government entities required to withhold under section 3402(t).

(a) In general.
(b) Government of the United States.
(c) State.
(d) Political Subdivision.
(e) [Reserved].
(f) Possessions of the United States.
(g) Passthrough entities.
(h) Small entity exception.
(i) Effective/applicability date.

§31.3402(t)–3 Payments subject to withholding.

(a) In general.
(b) Payment threshold of $10,000.
(c) No withholding on successive payments.
(d) Payments made through a payment administrator or to a contractor.
(e) Payments by credit card or payment card.
(f) Examples.
(g) Effective/applicability date.

§31.3402(t)–4 Certain payments excepted from withholding.

(a) Payments subject to withholding under chapter 3 or chapter 24 (other than section 3406).
(b) Payments subject to withholding under section 3406 with backup withholding deducted.
(c) [Reserved].
(d) Payments for real property.
(e) Payments to government entities, tax-exempt organizations, and foreign governments.
(f) Payments made pursuant to a classified or confidential contract.
(g) Exception for political subdivisions or instrumentalities thereof making less than $100,000,000 of payments for property or services annually.
(h) Payments made in connection with a public assistance or public welfare program.
(i) Payments made to any government employee with respect to his or her services.
(j) Payments received by nonresident alien individuals and foreign corporations.
(k) Payments to Indian tribal governments.
(l) Payments in emergency or disaster situations.

(m) Effective/applicability date.

§31.3402(t)–5 Application to passthrough entities.

(a) In general.

(b) Definitions.

(c) Payments from a passthrough entity.

(d) Payments to a passthrough entity.

(e) Effective/applicability date.

§31.3402(t)–6 Crediting of tax withheld under section 3402(t).

[Reserved].

§31.3402(t)–7 Effective date and transition rules.

(a) General rule.

(b) Exception for payments made under existing written binding contracts.

(c) Good faith exception for interest and penalties on payments before January 1, 2012.

§31.3402(t)–1 Withholding requirement on certain payments made by government entities.

(a) In general. Except as provided in §§31.3402(t)–3(b) and 31.3402(t)–4, the Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multi-State agencies) making any payment to any person providing any property or services shall deduct and withhold from such payment a tax in an amount equal to 3 percent of such payment.

(b) Special rules. See §31.3402(t)–2 for government entities required to withhold under this section, §31.3402(t)–3 for what constitutes a payment to a person for property or services and when such payment is deemed to occur for purposes of this section, and §31.3402(t)–4 for payments that are excepted from withholding under this section.

(c) Deposit and reporting requirements. See §31.6302–4 for deposit requirements with respect to withholding under section 3402(t). See §§31.6011(a)–4(b) and 31.6051–5 for the reporting requirements with respect to withholding under section 3402(t).

(d) Effective/applicability date. (1) Except as provided in paragraph (d)(2) of this section, this section is effective for payments by the Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multi-State agencies) to any person providing property or services made after the later of December 31, 2010, or the date that is 6 months after the date of publication in the Federal Register of final regulations under section 3402(t).

(2) Payments made under a written binding contract that was in effect on the later of December 31, 2010, or the date that is 6 months after the publication in the Federal Register of final regulations under section 3402(t), are not subject to the withholding requirements of this section. The preceding sentence does not apply to payments made under any contract that is materially modified after the later of December 31, 2010, or the date that is 6 months after the date of publication in the Federal Register of final regulations under section 3402(t).

§31.3402(t)–2 Government entities required to withhold under section 3402(t).

(a) In general. The requirement to withhold under section 3402(t) and §31.3402(t)–1(a) applies to the Government of the United States (see paragraph (b) of this section) and every State (see paragraph (c) of this section), as well as the instrumentalities of the foregoing. The requirement also applies to political subdivisions of every State (see paragraph (d) of this section), and their instrumentalities, unless the small entity exception of §31.3402(t)–4(g) applies.

(b) Government of the United States. The Government of the United States includes the legislative branch, the judicial branch, and the executive branch, and all components of the United States Government. Thus, departments and agencies are included within the definition of United States Government.

(c) State. The term State includes the District of Columbia. However, an Indian tribal government is not considered a State for purposes of section 3402(t) and §31.3402(t)–1(a). See section 7871(a).

(d) Political subdivision. The term political subdivision for purposes of section 3402(t) and §31.3402(t)–1(a) is defined as a political subdivision within the meaning of §1.103–1(b) of this chapter, except that a subdivision of an Indian tribal government is not considered a political subdivision. See section 7871(a) and (d).

(e) [Reserved].

(f) Possessions of the United States. For purposes of section 3402(t) and §31.3402(t)–1(a), the government of a possession or territory of the United States is not treated as a government entity subject to the withholding requirements of section 3402(t)(1).

(g) Passthrough entities. See §31.3402(t)–5(c) for the treatment of payments from certain passthrough entities as subject to the withholding requirements of §31.3402(t)–1.

(h) Small entity exception. See §31.3402(t)–4(g) for the exception from the withholding requirements of §31.3402(t)–1 for political subdivisions and instrumentalities thereof making less than $100,000,000 of payments for property or services annually.

(i) Effective/applicability date. This section is effective the later of January 1, 2011, or the date that is 6 months after the date of publication in the Federal Register of final regulations under section 3402(t).

§31.3402(t)–3 Payments subject to withholding.

(a) In general. A payment is subject to withholding for purposes of §§31.3402(t)–1 through 31.3402(t)–7 when paid by a government entity to any person, as defined in §301.7701–6(a) of this chapter, for property or services. If, however, the government entity uses a payment administrator to pay a person for property or services, payment occurs when the payment administrator pays such person. The government entity subject to the withholding requirements of §31.3402(t)–1 is liable for the withholding required and responsible for all related reporting regardless of whether the government entity or its payment administrator makes the payment for property or services.

(b) Payment threshold of $10,000—(1) In general. The term payment thres-
old means an amount equal to $10,000. The withholding requirements of §31.3402(t)–1 will not apply to any payment that is less than the payment threshold. Whether a payment is equal to or in excess of the payment threshold is determined when the payment is made.

(2) Payment threshold applied per payment. If a government entity makes a single payment to a person for property or services combining charges for more than one transaction with the person, the determination of whether the payment threshold provided by paragraph (b)(1) of this section applies will be based on the amount of the single payment, rather than the amount attributable to each separate transaction. Thus, if a government entity makes a single payment of $10,000 or more to a person, the government entity will be required to withhold on the payment, even if the payment is for more than one property or service. The same rule applies if a government entity enters into multiple transactions with a single person, each of which would result in a payment of less than $10,000 if paid separately, but elects to make a single payment covering all the transactions such that the aggregated payment is $10,000 or more. Under these circumstances, the government entity is required to withhold on the aggregated payment.

(3) Anti-abuse rule. If a government entity or payment administrator divides a payment or payments to any person for property or services into two or more payments primarily to avoid the $10,000 payment threshold provided in paragraph (b)(1) of this section on one or more of these payments, the divided payments will be treated as a single payment made on the date that the first of these payments is made.

(c) No withholding on successive payments. If a government entity or its payment administrator makes a payment that is subject to the withholding requirements of §31.3402(t)–1 to a person, no subsequent transfer of cash or property from that payment by such person to another person is treated as a payment subject to withholding for purposes of §§31.3402(t)–1 through 31.3402(t)–7.

(d) Payments made through a payment administrator or to a contractor—(1) Definition—For purposes of this section—

(i) A payment administrator is any person that acts with respect to a payment solely as an agent for a government entity by making the payment on behalf of the government entity to a person providing property or services to, or on behalf of, the government entity.

(ii) A payment administrator is treated as a person providing property or services for purposes of the withholding requirements of section 3402(t) to the extent it receives a fee from the government entity for its services as a payment administrator for the government entity.

(2) Payments to a contractor. If a person provides property or services to a government entity under a contract and is not a payment administrator, the person, who is in privity with the government entity, is treated as the person providing property or services subject to withholding under section 3402(t) for all payments received from the government entity, regardless of whether some payments the person receives relate to invoices for property or services provided by subcontractors.

(3) Application of payment threshold. Where a government entity uses a payment administrator to make a payment, the determination of whether the payment meets the payment threshold is made at the time the payment administrator makes the payment to the person providing property or services. If a government entity makes one transfer of funds to a payment administrator that is composed of a fee to compensate the payment administrator for its services and other funds that are to be paid to persons providing property or services, the determination of whether the payment threshold is met on the portion that is the fee is made at the time of the transfer of funds to the payment administrator.

(e) Payments by credit card or payment card. For purposes of section 3402(t), a payment made by a government entity by credit card or payment card to a person for property or services occurs when the credit card or payment card is tendered at the point of sale. The government entity is liable for withholding under section 3402(t) and reporting associated with such withholding. See section 6050W of the Internal Revenue Code for separate reporting obligations imposed on the acquiring bank of the person receiving payment by credit card or payment card.

(f) Examples. This section is illustrated by the following examples:

Example 1. (i) Prime contractor X has a contract with a government entity to provide services and property to the government entity. X contracts with numerous subcontractors to provide services and property in connection with the contract. While the engagement of any particular subcontractor is subject to approval by the government entity, the subcontractors are not parties to the contract between X and the government entity, and the government entity is not a party to the contracts between X and subcontractors. Under its contract with the government entity, X submits an invoice for $48,000 for providing services and property to the government entity, including charges for services and property provided by two subcontractors, M and N. The invoice reflects charges of $16,000 for M and $2,000 for N. The government entity pays X the entire amount of the invoice in one payment of $48,000. X pays M for M’s billed portion of the invoice in a single payment of $16,000, and X pays N for N’s billed portion of the invoice in a single payment of $2,000.

(ii) Under the facts of this Example 1, X is the person providing property or services to, or for the benefit of, the government entity with respect to the entire amount of the $48,000 payment under the invoice, including the charges for services or property provided by its subcontractors M and N. X is not a payment administrator (as defined in paragraph (d)(1)(i) of this section) because X is not making payments solely as an agent of the government entity to persons providing property or services. Instead, X makes payments to subcontractors M and N pursuant to X’s separate contracts with these subcontractors to which the government entity is not a party. Therefore, under paragraphs (a) and (d)(2) of this section, the entire amount of the $48,000 payment to X under the invoice, including the charges for services and property provided by its subcontractors M and N, is the payment subject to withholding for purposes of section 3402(t).

(iii) Under paragraph (b)(1) of this section, the determination whether the payment meets the payment threshold is based on the entire amount of the payment from the government entity to X. Withholding under section 3402(t) applies to the government entity’s $48,000 payment to X because the payment meets the payment threshold and is not otherwise excepted from section 3402(t) withholding. Thus, the payment is subject to withholding of 3 percent, or $1440.

(iv) Payments made by X to the subcontractors, M and N, are not payments by the government entity or its payment administrator. Thus, X’s $16,000 payment to M and X’s $2,000 payment to N for services or property under the contract are not subject to withholding under section 3402(t). See paragraphs (c) and (d)(2) of this section.

(v) The government entity is liable for the $1440 withholding required under section 3402(t) on its payment to X and is responsible for the related reporting required under §31.6051–5. See paragraph (a) of this section. X is the person receiving the payment for purposes of reporting under §31.6051–5. Thus, the government entity is responsible for providing X with a Form 1099 including the entire amount of the payment ($48,000) and the entire amount of the withholding ($1440).
Example 2. (i) Z has a contract with a government entity to make payments as an agent of the government entity to persons providing services or property to, or on behalf of, the government entity. The only services Z provides under the contract are its services in acting as an agent for the government entity in making payments to persons providing property or services to, or on behalf of, the government. The government entity transfers funds of $71,000 to Z, which includes a fee of $1,000 to Z for its services as an agent under the contract. Z then makes payments of the $70,000 remainder of the funds to persons providing property or services to, or on behalf of, the government entity, including a single payment of $18,000 to P and a single payment of $7,000 to R.

(ii) Under the facts of this Example 2, Z is a payment administrator (as defined in paragraph (d)(1)(i) of this section) because Z makes payments solely as an agent for the government entity to persons providing property or services to, or on behalf of, the government entity. Under paragraphs (a) and (d) of this section, Z is not treated as a person providing property or services with respect to $70,000 of the transfer of funds (the amount of the funds to be paid to persons providing property or services to, or on behalf of, the government entity). Because Z is not treated as a person providing property or services with respect to this $70,000 portion of the funds, this portion of the transfer of funds by the government entity to Z is not subject to withholding under section 3402(t) when transferred to Z.

(iii) Under paragraph (d)(1)(ii) of this section, the payment administrator is treated as a person providing property or services with respect to the portion of the $71,000 fund transfer that is a fee for its services as a payment administrator, or $1,000. Under paragraph (d)(3) of this section, the determination of whether the payment threshold is met with respect to the fee portion of the payment from the government entity to Z is made at the time of the payment from the government entity to Z. Because the $1,000 fee portion of the payment falls beneath the $10,000 payment threshold, withholding under section 3402(t) is not required with respect to that portion of the payment.

(iv) P and R are persons providing services or property to, or on behalf of, the government entity with respect to the payments they receive from Z.

(v) Withholding is required under section 3402(t) on the payment by Z, a payment administrator, to a person providing property or services to, or on behalf of, a government entity provided the payment meets the payment threshold and is not otherwise excepted. Under paragraph (d)(3) of this section, the determination of whether the payment threshold is met on the payment Z makes to a person providing property or services is made at the time Z pays the person providing property or services. Under the facts of this Example 2, Z’s payment to P of $18,000 meets the payment threshold, and therefore withholding of $540 under section 3402(t) applies. Z’s payment to R of $7,000 does not meet the payment threshold, and therefore, no withholding under section 3402(t) is required.

(vi) The government entity, not Z, is liable for any withholding required under section 3402(t) on the payments from Z to persons providing property or services. Also, the government entity, not Z, is responsible for any reporting required under §31.6051–5 on the payment from Z to persons providing property or services. See paragraph (a) of this section. Each person providing property or services with respect to which withholding is required, not Z, is the person receiving the payment for purposes of the reporting required under §31.6051–5 if withholding under section 3402(t) applies. Thus, the government entity is responsible for issuing a Form 1099 reflecting the amount of the payment from Z to P of $18,000 and the amount of withholding of $540.

(g) Effective/applicability date. This section is effective for payments by the Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multi-State agencies) to any person providing property or services made after the later of December 31, 2010, or the date that is 6 months after the date of publication in the Federal Register of final regulations under section 3402(t).

§31.3402(t)–4 Certain payments excepted from withholding.

(a) Payments subject to withholding under chapter 3 or chapter 24 (other than section 3406)—(1) In general. Payments are excepted from withholding under section §31.3402(t)–1(a) if they are subject to withholding under chapter 3 of the Internal Revenue Code (Code) or under sections 3401 through 3405 of the Code (other than section 3402(t)).

(2) Payments subject to withholding under chapter 3. Payments subject to withholding under chapter 3 include those payments that are subject to, but exempt from, withholding under chapter 3 on the ground that the payments are exempt from United States income tax pursuant to an income tax convention to which the United States is a party.

(3) Payments subject to withholding at election of payee. For purposes of this exception from section 3402(t), payments for which the payee may elect withholding are exempt from withholding under §31.3402(t)–1(a) regardless of whether the payee in fact makes such an election. These payments include—

(i) Unemployment compensation as defined in section 85(b) (see section 3402(p)(2));

(ii) Social security benefits as defined in section 86(d) (see section 3402(p)(1)(C)(i));

(iii) Any payment referred to in the second sentence of section 451(d) that is treated as insurance proceeds, relating to certain disaster payments received under the Agricultural Act of 1949, as amended, or Title II of the Disaster Assistance Act of 1988 (see section 3402(p)(1)(C)(ii));

(iv) Any amount that is includable in gross income under section 77(a), relating to amounts received as loans from the Commodity Credit Corporation that the taxpayer has elected to treat as income (see section 3402(p)(1)(C)(iii)); and

(v) Any payment of an annuity to an individual.

(b) Payments subject to withholding under section 3406 with backup withholding deducted. A payment is not subject to withholding under section 3402(t) if the payment is subject to withholding under section 3406, relating to backup withholding, and if backup withholding is actually being withheld from such payment.

(c) [Reserved].

(d) Payments for real property. Payments for real property are not subject to the withholding requirements of §31.3402(t)–1. For purposes of this exception, the term payments for real property includes the purchase and the leasing of real property. However, payments for the construction of buildings or other public works projects, such as bridges or roads, are not payments for real property.

(e) Payments to government entities, tax-exempt organizations, and foreign governments.—(1) Government entities. Payments are not subject to withholding under section 3402(t) if the payments are made to government entities that are subject to the withholding requirements of section 3402(t)(1) pursuant to §31.3402(t)–2. For purposes of this exception, payments to government entities that qualify for the exception for political subdivisions and instrumentalities making less than $100,000,000 of payments for property and services annually, as provided by section 3402(t)(2)(G) and paragraph (g) of this section, are treated as payments to government entities that are subject to the withholding requirements of section 3402(t)(1).

(2) Tax-exempt organizations. Payments to an organization that is exempt from taxation under section 501(a) as an organization described in section 501(c), 501(d), or 401(a) are not subject to withholding under section 3402(t).

(3) Foreign governments. Payments to foreign governments are not subject to
withholding under section 3402(t). For purposes of this paragraph (e), a government of a possession or territory of the United States is treated as a foreign government.

(1) Payments made pursuant to a classified or confidential contract. Payments made pursuant to a classified or confidential contract described in section 6050M(e)(3) are not subject to withholding under section 3402(t).

(g) Exception for political subdivisions or instrumentalities thereof making less than $100,000,000 of payments for property or services annually.—(1) In general. Section 3402(t) withholding is not required on payments made by a political subdivision of a State (or any instrumentality of a political subdivision of a State) that makes less than $100,000,000 of payments for property or services annually.

(2) Determination of whether an entity is a political subdivision of a State. The determination of whether an entity is a political subdivision of a State is made under §31.3402(t)–2(d).

(3) Determination of whether a political subdivision or instrumentality makes less than $100,000,000 of payments for property or services annually. The determination of whether the exception provided by paragraph (g)(1) of this section applies is made for each calendar year. For purposes of any calendar year, the determination of whether a political subdivision or instrumentality makes less than $100,000,000 of payments for property or services annually is based on the total payments made by the entity for property or services in the entity’s accounting year ending with or within the second preceding calendar year. For purposes of this paragraph (g), payments that would have qualified for the exceptions from withholding under §31.3402(t)–4(a) through (l) had these regulations been in effect shall not be included in calculating the total payments made. However, payments that would have been excepted from withholding only because such payments were less than the $10,000 payment threshold contained in §31.3402(t)–3(b) are included in calculating the total payments for purposes of this paragraph (g). Also, payments that were not subject to withholding under section 3402(t) solely based on the effective date rules or transition rules contained in §31.3402(t)–1(d), §31.3402(t)–2(i), §31.3402(t)–3(g), §31.3402(t)–4(m), §31.3402(t)–5(e), or §31.3402(t)–7 are included in calculating total payments for purposes of this paragraph (g).

For purposes of this determination, the accounting year refers to the fiscal year (consisting of 12 months) or calendar year used by the government entity in setting its budgets and keeping its accounting books. If a political subdivision or instrumentality was not in existence in the second preceding calendar year or if no 12-month accounting year exists ending in the second preceding calendar year, the determination of whether this exception applies for a calendar year shall be based on the total payments as projected for the accounting year consisting of 12 months ending in that calendar year.

(4) Example. (i) Government entity X, which qualifies as a political subdivision or instrumentality thereof for the calendar years 2011 and 2012, uses a fiscal year ending June 30 to determine its budgets and to keep its accounting books. During its fiscal year ending June 30, 2009, X made payments to persons for property and services of $200,000,000, including $102,000,000 of payments that would have been excepted under §31.3402(t)–4(a) through (l) if section 3402(t) had been in effect.

(ii) During its fiscal year ending June 30, 2010, X made payments for property and services of $210,000,000, including $106,000,000 that would have been excepted under §31.3402(t)–4(a) through (l) if section 3402(t) had been in effect. In addition, during the fiscal year ending June 30, 2010, X made $15,000,000 of payments that were below the payment threshold of $10,000 in §31.3402(t)–3(b) if section 3402(t) had been in effect.

(iii) For the calendar year 2011, X determines whether it is eligible for the exception provided by this paragraph (g) based on the total payments X made for its accounting year ending June 30, 2009. Because total payments for this purpose exclude payments that would be excepted under §31.3402(t)–4(a) through (l), total payments were $200,000,000 less $102,000,000, or $98,000,000. Therefore, for calendar year 2011, X would qualify for the exception provided by this paragraph (g), and would not be required to withhold under section 3402(t).

(iv) For the calendar year 2012, X determines whether it is eligible for the exception provided by this paragraph (g) based on the total payments it made for its accounting year ending June 30, 2010. Because total payments for this purpose exclude payments that would have been excepted under §31.3402(t)–4(a) through (l), but include payments below the payment threshold of $10,000 provided under §31.3402(t)–3(b), total payments were $210,000,000 less $106,000,000, or $104,000,000. Therefore, for calendar year 2012, X would not qualify for the exception provided by this paragraph (g) and would be required to withhold under section 3402(t).

(h) Payments made in connection with a public assistance or public welfare program.—(1) In general. Section 3402(t) withholding shall not apply to payments made in connection with a public assistance or public welfare program for which eligibility is determined by a needs or income test.

(2) Needs or income test. Eligibility for a public assistance or public welfare program is not considered to be determined by a needs or income test if eligibility for the program is based solely on the age of the beneficiary. A public assistance program providing disaster relief to victims of a natural or other disaster is considered to be a program for which eligibility is determined under a needs test. Payments under government programs to provide health care or other services that are not based on the needs or income of the recipient are subject to section 3402(t) withholding, including programs where eligibility is based on the age of the beneficiary.

(3) Payments to third parties. The exception provided by this paragraph (h) also applies to payments made to third parties to provide benefits to beneficiaries under a public assistance or public welfare program for which eligibility is determined by a needs or income test.

(i) Payments made to any government employee with respect to his or her services. Section 3402(t) withholding shall not apply to payments made to any government employee with respect to his or her services as an employee of the government. This exception applies to contributions to deferred compensation plans on behalf of an employee, contributions to employee benefit plans on behalf of an employee, fringe benefits provided to employees, and payments to employees under accountable plans for the individual travel expenses of the employee. This exception also applies to payments made by the government employee under accountable plans to providers of the employee’s travel, meals, and lodging when the government employee is traveling on government business.

(j) Payments received by nonresident alien individuals and foreign corporations. Section 3402(t) withholding shall not apply to any payment received by a nonresident alien individual or foreign corporation (foreign person) for providing services or property if the payment is derived from sources outside the United States, as determined under sections 861, 862, 863,
and 865, and is not effectively connected with the conduct of a trade or business within the United States by the foreign person.

(k) Payments to Indian tribal governments. Section 3402(t) withholding shall not apply to any payment made to an Indian tribal government or its political subdivisions.

(l) Payments in emergency or disaster situations. The Secretary may provide by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(b) of this chapter) for additional exceptions from section 3402(t) withholding for certain payments made in an emergency or disaster situation if the Secretary determines that withholding from the payments would impede a government entity’s efforts to respond to the emergency or disaster.

(m) Effective/applicability date. This section is effective for payments by the Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multi-State agencies) to any person providing property or services made after the later of December 31, 2010, or the date that is 6 months after the date of publication in the Federal Register of final regulations under section 3402(t).
§31.6051–5 Statement and information return required in case of withholding by government entities.

(a) Statements required from government entities. Every government entity required to deduct and withhold tax under section 3402(t) must furnish to the payee a written statement containing the information required by paragraph (d) of this section.

(b) Information returns required from government entities. Every government entity required to furnish a payee statement under paragraph (a) of this section must file a duplicate of such statement with the Secretary. Such duplicate shall constitute an information return.

(c) Prescribed form. The prescribed form for the statement required by this section is Form 1099–MISC, “Miscellaneous Income.”

(d) Information required. Each statement on Form 1099–MISC must show the following—

1. The name, address, and taxpayer identification number of the person receiving the payment subject to withholding under section 3402(t);
2. The amount of the payment withheld upon;
3. The amount of tax deducted and withheld under section 3402(t);
4. The name, address, and taxpayer identification number of the government entity filing the form;
5. A legend stating that such amount is being reported to the Internal Revenue Service; and
6. Such other information as is required by the form.

(e) Time for furnishing statements. The statement must be furnished to the payee no later than January 31 of the year following the calendar year in which the payment subject to withholding was made.

(f) Cross references. For provisions relating to the time for filing the information returns required by this section and to extensions of the time for filing, see §§31.6071(a)–1(a)(3) and 1.6081–1(b)(3), respectively. For penalties applicable to failure to file information returns and furnish payee statements, see sections 6721 through 6724.

(g) Effective/applicability date. This section is effective on the later of January 1, 2011, or the date that is 6 months after the date of publication in the Federal Register of final regulations under section 3402(t).

Par. 6. Section 31.6071(a)–1 is amended by revising paragraph (a)(3)(i) to read as follows:

§31.6071(a)–1 Time for filing returns and other documents.

* * * * *

(3) Information returns—(i) General rule. Each information return in respect of wages as defined in the Federal Insurance Contributions Act or of income tax withheld from wages which is required to be made under §31.6051–2 or of income tax withheld from payments by government entities as required under §31.6051–5 shall be filed on or before the last day of February (March 31 if filed electronically) of the year following the calendar year for which it is made, except that, if a tax return under §31.6011(a)–5(a) is filed as a final return for a period ending prior to December 31, the information statement shall be filed on or before the last day of the second calendar month following the period for which the tax return is filed.

* * * * *

Par. 7. Section 31.6302–1 is amended by adding paragraph (e)(1)(iii)(E) and revising paragraph (n) to read as follows:


* * * * *

(e) * * * (1) * * *

(iii) * * *

(E) Certain payments made by government entities under section 3402(t); and

* * * * *

(n) Effective/applicability date. Except for the deposit of employment taxes attributable to payments made by government entities under section 3402(t), §§31.6302–1 through 31.6302–3 apply with respect to the deposit of employment taxes attributable to payments made after December 31, 1992. Section 31.6302–1(e)(1)(iii)(E) applies with respect to the deposit of employment taxes attributable to payments made by government entities under section 3402(t) made...
ACTIONS: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9435) giving guidance regarding the distribution of stock of a controlled corporation acquired in a transaction described in section 355(a)(3)(B) of the Internal Revenue Code. This action is necessary in light of amendments to section 355(b). The text of those regulations also serves as the text of these proposed regulations. These regulations will affect corporations and their shareholders.

DATES: Written or electronic comments and requests for a public hearing must be received by March 16, 2009.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG–150670–07), 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–150670–07), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224, or sent electronically via the Federal eRulemaking Portal at www.regulations.gov (IRS REG–150670–07).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Russell P. Subin, (202) 622–7790; concerning submission of comments and/or requests for a public hearing, Oluwafunmilayo (Funmi) Taylor, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions


Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that section 355(a)(3)(B) generally applies to parent-subsidiary groups of corporations, which tend to be larger businesses, and that these regulations primarily grant relief from the application of section 355(a)(3)(B) in certain situations. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. As described in the preamble to the temporary regulations, comments are also requested regarding the overall approach taken in these proposed rules, including the extent to which the definition of a taxable transaction should be the same under section 355(a)(3)(B) and section 355(b), and whether the exception for acquisitions from affiliates should be the same under those sections. Comments are also requested regarding the need for future guidance described in sections 4.A.
and 4.B. of such preamble, relating to predecessors of distributing corporations, acquisitions involving corporations that join the distributing corporation’s separate affiliated group, predecessors of controlled corporations, acquisitions involving corporations that join the controlled corporation’s separate affiliated group, the application of Dunn Trust v. Commissioner, 86 T.C. 745 (1986), and the treatment of stock issuances by the controlled corporation to the distributing corporation. Comments are also requested regarding the potential application of the hot stock rule to redemptions of controlled corporation stock described in section 4.C. of such preamble. With respect to redemptions, comments are specifically requested regarding the circumstances under which section 355(a)(3)(B) should apply.

All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the Federal Register.

Drafting Information

The principal author of these regulations is Russell P. Subin of the Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development. * * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.355–2(g) and (i) also issued under 26 U.S.C. 355(b)(3)(D). * * *

Par. 2. Section 1.355–2 is amended by revising paragraph (g) and adding paragraph (i) to read as follows:

§1.355–2 Limitations.

* * * * *

(g) [The text of the proposed amendments to §1.355–2(g) is the same as the text of §1.355–2T(g) published elsewhere in this issue of the Bulletin].

* * * * *

(i) [The text of the proposed amendments to §1.355–2(i) is the same as the text of §1.355–2T(i) published elsewhere in this issue of the Bulletin].

Steve T. Miller,
(Acting) Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on December 12, 2008, 8:45 a.m., and published in the issue of the Federal Register for December 15, 2008, 73 FR 75979)

Notice of Proposed Rulemaking

Conduit Financing Arrangements

REG–113462–08

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to conduit financing arrangements issued under the authority granted by section 7701(l) of the Internal Revenue Code (Code). The proposed regulations apply to multiple-party financing arrangements that are effected through disregarded entities, and are necessary in order to determine which of those arrangements should be recharacterized under section 7701(l) and Treas. Reg. §1.881–3. The regulations apply to conduit financing arrangements pursuant to the authority granted by section 7701(l).

In general, §1.881–3 allows the IRS to disregard the participation of one or more intermediate entities in a financing arrangement where such entities are acting as conduit entities, and to recharacterize the financing arrangement as a transaction directly between the remaining parties to the financing arrangement for purposes of imposing tax under sections 871, 881, 1441 and 1442 of the Code. Section 1.881–3(a)(2)(i)(A) of the regulations defines a financing arrangement to mean a series of financing transactions by which one person (the financing entity) advances money or other property, or grants rights to use property, and another person (the financed entity) receives money or other property, or rights to use property, if the advance and receipt are effected through one or more other persons (intermediate entities). Except in cases to which §1.881–3(a)(2)(i)(B) (special rule for related parties) applies, the regulations apply

only if financing transactions as defined in §1.881–3(a)(2)(ii) link the financing entity, each of the intermediate entities, and the financed entity.

Since the publication of §1.881–3 on August 10, 1995, the Treasury Department and IRS issued the so-called “check-the-box” regulations, under §§301.7701–1 through 301.7701–3, effective January 1, 1997 (T.D. 8697, 1997–1 C.B. 215 [61 FR 66854]). Section 301.7701–3 provides, in part, that an entity that is not classified as a corporation and that has a single owner may elect to be disregarded as an entity separate from its owner (a disregarded entity).

The Treasury Department and IRS are aware that issues have arisen regarding the proper treatment of disregarded entities under §1.881–3. These proposed regulations clarify that a disregarded entity is a person for purposes of §1.881–3. Thus, transactions that a disregarded entity enters into will be taken into account for purposes of determining whether a financing arrangement exists.

The Treasury Department and IRS are continuing to study conduit financing arrangements and may issue separate guidance to address the treatment under §1.881–3 of certain hybrid instruments. Specifically, the Treasury Department and IRS are studying transactions where a financing entity advances cash or other property to an intermediate entity in exchange for a hybrid instrument that is treated as debt under the laws of the foreign jurisdiction where the intermediate entity is resident and is not treated as debt for U.S. federal tax purposes. The issue under consideration is whether such instruments should constitute a financing transaction under §1.881–3(a)(2)(ii)(A) and part of a financing arrangement within the meaning of §1.881–3(a)(2)(ii)(A).

No inference should be drawn from the approaches described in this preamble regarding the treatment of such instruments under current law, including judicial doctrines with respect to conduit financing transactions.

One possible approach is to treat all transactions involving such hybrid instruments between a financing entity and an intermediate entity as financing transactions under §1.881–3(a)(2)(ii)(A). Comments are requested on this approach, including whether and to what extent a connection or relationship between the issuer and recipient of the hybrid instrument (for example, an equity ownership percentage) should be required in order to treat such instruments as financing transactions.

Another possible approach is to add additional factors to consider in determining when stock in a corporation (or other similar interest in a partnership or trust) may constitute a financing transaction under §1.881–3(a)(2)(ii)(B). The additional factors would focus on whether, based on the facts and circumstances surrounding the stock (or other similar interest in a partnership or trust), the financing entity had sufficient legal rights to, or other practical assurances regarding, the payment received by the intermediate entity to treat the stock as a financing transaction. Some possible factors to indicate the presence of a financing transaction might include:

(1) Intent of the parties to pay all or substantially all payments received by the intermediate entity to the financing entity;
(2) History of payment of amounts received by the intermediate entity to the financing entity; and
(3) Precedence of the obligees over other creditors regarding the payment of interest and principal, currently or in bankruptcy.

Comments are requested concerning other possible approaches and any additional factors that the Treasury Department and IRS should consider in expanding the conduit financing regulations under §1.881–3.

Explanation of Provisions

Section 1.881–3(a)(2)(ii)(C) of the proposed regulations provides that for purposes of this section, the term person includes a business entity that is disregarded as an entity separate from its single member owner under §§301.7701–1 through 301.7701–3. Because a disregarded entity is a person, any transaction that it enters into will be taken into account for purposes of determining whether a conduit financing arrangement exists.

These proposed regulations also modify the parenthetical in §1.881–3(a)(2)(ii)(A)(2) and §1.881–3(a)(2)(ii)(B)(1). The proposed regulations also correct a typographical error in §1.881–3(a)(3)(ii)(B) of the final regulations and update titles and cross-references in the final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that this regulation will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the Federal Register.

Drafting Information

The principal author of these regulations is Paul J. Carline, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

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 * * * * *
1. Removing the language “district director” throughout this section and adding “director of field operations” in its place.

2. Removing the language “§1.1441–3(j)” throughout this section and adding “§1.1441–3(g)” in its place.

3. Removing the language “§1.1441–7(d)” throughout this section and adding “§1.1441–7(f)” in its place.

4. In the last sentence of paragraph (a)(3)(ii)(B), removing the second “financed” and adding “financing” in its place.

5. Removing the parenthetical language “(or a similar interest in a partnership or trust)” in paragraphs (a)(2)(ii)(A)(2) and (a)(2)(ii)(B)(1) and adding “(or a similar interest in a partnership, trust, or other person)” in its place.


7. In paragraph (e), redesignating Examples 3, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17, 18, 19, 20, 21, 22, 23, 24, and 25 as Examples 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17, 18, 19, 20, 21, 22, 23, 24, 25, and 26, respectively.

8. Adding a new Example 3 in paragraph (e).

9. Adding a new sentence at the end of paragraph (f).

The additions read as follows:

§1.881–3 Conduit financing arrangements.

* * * * *

(a) * * *

(2) * * *

(i) * * *

(C) Treatment of disregarded entities.

For purposes of this section, the term person includes a business entity that is disregarded as an entity separate from its single member owner under §§301.7701–1 through 301.7701–3.

* * * * *

(e) Examples. * * *

Example 3. Participation of a disregarded intermediate entity. (i) The facts are the same as in Example 2, except that, in addition, FS is an entity that is disregarded as an entity separate from its owner, FP, under §301.7701–3. Under paragraph (a)(2)(i)(C) of this section, FS is a person and therefore may itself be an intermediate entity that is linked by financing transactions to other persons in a financing arrangement. The DS note held by FS and the FS note held by FP are financing transactions within the meaning of paragraph (a)(2)(ii) of this section, and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section.

* * * * *

(f) Effective/applicability date. * * *

Paragraph (a)(2)(i)(C) of this section is effective for payments made on or after the date of publication of the Treasury decision adopting these regulations as final regulations in the Federal Register.

Linda E. Stiff, Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on December 19, 2008, 8:45 a.m., and published in the issue of the Federal Register for December 22, 2008, 73 F.R. 78252)
Definition of Terms

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

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

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

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

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

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

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

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

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

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.
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Ann Announcement
CD Court Decision
DO Delegation Order
EO Executive Order
PL Public Law
PTE Prohibited Transaction Exemption
RP Revenue Procedure
RR Revenue Ruling
SPR Statement of Procedural Rules
TC Tax Convention
TD Treasury Decision
TDO Treasury Department Order

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