Internal Revenue
bulletin

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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.

SPECIAL ANNOUNCEMENT

Announcement 2004–26, page 743.

This document contains the annual report to the public concerning Advance Pricing Agreements (APAs) and the experience of the APA program during calendar year 2003. This document does not provide guidance regarding the application of the arm's length standard; rather, it reports on the structure and activities of the APA program.

Announcement 2004–29, page 772.

The definition of tax shelter opinion for purposes of section 10.35 of Treasury Department Circular No. 230 (31 CFR part 10) will not apply, if at all, to written advice concerning municipal bonds rendered less than 120 days after the publication of the final regulations in the Federal Register.

INCOME TAX

Rev. Rul. 2004–38, page 717.

Health Savings Accounts (HSAs). This ruling provides that if an individual is covered by both a high deductible health plan (HDHP) that does not cover prescription drugs and by a separate prescription drug plan (or rider) that provides benefits before the minimum annual deductible of the HDHP has been satisfied, that individual is not an eligible individual under section 223(c)(1)(A) of the Code and may not make contributions to a Health Savings Account.

Rev. Rul. 2004–40, page 716.

Low-income housing credit; satisfactory bond; "bond factor" amounts for the period April through June 2004. This ruling announces the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period April through June 2004.

T.D. 9117, page 721.
REG–167265–03, page 730.

Final, temporary, and proposed regulations under section 1502 of the Code, as applied under sections 108 and 1245, govern the timing of certain basis adjustments when a member of a consolidated group realizes discharge of indebtedness income that is excluded from gross income and the reduction of attributes when there is excluded income. In addition, the regulations govern the timing and calculations of certain basis adjustments to prevent circular basis adjustments on the disposition of stock of a group member.

T.D. 9118, page 718.
REG–153172–03, page 729.

Final, temporary, and proposed regulations under section 337 of the Code clarify that in computing the amount of stock loss attributable to the recognition of built-in gain, gain recognized on the disposition of an asset may be reduced by expenses directly attributable to the recognition of that gain. These regulations also clarify that a worthless stock deduction in stock of a member of a consolidated group results in the elimination of that member's apportioned losses only if, following the year in which the worthless stock deduction is claimed, the member has no separate return year. The regulations further clarify that stock of a member of a consolidated group may be treated as worthless, provided it otherwise qualifies for such treatment under the Code immediately prior to the time that the subsidiary ceases to be a member of the group.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

Notice 2004–23, page 725.
This notice provides a safe harbor for preventive care benefits allowed to be provided by a high deductible health plan (HDHP) under section 223(c)(2) of the Code.

Notice 2004–25, page 727.
This notice provides transition relief from the rule in Notice 2004–2, 2004–2 I.R.B. 269, Q&A 26, that a Health Savings Account (HSA) must pay or reimburse on a tax-free basis only qualified medical expenses incurred after the HSA has been established. The notice provides that for calendar year 2004, an HSA established on or before April 15, 2005, may pay or reimburse otherwise qualified medical expenses on a tax-free basis if the expenses were incurred on or after the later of (1) January 1, 2004, or (2) the first day of the first month the taxpayer became eligible to establish an HSA. Notice 2004–2 modified.

Rev. Proc. 2004–22, page 727.
This procedure provides transition relief from Rev. Rul. 2004–38 for determining an "eligible individual" under section 223 of the Code who may make contributions to a Health Savings Account (HSA). The transition relief covers the months before January 1, 2006, in the case of an individual who is covered by both a high deductible health plan (HDHP) and by a separate plan or rider that provides prescription drug benefits before the minimum annual deductible of the HDHP is satisfied. Rev. Rul. 2004–38 modified.

EXEMPT ORGANIZATIONS

Announcement 2004–25, page 737.
A list is provided of organizations now classified as private foundations.

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:

Part I.—1986 Code.
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.

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Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 42.—Low-Income Housing Credit

Low-income housing credit; satisfactory bond; "bond factor" amounts for the period April through June 2004. This ruling announces the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period April through June 2004.

Rev. Rul. 2004–40

In Rev. Rul. 90–60, 1990–2 C.B. 3, the Internal Revenue Service provided guidance to taxpayers concerning the general methodology used by the Treasury Department in computing the bond factor amounts used in calculating the amount of bond considered satisfactory by the Secretary under § 42(j)(6) of the Internal Revenue Code. It further announced that the Secretary would publish in the Internal Revenue Bulletin a table of bond factor amounts for dispositions occurring during each calendar month.

Rev. Proc. 99–11, 1999–1 C.B. 275, established a collateral program as an alternative to providing a surety bond for taxpayers to avoid or defer recapture of the low-income housing tax credits under § 42(j)(6). Under this program, taxpayers may establish a Treasury Direct Account and pledge certain United States Treasury securities to the Internal Revenue Service as security.

This revenue ruling provides in Table 1 the bond factor amounts for calculating the amount of bond considered satisfactory under § 42(j)(6) or the amount of United States Treasury securities to pledge in a Treasury Direct Account under Rev. Proc. 99–11 for dispositions of qualified low-income buildings or interests therein during the period April through June 2004.

Table 1
Rev. Rul. 2004–40
Monthly Bond Factor Amounts for Dispositions Expressed
As a Percentage of Total Credits

	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year										
Month of Disposition	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Apr '04	15.55	28.88	40.34	50.12	58.45	57.84	57.87	57.99	58.25	58.56	58.98
May '04	15.55	28.88	40.34	50.12	58.45	57.71	57.75	57.87	58.13	58.45	58.87
Jun '04	15.55	28.88	40.34	50.12	58.45	57.59	57.63	57.75	58.02	58.34	58.77

Table 1 (cont'd)
Rev. Rul. 2004–40
Monthly Bond Factor Amounts for Dispositions Expressed
As a Percentage of Total Credits

	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year										
Month of Disposition	2001	2002	2003	2004							
Apr '04	59.74	60.79	62.04	62.68							
May '04	59.64	60.69	61.93	62.68							
Jun '04	59.55	60.59	61.84	62.68							

For a list of bond factor amounts applicable to dispositions occurring during other calendar years, see: Rev. Rul. 98–3, 1998–1 C.B. 248; Rev. Rul. 2001–2, 2001–1 C.B. 255; Rev. Rul. 2001–53, 2001–2 C.B. 488; Rev. Rul. 2002–72, 2002–2 C.B. 759; and Rev. Rul. 2003–117, 2003–46 I.R.B. 1051. For dispositions occurring during the period January through March 2004, see Rev. Rul. 2004–16, 2004–8 I.R.B. 503.

DRAFTING INFORMATION

The principal author of this revenue ruling is Gregory N. Doran of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Mr. Doran at (202) 622–3040 (not a toll-free call).

Section 223.—Health Savings Accounts

Health Savings Accounts (HSAs). This ruling provides that if an individual is covered by both a high deductible health plan (HDHP) that does not cover prescription drugs and by a separate prescription drug plan (or rider) that provides benefits before the minimum annual deductible of the HDHP has been satisfied, that individual is not an eligible individual under section 223(c)(1)(A) of the Code and may not make contributions to a Health Savings Account.

Rev. Rul. 2004–38

ISSUE

May an individual contribute to a Health Savings Account (HSA) under section 223 of the Internal Revenue Code if the individual is covered by both a high deductible health plan (HDHP) that does not cover prescription drug benefits and by a separate prescription drug plan (or rider) that does not qualify as an HDHP because the plan provides benefits before the individual has satisfied the minimum annual deductible required by section 223(c)(2)(A)?

FACTS

Individual A is covered by a health plan that satisfies the requirements for an HDHP under section 223(c)(2), including the minimum annual deductible required by section 223(c)(2)(A). The HDHP does not include coverage for prescription drug benefits. Individual A is also covered by another plan (or rider) which provides prescription drug benefits. The prescription drug coverage is not subject to a deductible, but requires a copayment for each prescription. Individual A has no other health coverage, is not eligible for Medicare and may not be claimed as a dependent on another's return.

LAW AND ANALYSIS

Section 223(a) allows a deduction for contributions to an HSA for an "eligible individual." Section 223(c)(1)(A) provides that an "eligible individual" means, with respect to any month, any individual who, in addition to other requirements, is covered under an HDHP on the first day of such month and is not, while covered under an HDHP, "covered under any health plan which is not a high deductible health plan, and which provides coverage for any benefit which is covered under the high deductible health plan."

Section 223(c)(2)(A) defines an HDHP as a health plan that satisfies certain requirements with respect to minimum annual deductibles and maximum annual out-of-pocket expenses.

Section 223(c)(1)(B) provides that, in addition to coverage under an HDHP, an eligible individual may also have specifically enumerated coverage that is disregarded for purposes of the deductible. Disregarded coverage includes "permitted insurance" and other specified coverage ("permitted coverage"). "Permitted insurance" is coverage under which substantially all of the coverage provided relates to liabilities incurred under workers' compensation laws, tort liabilities, liabilities relating to ownership or use of property, insurance for a specified disease or illness, and insurance that pays a fixed amount per day (or other period) of hospitalization. "Permitted coverage" (whether through insurance or otherwise) is coverage for accidents, disability, dental care, vision care or long-term care. Prescription drug benefits are not listed as permitted insurance or as permitted coverage under section 223(c)(1)(B).

The legislative history of section 223 explains these provisions by stating that "eligible individuals for HSAs are individuals who are covered by a high deductible health plan and no other health plan that is not a high deductible health plan." The legislative history also explains that, "[a]n individual with other coverage in addition to a high deductible health plan is still eligible for an HSA if such other coverage is certain permitted insurance or permitted coverage." H.R. Conf. Rep. No. 391, 108th Cong., 1st Sess. 841 (2003).

Under section 223, an eligible individual cannot be covered by a health plan that is not an HDHP unless that health plan provides coverage for permitted insurance or permitted coverage. A plan that provides benefits for prescription drugs is a health plan. Prescription drug benefits are not in the list of permitted insurance or permitted coverage. Consequently, an individual who is covered by both an HDHP and by a prescription drug plan is not an eligible individual for the purpose of contributing to an HSA unless the prescription drug coverage is also an HDHP (*i.e.*, the prescription drug plan does not provide benefits unless the required minimum annual deductible under section 223(c)(2)(A) for an HDHP has been satisfied).

HOLDINGS

Individual A is covered by both an HDHP that does not cover prescription drugs and by a separate prescription drug plan (or rider) that provides benefits before the minimum annual deductible of the HDHP has been satisfied. Individual A is not an "eligible individual" under section 223(c)(1)(A) and may not make contributions to an HSA. The result is the same if this prescription drug benefit is provided as a benefit under a health plan (and not separately) or as a benefit for Individual A under a spouse's plan.

However, if a separate prescription drug plan (or rider) does not provide benefits until the minimum annual deductible of the HDHP has been satisfied, or the prescription drug plan is part of an HDHP and subject to the minimum annual deductible, Individual A is an eligible individual under section 223(c)(1)(A).

See Rev. Proc. 2004–22, published elsewhere in this Internal Revenue Bulletin for information concerning transition relief.

DRAFTING INFORMATION

The principal author of this Rev. Rul. is Shoshanna Tanner of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this Rev. Rul., contact Ms. Tanner at (202) 622–6080 (not a toll-free call).

Section 337.—Nonrecognition for Property Distributed to Parent in Complete Liquidation of Subsidiary

26 CFR 1.337(d)–2T: Loss limitation window period (temporary).

T.D. 9118

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Loss Limitation Rules

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains amendments relating to certain aspects of the temporary regulations addressing the deductibility of losses recognized on dispositions of subsidiary stock by members of a consolidated group and to the consequences of treating subsidiary stock as worthless. In addition, this document contains temporary regulations that clarify when stock of a member of a consolidated group may be treated as worthless. These regulations apply to corporations filing consolidated returns. The text of these regulations also serves as the text of the proposed regulations (REG–153172–03) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective March 18, 2004.

Applicability Date: For dates of applicability, see §§1.337(d)–2T(g), 1.1502–35T(f) and 1.1502–80T(c).

FOR FURTHER INFORMATION CONTACT: Regarding the amendments under section 337(d), Mark Weiss (202–622–7790) of the Office of Associate Chief Counsel (Corporate), and, regarding the amendments under section 1502, Lola L. Johnson (202–622–7550) of the Office of Associate Chief Counsel (Corporate) (neither is a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On March 12, 2002, the IRS and Treasury published T.D. 8984, 2002–1 C.B. 668 [67 FR 11034]), which included temporary regulations under sections 337(d) and 1502 that limit the deductibility of loss recognized by a consolidated group on the disposition of stock of a subsidiary and that require certain basis reductions on the deconsolidation of stock of a subsidiary. Those regulations are intended to prevent a corporation from avoiding the recognition of gain on the disposition of assets through the use of the consolidated return regulations.

Section 1.337(d)–2T disallows loss recognized by a member of a consolidated group with respect to the disposition of stock of a subsidiary to the extent that such loss is attributable to the recognition of built-in gain on the disposition of an asset. For this purpose, built-in gain is gain recognized on the disposition of an asset to the extent attributable, directly or indirectly, in whole or in part, to any excess of value over basis that is reflected, before the disposition of the asset, in the basis of the share, directly or indirectly, in whole or in part, after applying section 1503(e) and other applicable provisions of the Internal Revenue Code and regulations.

On March 14, 2003, the IRS and Treasury published T.D. 9048, 2003–1 C.B. 645 [68 FR 12287]), which included temporary regulations generally intended to prevent consolidated groups from obtaining more than one tax benefit from a single economic loss. In particular, §1.1502–35T(f) of those temporary regulations prescribes rules that are intended to prevent groups from obtaining more than one tax benefit from a single economic loss when a group member claims a worthless stock deduction with respect to stock of a subsidiary. In such cases, the regulation requires an apportionment of the group's consolidated net operating loss (CNOL) to the subsidiary under the principles of §1.1502–21T(b), and then treats the apportioned losses as expired.

On August 15, 1994, the IRS and Treasury Department published T.D. 8560, 1994–2 C.B. 200 [59 FR 41666]) adding paragraph (c) to §1.1502–80. Section 1.1502–80(c) provides that, for consolidated return years beginning on or after January 1, 1995, stock of a member is not treated as worthless under section 165 before the stock is treated as disposed of under the principles of §1.1502–19(c)(1)(iii). Under §1.1502–19(c)(1)(iii), stock of a subsidiary is treated as disposed of, by reason of worthlessness, at the time substantially all of the subsidiary's assets are treated as disposed of, abandoned, or destroyed for federal income tax purposes, at the time of certain discharges of indebtedness of the subsidiary, or at the time a member takes into account certain deductions and losses with respect to indebtedness of the subsidiary. Section 1.1502–80(c) was promulgated to more fully implement the single entity treatment of consolidated groups. It also had the effects of preventing certain inappropriate disallowances of loss that occurred when §1.1502–20 governed the allowance of stock losses and of alleviating concerns regarding protecting the attributes of bankrupt subsidiaries.

Explanation of Provisions

Taxpayers have raised several questions regarding the interpretation and application of §§1.337(d)–2T, 1.1502–35T(f), and 1.1502–80(c). The following paragraphs describe these questions and the manner in which they are addressed in these temporary regulations.

A. §1.337(d)–2T

Taxpayers have questioned whether, in computing the amount of stock loss that is attributable to the recognition of built-in gain, gain recognized on the disposition of an asset may be reduced by expenses directly attributable to the recognition of that gain. The IRS and Treasury Department believe that, because expenses attributable to the recognition of built-in gain reduce the basis of the subsidiary's stock, the computation of the amount of stock loss that is attributable to the recognition of built-in gain should take such expenses into account. Accordingly, this document amends §1.337(d)–2T to provide that stock loss is not disallowed to the extent the taxpayer establishes that the loss or basis is not attributable to recognized built-in gain reduced by expenses directly related to the recognition of that gain, including, in certain cases, federal income taxes related

to the recognition of such gain. In addition, this document makes a non-substantive technical correction to the example set forth in §1.337(d)–2T(c)(4).

The IRS and Treasury Department continue to consider alternative methods of implementing section 337(d) in the consolidated return context.

B. §1.1502–35T(f)

Taxpayers have commented that, in certain cases, §1.1502–35T(f) may eliminate losses where there is no risk of duplication. In particular, taxpayers are concerned that the rule appears to eliminate a subsidiary's apportioned part of the CNOL even if the subsidiary has a separate return year following the year in which a member of the group claims a worthless stock deduction with respect to the subsidiary's stock. The IRS and Treasury Department believe that the elimination of a subsidiary's apportioned CNOL is generally necessary to prevent duplication only if a member of the group claims a worthless stock deduction with respect to subsidiary stock and the subsidiary has no separate return year following the year in which the worthless stock deduction is claimed. These temporary regulations, therefore, amend §1.1502–35T(f) to provide that the subsidiary's apportioned part of the CNOL is treated as expired if a member (the claiming member) claims a worthless stock deduction with respect to the subsidiary's stock and, immediately following the taxable year in which the worthless stock deduction is claimed, the subsidiary is a member of a group that includes any corporation (other than a lower-tier subsidiary of the member the stock of which was treated as worthless) that, during that taxable year, was a member of the group that includes the claiming member.

The IRS and the Treasury Department continue to consider methods of preventing groups from obtaining more than a single tax benefit from a single economic loss other than the methods employed in §1.1502–35T.

C. §1.1502–80(c)

Taxpayers have also raised concerns that, in certain circumstances, §1.1502–80(c) may prevent a group from claiming a worthless stock deduction with respect to subsidiary stock that is worthless within the meaning of section 165 if the subsidiary ceases to be a member of the group before it satisfies the requirements of §1.1502–19(c)(1)(iii). For example, assume that the stock of a subsidiary is worthless within the meaning of section 165 but the subsidiary has not disposed of, abandoned, or destroyed substantially all of its assets and the requirements of §1.1502–19(c)(1)(iii) are not otherwise satisfied. At that time, §1.1502–80(c) would prevent the group from treating the subsidiary's stock as worthless. If the subsidiary then cancels its outstanding shares and issues new shares to its creditors, which are not members of the group, the subsidiary will cease to be a member of the group before it satisfies the requirements of §1.1502–80(c). Taxpayers are concerned that, unless §1.1502–80(c) is treated as inapplicable immediately prior to the cancellation of the subsidiary's stock, the group will never be entitled to claim a worthless stock deduction with respect to that stock.

Section 1.1502–80(c) is intended to defer, not disallow, worthless stock deductions with respect to subsidiary stock. Therefore, these temporary regulations amend §1.1502–80(c) and add §1.1502–80T(c) to clarify that the deferral of an otherwise allowable loss under section 165 terminates immediately prior to the time that the subsidiary ceases to be a member of the group. Accordingly, in the example above, the group would be entitled to the worthless stock deduction in the taxable year in which the subsidiary ceases to be a member of the group.

Taxpayers have questioned whether §1.1502–80(c) remains necessary given that §1.1502–20 no longer governs the allowance of loss on sales of subsidiary stock. The IRS and Treasury are evaluating whether the rule of §1.1502–80(c) continues to be necessary or appropriate.

Effective Date

The amendments set forth in these temporary regulations are applicable to tax years beginning after March 18, 2004. However, taxpayers may apply these temporary regulations to certain prior periods.

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. These temporary regulations are necessary to provide taxpayers with immediate guidance regarding allowable loss and basis reductions in connection with dispositions and deconsolidations of subsidiary stock. These temporary regulations clarify existing rules and simplify their application in order to ease taxpayer compliance. Accordingly, good cause is found for dispensing with notice and public procedure pursuant to 5 U.S.C. 553(b)(B) and with a delayed effective date pursuant to 5 U.S.C. 553(d)(1) and (3). For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the Special Analyses section of the preamble to the cross-reference notice of proposed rulemaking published in the Bulletin. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of the regulations under section 337(d) is Mark Weiss, Office of Associate Chief Counsel (Corporate). The principal author of the regulations under section 1502 is Lola L. Johnson, Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury participated in their development.

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

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

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

Par. 2. Section 1.337(d)–2T is amended by revising paragraph (c)(2) and the example in paragraph (c)(4) to read as follows:

§1.337(d)–2T Loss limitation window period (temporary).

* * * * *

(c) * * *

(2) *General rule*. Loss is not disallowed under paragraph (a)(1) of this section and basis is not reduced under paragraph (b)(1) of this section to the extent the taxpayer establishes that the loss or basis is not attributable to the recognition of built-in gain, net of directly related expenses, on the disposition of an asset (including stock and securities). Loss or basis may be attributable to the recognition of built-in gain on the disposition of an asset by a prior group. For purposes of this section, gain recognized on the disposition of an asset is built-in gain to the extent attributable, directly or indirectly, in whole or in part, to any excess of value over basis that is reflected, before the disposition of the asset, in the basis of the share, directly or indirectly, in whole or in part, after applying section 1503(e) and other applicable provisions of the Internal Revenue Code and regulations. Federal income taxes may be directly related to built-in gain recognized on the disposition of an asset only to the extent of the excess (if any) of the group's income tax liability actually imposed under Subtitle A of the Internal Revenue Code for the taxable year of the disposition of the asset over the group's income tax liability for the taxable year redetermined by not taking into account the built-in gain recognized on the disposition of the asset. For this purpose, the group's income tax liability actually imposed and its redetermined income tax liability are determined without taking into account the foreign tax credit under section 27(a) of the Internal Revenue Code. This paragraph (c)(2) applies to dispositions and deconsolidations on or after March 18, 2004. Taxpayers, however, may choose to apply this paragraph (c)(2) to dispositions and deconsolidations on or after March 7, 2002; otherwise, paragraph (c)(2) of §1.337(d)–2T as contained in 26 CFR part 1 edition revised as of April 1, 2003, shall apply.

* * * * *

(4) * * *

Example. *Loss offsetting built-in gain in a prior group*. (i) P buys all the stock of T for $50 in Year 1, and T becomes a member of the P group. T has 2 assets. Asset 1 has a basis of $50 and a value of $0, and asset 2 has a basis of $0 and a value of $50. T sells asset 2 during Year 3 for $50 and recognizes a $50 gain. Under the investment adjustment system, P's basis in the T stock increased to $100 as a result of the recognition of gain. In Year 5, all of the stock of P is acquired by the P1 group, and the former members of the P group become members of the P1 group. T then sells asset 1 for $0, and recognizes a $50 loss. Under the investment adjustment system, P's basis in the T stock decreases to $50 as a result of the loss. T's assets decline in value from $50 to $40. P then sells all the stock of T for $40 and recognizes a $10 loss.

(ii) P's basis in the T stock reflects both T's unrecognized gain and unrecognized loss with respect to its assets. The gain T recognizes on the disposition of asset 2 is built-in gain with respect to both the P and P1 groups for purposes of paragraph (c)(2) of this section. In addition, the loss T recognizes on the disposition of asset 1 is built-in loss with respect to the P and P1 groups for purposes of paragraph (c)(2) of this section. T's recognition of the built-in loss while a member of the P1 group offsets the effect on T's stock basis of T's recognition of the built-in gain while a member of the P group. Thus, P's $10 loss on the sale of the T stock is not attributable to the recognition of built-in gain, and the loss is therefore not disallowed under paragraph (c)(2) of this section.

(iii) The result would be the same if, instead of having a $50 built-in loss in asset 1 when it becomes a member of the P group, T has a $50 net operating loss carryover and the carryover is used by the P group.

* * * * *

Par. 3. Section 1.1502–35T is amended by revising paragraph (f)(1) to read as follows:

§1.1502–35T Transfers of subsidiary member stock and deconsolidations of subsidiary members (temporary).

* * *

(f) *Worthlessness not followed by separate return years*—(1) *General rule*. Notwithstanding any other provision in the regulations under section 1502, if a member of a group (the claiming group) treats stock of a subsidiary as worthless under section 165 (taking into account the provisions of §1.1502–80(c)) and, on the day following the last day of the claiming group's taxable year in which the worthless stock deduction is claimed, the subsidiary (or its successor, determined without regard to paragraphs (d)(5)(iii) and (iv) of this section) is a member of a group that includes any corporation that, during that taxable year, was a member of the claiming group (other than a lower-tier subsidiary of the subsidiary) or is a successor (determined without regard to paragraphs (d)(5)(iii) and (iv) of this section) of such a member, then all losses treated as attributable to the subsidiary under the principles of §1.1502–21T(b)(2)(iv) shall be treated as expired as of the day following the last day of the claiming group's taxable year in which the worthless stock deduction is claimed. In addition, notwithstanding any other provision in the regulations under section 1502, if a member recognizes a loss with respect to subsidiary stock and on the following day the subsidiary is not a member of the group and does not have a separate return year, then all losses treated as attributable to the subsidiary under the principles of §1.1502–21T(b)(2)(iv) shall be treated as expired as of the day following the last day of the group's taxable year in which the stock loss is claimed. For purposes of this paragraph (f), the determination of the losses attributable to the subsidiary shall be made after computing the taxable income of the group for the taxable year in which the group treats the stock of the subsidiary as worthless or the subsidiary liquidates and after computing the taxable income for any taxable year to which such losses may be carried back. The loss treated as expired under this paragraph (f) shall not be treated as a noncapital, nondeductible expense under §1.1502–32(b)(2)(iii). This paragraph (f) applies to worthlessness determinations and liquidations that occur after March 18, 2004, and before March 12, 2006. However, the group may apply this paragraph (f) to worthlessness determinations and liquidations that occur on or after March 7, 2002, and before March 18, 2004; otherwise, paragraph (f) of §1.1502–35T as contained in 26 CFR part 1 edition revised as of April 1, 2003, shall apply to such determinations of worthlessness and liquidations.

* * * * *

Par. 4. Section 1.1502–80 is amended by adding a sentence to the end of paragraph (c) to read as follows:

§1.1502–80 Applicability of other provisions of law.

* * * * *

(c) * * * For further guidance, see §1.1502–80T(c).

Par. 5. Section 1.1502–80T is added to read as follows:

§1.1502–80T Applicability of other provisions of law (temporary).

(a) and (b) [Reserved]. For further guidance, see §1.1502–80(a) and (b).

(c) *Deferral of section 165*. Stock of a member is not treated as worthless under section 165 before the stock is treated as disposed of under the principles of §1.1502–19(c)(1)(iii). If stock of a member would otherwise be treated as worthless under the principles of section 165, then, notwithstanding the previous sentence, such stock may be treated as worthless under section 165 immediately prior to the time such member ceases to be a member of the group. See §§1.1502–11(c) and 1.1502–35T for additional rules relating to stock loss. This paragraph (c) applies to taxable years beginning after March 18, 2004, and before March 18, 2007. Taxpayers, however, may apply this paragraph (c) to taxable years beginning on or after January 1, 1995, and before March 18, 2004; otherwise, paragraph (c) of §1.1502–80 as contained in 26 CFR part 1 edition revised as of April 1, 2003, shall apply to taxable years beginning on or after January 1, 1995, and on or before March 18, 2004.

(d) through (f) [Reserved]. For further guidance, see §1.1502–80(d) through (f).

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

Approved March 9, 2004.

Gregory F. Jenner,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 17, 2004, 8:45 a.m., and published in the issue of the Federal Register for March 18, 2004, 69 F.R. 12799)

Section 1502.—Regulations

26 CFR 1.1502–13: Intercompany transactions.

T.D. 9117

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Guidance Under Section 1502; Application of Section 108 to Members of a Consolidated Group

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary and final regulations.

SUMMARY: This document contains temporary regulations under section 1502 that govern the application of section 108 when a member of a consolidated group realizes discharge of indebtedness income. These regulations affect corporations filing consolidated returns.

DATES: *Effective Date*: These regulations are effective March 15, 2004.

Applicability Dates: For dates of applicability, see §§1.1502–13T(l) and 1.1502–28T(d).

FOR FURTHER INFORMATION CONTACT: Candace Ewell or Marie Milnes-Vasquez at (202) 622–7530 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

On September 4, 2003, the IRS and Treasury Department published in the **Federal Register** a notice of proposed rulemaking (REG–132760–03, 2003–43 I.R.B. 933 [68 FR 52542]) and temporary regulations (T.D. 9089, 2003–43 I.R.B. 906 [68 FR 52487]) under section 1502 of the Internal Revenue Code. The temporary regulations added §1.1502–28T, which provides guidance regarding the determination of the attributes that are available for reduction when a member of a consolidated group realizes discharge of indebtedness income that is excluded from gross income (excluded COD income) and the method for reducing those attributes. Section 1.1502–28T reflects a consolidated approach that is intended to make available for reduction attributes that are available to the debtor member. The regulations contain a rule governing the order in which attributes are reduced and a look-through rule that provides that when the basis of stock of a member (the lower-tier member) that is owned by another member is reduced, the lower-tier member must reduce its attributes as if it had realized excluded COD income in the amount of the basis reduction.

On December 11, 2003, the IRS and Treasury Department published in the **Federal Register** a notice of proposed rulemaking (REG–153319–03, 2003–52 I.R.B. 1256 [68 FR 69062]) and temporary regulations (T.D. 9098, 2003–52 I.R.B. 1248 [68 FR 69024]) under section 1502 amending §1.1502–28T. Those regulations clarify that certain attributes that arise (or are treated as arising) in a separate return year are subject to reduction when no SRLY limitation applies to the use of such attributes.

The IRS and Treasury Department have received comments regarding certain technical issues that arise under the regulations. The temporary regulations included in this document address certain issues related to the application of section 1245 and the matching rule of §1.1502–13, and certain issues related to the inclusion of excess loss accounts in cases in which excluded COD income is not fully applied to reduce attributes. The IRS and Treasury Department anticipate that there may be further changes to the regulations but believe that immediate guidance on these issues is desirable. The following sections describe these issues and the manner in which they are addressed in these temporary regulations.

A. *Application of Section 1245*

Under section 108(b), asset basis is an attribute that is subject to reduction in respect of excluded COD income. Under section 108(b)(5), the taxpayer may elect to apply any portion of excluded COD income to reduce basis in depreciable assets under the rules of section 1017 prior to reducing other attributes.

Section 1017 provides rules that apply in cases in which excluded COD income is applied to reduce the basis of property. Under section 1017(d)(1), any property the basis of which is reduced and which is

neither section 1245 property nor section 1250 property is treated as section 1245 property and the basis reduction is treated as a deduction allowed for depreciation. Under section 1017(b)(3)(D), if a corporation that has excluded COD income is a member of a consolidated group, it can elect to treat the stock of another member as depreciable property if that other member consents to a corresponding reduction in the basis of its depreciable property.

Generally, if section 1245 property is disposed of, the amount by which the lower of (1) the recomputed basis of the property, or (2) in the case of a sale, exchange or involuntary conversion, the amount realized, or (3) in the case of any other disposition, the fair market value of such property, exceeds the adjusted basis of such property is treated as ordinary income (the recapture amount). The recomputed basis is the adjusted basis of property increased by adjustments reflected in that basis that are attributable to deductions allowed or allowable for depreciation or amortization. Application of the recapture rule of section 1245 to property the basis of which has been reduced by reason of the realization of excluded COD income ensures that the character of the income deferred by reason of attribute reduction (*i.e.*, the extra gain that may be recognized on the disposition of an asset the basis of which has been reduced) will be ordinary (even if the asset is held as a capital asset), which character the excluded COD income would have had if it had been included in income when realized.

Commentators have noted that if the basis of subsidiary stock is reduced in respect of a member's excluded COD income and then the basis of the assets of that subsidiary are reduced pursuant to the look-through rule, both the stock of the subsidiary as well as its assets would be treated as section 1245 property. As a result of that treatment, in certain cases, the group may be required to include in income an inappropriate amount of ordinary income. A similar result may obtain if a member consents under section 1017(b)(3)(D) to reduce the basis of its depreciable property when stock of the subsidiary is treated as depreciable property.

For example, assume a member (a higher-tier member) realizes excluded COD income that is applied to reduce the higher-tier member's basis in the stock of another member (a lower-tier member) and, as a result, a corresponding reduction to the basis of property of the lower-tier member is made. The following year, the lower-tier member transfers all of its assets to the higher-tier member in a liquidation to which section 332 applies. Under section 1245, recapture on the lower-tier member's property that is treated as section 1245 property by reason of section 1017(d)(1) is limited to the amount of the gain recognized by the lower-tier member in the liquidation. However, no similar limitation applies to the stock of the lower-tier member that is also treated as section 1245 property. Therefore, the higher-tier member would be required to include as ordinary income the entire recapture amount with respect to the lower-tier member stock. In addition, when the higher-tier member sells the assets of the former lower-tier member the bases of which were reduced, the higher-tier member would be required to include as ordinary income the recapture amount with respect to such assets. In that case, the group may be required to include in consolidated taxable income the amounts representing the same excluded COD income more than once.

The IRS and Treasury Department believe that it is appropriate for the group to include in income as ordinary income amounts reflecting previously excluded COD income only once. Therefore, to prevent a double inclusion of ordinary income amounts representing the same excluded COD income, these regulations provide that a reduction of the basis of subsidiary stock is treated as a deduction allowed for depreciation only to the extent that the amount by which the basis of the subsidiary stock is reduced exceeds the total amount of the attributes attributable to such subsidiary that are reduced pursuant to the subsidiary's consent under section 1017(b)(3)(D) or as a result of the application of the look-through rule. This rule has the effect of limiting the ordinary income recapture amount to the amount of the stock basis reduction that does not result in a corresponding reduction of the tax attributes attributable to the subsidiary.

B. *Application of Matching Rule*

If the member that realizes excluded COD income is the creditor with respect to an intercompany obligation, it is possible that the basis of that intercompany obligation would be reduced under sections 108 and 1017, and §1.1502–28T. Section 1.1502–13 provides rules relating to the treatment of transactions between members of a consolidated group. In general, in the case of a transaction between two members (S and B) of a consolidated group, the regulations operate to match the items of both members. In particular, under §1.1502–13(c)(1)(i), the separate entity attributes of S's intercompany items and B's corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation, and the intercompany transaction were a transaction between divisions. Under paragraph §1.1502–13(c)(6)(i), subject to certain limitations, S's intercompany item might be redetermined to be excluded from gross income or treated as a noncapital, nondeductible amount.

Some commentators have asked whether the rule of §1.1502–13(c)(6)(i) operates to exclude from gross income any income recognized that is attributable to the application of excluded COD income to reduce the basis of an intercompany obligation. The application of the rule of §1.1502–13(c)(6)(i) in this manner would render without consequence the reduction of the basis of the intercompany obligation. These temporary regulations, therefore, reflect the IRS's and Treasury Department's position that, if the basis of an intercompany obligation held by a creditor member is reduced in respect of excluded COD income, §1.1502–13(c)(6)(i) will not apply to exclude income of the creditor member attributable to the basis reduction in the intercompany obligation.

C. *Taking into Account of Excess Loss Account*

Under §§1.1502–19 and 1.1502–19T, when an indebtedness of a subsidiary is discharged and any part of the amount discharged is not included in gross income and is not treated as tax-exempt income under §1.1502–32, if there is an excess loss

account in the stock of the subsidiary, that excess loss account must be included in income to the extent of the amount discharged that is not treated as tax-exempt income. Questions have arisen regarding the timing of the taking into account of excess loss accounts required pursuant to §§1.1502–19 and 1.1502–19T.

The IRS and Treasury Department have considered whether an excess loss account that is required to be included as a result of the application of §1.1502–19(c)(1)(iii)(B) is properly included in the group's consolidated taxable income for the taxable year that includes the date on which the member realizes the excluded COD income. Some have suggested that, because pursuant to section 108(b)(4)(A) attributes are reduced only after the computation of tax for the year of the excluded COD income and, therefore, whether an excess loss account must be included in income is determined only after the computation of tax, the inclusion of the excess loss account should not be required on the return for the taxable year that includes the date on which the excluded COD income was realized. Because the inclusion of the excess loss account is required in connection with the realization of the excluded COD income, the IRS and Treasury Department believe that it is properly included on the return for the taxable year that includes the date on which the excluded COD income was realized.

Some have suggested that inclusion of the excess loss account on the return for the taxable year that includes the date on which the excluded COD income was realized could result in circular calculations. That is, the inclusion of the excess loss account would be offset by losses that would have otherwise been subject to reduction, potentially increasing the amount of excluded COD income that is not applied to reduce attributes and, therefore, the amount of excess loss account required to be taken into account. To address this concern, contemporaneously with the issuance of these temporary regulations, the IRS and Treasury Department are proposing regulations (REG–167265–03) that address these and other circular computations that would otherwise arise when there is an actual disposition of subsidiary stock, or an event that is treated as a disposition of subsidiary stock under §1.1502–19, in the year that a member of the group realizes excluded COD income. Those regulations are published elsewhere in this issue of the Bulletin.

Special Analysis

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. These temporary regulations are necessary to provide taxpayers with immediate guidance regarding the application of section 108 when a member of a consolidated group realizes discharge of indebtedness income that is excluded from gross income and the consequences of such application. Accordingly, good cause is found for dispensing with notice and public procedure pursuant to 5 U.S.C. 553(b)(B) and with a delayed applicability date pursuant to 5 U.S.C. 553(d)(3). For applicability of the Regulatory Flexibility Act, please refer to the cross-reference notice of proposed rulemaking published elsewhere in this issue of the Bulletin. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Marie C. Milnes-Vasquez 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 is amended by adding an entry in numerical order to read in part as follows:

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

Section 1.1502–13T also issued under 26 U.S.C. 1502. * * *

Par. 2. Paragraph (g)(3)(ii)(B) of §1.1502–13 is revised to read as follows:

§1.1502–13 Intercompany transactions.

* * *

(g) * * *

(3) * * *

(ii) * * *

(B) [Reserved]. For further guidance, see §1.1502–13T(g)(3)(ii)(B).

* * * * *

Par. 3. Section 1.1502–13T is added to read as follows:

§1.1502–13T Intercompany transactions (temporary).

(a) through (g)(3)(ii)(A) [Reserved]. For further guidance, see §1.1502–13(a) through (g)(3)(ii)(B).

(g)(3)(ii)(B) *Timing and attributes*. For purposes of applying the matching rule and the acceleration rule —

(*1*) Paragraph (c)(6)(ii) of this section (limitation on treatment of intercompany income or gain as excluded from gross income) does not apply to prevent any intercompany income or gain from being excluded from gross income;

(*2*) Any gain or loss from an intercompany obligation is not subject to section 108(a), section 354 or section 1091;

(*3*) The reduction of the basis of an intercompany obligation pursuant to sections 108 and 1017 and §1.1502–28T does not result in the realization of any amount with respect to such obligation; and

(*4*) Paragraph (c)(6)(i) of this section (treatment of intercompany items if corresponding items are excluded or nondeductible) will not apply to exclude any amount of income or gain attributable to a reduction of the basis of an intercompany obligation pursuant to sections 108 and 1017 and §1.1502–28T.

(g)(3)(iii) through (k) [Reserved]. For further guidance, see §1.1502–13 (g)(3)(iii) through (k).

(l) *Effective dates*. Paragraph (g)(3)(ii)(B) of this section applies to transactions or events occurring during a taxable year the original return for which is due (without extensions) after March 12, 2004.

Par. 4. Section 1.1502–28T is amended by:

1. Adding paragraphs (b)(4), (b)(5), and (b)(6).

2. Revising paragraph (d).

The additions and revision read as follows:

§1.1502–28T Consolidated section 108 (temporary).

* * * * *

(b) * * *

(4) *Application of section 1245*. Notwithstanding section 1017(d)(1)(B), a reduction of the basis of subsidiary stock is treated as a deduction allowed for depreciation only to the extent that the amount by which the basis of the subsidiary stock is reduced exceeds the total amount of the attributes attributable to such subsidiary that are reduced pursuant to the subsidiary's consent under section 1017(b)(3)(D) or as a result of the application of paragraph (a)(3)(ii) of this section.

(5) *Reduction of basis of intercompany obligations*. See §1.1502–13T(g)(3)(ii)(B)(3) and (4) for special rules related to the application of the matching and acceleration rules of §1.1502–13 when the basis of an intercompany obligation is reduced pursuant to sections 108 and 1017 and paragraph (a)(2) or (3) of this section.

(6) *Taking into account of excess loss account*—(i) *Determination of inclusion*. [Reserved.]

(ii) *Timing of inclusion*. To the extent an excess loss account in a share of stock of a subsidiary that realizes excluded COD income is required to be taken into account as a result of the application of §1.1502–19(c)(1)(iii)(B), such amount shall be included on the group's tax return for the taxable year that includes the date on which the subsidiary realizes such excluded COD income.

* * * * *

(d) *Effective dates*. (1) This section, other than paragraphs (a)(4), (b)(4), (b)(5), and (b)(6) of this section, applies to discharges of indebtedness that occur after August 29, 2003.

(2) Paragraph (a)(4) of this section applies to discharges of indebtedness that occur after August 29, 2003, but only if the discharge occurs during a taxable year the original return for which is due (without regard to extensions) after December 11, 2003. However, groups may apply paragraph (a)(4) of this section to discharges of indebtedness that occur after August 29, 2003, and during a taxable year the original return for which is due (without regard to extensions) on or before December 11, 2003. For discharges of indebtedness that occur after August 29, 2003, and during a taxable year the original return for which is due (without regard to extensions) on or before December 11, 2003, paragraph (a)(4) of this section shall apply as in effect on August 29, 2003.

(3) Paragraphs (b)(4), (b)(5), and (b)(6)(ii) of this section apply to discharges of indebtedness that occur after August 29, 2003, but only if the discharge occurs during a taxable year the original return for which is due (without regard to extensions) after March 12, 2004. However, groups may apply paragraphs (b)(4), (b)(5), and (b)(6) of this section to discharges of indebtedness that occur after August 29, 2003, and during a taxable year the original return for which is due (without regard to extensions) on or before March 12, 2004.

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

Approved March 4, 2004.

Gregory F. Jenner,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 12, 2004, 8:45 a.m., and published in the issue of the Federal Register for March 15, 2004, 69 F.R. 12069)

Part III. Administrative, Procedural, and Miscellaneous

Health Savings Accounts—Preventive Care

Notice 2004–23

PURPOSE

This notice provides a safe harbor for preventive care benefits allowed to be provided by a high deductible health plan (HDHP) without satisfying the minimum deductible under section 223(c)(2) of the Internal Revenue Code.

BACKGROUND

Section 1201 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, Pub. L. No. 108–173, added section 223 to the Internal Revenue Code to permit eligible individuals to establish Health Savings Accounts (HSAs) for taxable years beginning after December 31, 2003.

Among the requirements for an individual to qualify as an eligible individual under section 223(c)(1) (and thus to be eligible to make tax-favored contributions to an HSA) is the requirement that the individual be covered under an HDHP. An HDHP is a health plan that satisfies certain requirements with respect to minimum deductibles and maximum out-of-pocket expenses. Generally, an HDHP may not provide benefits for any year until the deductible for that year is satisfied. However, section 223(c)(2)(C) provides a safe harbor for the absence of a preventive care deductible. That section states, "[a] plan shall not fail to be treated as a high deductible health plan by reason of failing to have a deductible for preventive care (within the meaning of section 1871 of the Social Security Act, except as otherwise provided by the Secretary)." An HDHP may therefore provide preventive care benefits without a deductible or with a deductible below the minimum annual deductible. On the other hand, there is no requirement in section 223 that an HDHP provide benefits for preventive care or provide preventive care with a deductible below the minimum annual deductible.

PREVENTIVE CARE SAFE HARBOR

Preventive care for purposes of section 223(c)(2)(C) includes, but is not limited to, the following:

- Periodic health evaluations, including tests and diagnostic procedures ordered in connection with routine examinations, such as annual physicals.
- Routine prenatal and well-child care.
- Child and adult immunizations.
- Tobacco cessation programs.
- Obesity weight-loss programs.
- Screening services (see attached APPENDIX).

However, preventive care does not generally include any service or benefit intended to treat an existing illness, injury, or condition (See below for request for comments regarding drug treatments.)

INTERACTION WITH STATE LAW HEALTH CARE REQUIREMENTS

Section 220(c)(2)(B)(ii) allows a high deductible health plan for purposes of an Archer Medical Savings Account to provide preventive care without a deductible if required by state law. However, section 220 does not define preventive care for this purpose. Section 223(c)(2)(C), for purposes of an HSA, does not condition the exception for preventive care on state law requirements. State insurance laws often require health plans to provide certain health care without regard to a deductible or on terms no less favorable than other care provided by the health plan. The determination of whether health care that is required by state law to be provided by an HDHP without regard to a deductible is "preventive" for purposes of the exception for preventive care under section 223(c)(2)(C) will be based on the standards set forth in this notice and other guidance issued by the IRS, rather than on how that care is characterized by state law.

COMMENTS REQUESTED

Notice 2004–2, 2004–2 I.R.B. 269, requested comments concerning the appropriate standard for preventive care in section 223(c)(2)(C). We continue to request comments on the appropriate standard for preventive care, and in particular, recommendations concerning any benefit or service that should be added to those set forth in this notice and appendix. In addition, we request comments on the extent to which benefits provided by an employee assistance program, mental health program or wellness program may qualify as preventive care, including comments regarding the scope of treatments provided as benefits through counseling and health assessments. In particular, we request comments on the extent to which drug treatments, either solely by prescription or as part of an overall treatment regimen should be treated as preventive care and the appropriate standards for differentiating between drug treatments that would be considered preventive care and those that would not be considered preventive care.

Send comments to: CC:PA:LPD:PR (Notice 2004–2), Room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Comments may be hand-delivered between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (Notice 2004–2), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, D.C. Alternatively, taxpayers may submit comments electronically at: *Notice.2004.2.Comments@irscounsel.treas.gov* (a Service Comments e-mail address).

DRAFTING INFORMATION

The principal author of this notice is Shoshanna Tanner of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, contact Ms. Tanner at (202) 622–6080 (not a toll-free call).

APPENDIX

Safe Harbor Preventive Care Screening Services

Cancer Screening
Breast Cancer (*e.g.*, Mammogram)
Cervical Cancer (*e.g.*, Pap Smear)
Colorectal Cancer
Prostate Cancer (*e.g.*, PSA Test)
Skin Cancer
Oral Cancer
Ovarian Cancer
Testicular Cancer
Thyroid Cancer

Heart and Vascular Diseases Screening
Abdominal Aortic Aneurysm
Carotid Artery Stenosis
Coronary Heart Disease
Hemoglobinopathies
Hypertension
Lipid Disorders

Infectious Diseases Screening
Bacteriuria
Chlamydial Infection
Gonorrhea
Hepatitis B Virus Infection
Hepatitis C
Human Immunodeficiency Virus (HIV) Infection
Syphilis
Tuberculosis Infection

Mental Health Conditions and Substance Abuse Screening
Dementia
Depression
Drug Abuse
Problem Drinking
Suicide Risk
Family Violence

Metabolic, Nutritional, and Endocrine Conditions Screening
Anemia, Iron Deficiency
Dental and Periodontal Disease
Diabetes Mellitus
Obesity in Adults
Thyroid Disease

Musculoskeletal Disorders Screening
Osteoporosis

Obstetric and Gynecologic Conditions Screening
Bacterial Vaginosis in Pregnancy
Gestational Diabetes Mellitus
Home Uterine Activity Monitoring
Neural Tube Defects
Preeclampsia
Rh Incompatibility
Rubella
Ultrasonography in Pregnancy

APPENDIX

Safe Harbor Preventive Care Screening Services — Continued

Pediatric Conditions Screening
Child Developmental Delay
Congenital Hypothyroidism
Lead Levels in Childhood and Pregnancy
Phenylketonuria
Scoliosis, Adolescent Idiopathic

Vision and Hearing Disorders Screening
Glaucoma
Hearing Impairment in Older Adults
Newborn Hearing

Health Savings Accounts—Transition Relief

Notice 2004–25

PURPOSE

This notice provides transition relief for calendar year 2004 for eligible individuals who establish an HSA or on before April 15, 2005, from the requirement that qualified medical expenses may only be paid or reimbursed by an HSA if incurred after the HSA has been established. This notice modifies prior guidance in Q&A 26 of Notice 2004–2, 2004–2 I.R.B. 269.

Section 1201 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, Pub. L. No. 108–173, added section 223 to the Internal Revenue Code to permit eligible individuals to establish Health Savings Accounts (HSAs) for taxable years beginning after December 31, 2003. Because of the short period between the enactment of HSAs and the effective date of section 223, many taxpayers who otherwise would be eligible to establish and contribute to HSAs (*i.e.*, generally, individuals covered by a high deductible health plan (HDHP)) have been unable to do so because they cannot locate trustees or custodians who are willing and able to open HSAs at this time.

BACKGROUND

Contributions to an HSA may only be made by or on behalf of eligible individuals as defined in section 223(c)(1)(A). For any month, an eligible individual must, among other requirements, be covered on the first day of the month by a HDHP (as defined by section 223(c)(2)). Although the amount of the contribution to an HSA is based on the number of months an individual is an eligible individual (*i.e.*, is covered by the HDHP), contributions up to the annual maximum limit generally may be made to the HSA as early as the first day of the taxable year and as late as April 15 of the year following the year for which contributions are made. Notice 2004–2, Q&A 21.

On January 12, 2004, Notice 2004–2 was published, providing general guidance concerning HSAs under section 223. The notice provides that distributions from an HSA exclusively to pay or reimburse qualified medical expenses of the account beneficiary, his or her spouse, or dependents, are excluded from gross income. Answer 26 of the notice states that, "The qualified medical expenses must be incurred only after the HSA has been established." However, after an HSA is established, distributions from the HSA exclusively to pay or reimburse qualified medical expenses continue to be excluded from the account beneficiary's gross income whether or not the account beneficiary continues to be an eligible individual. Notice 2004–2, Q&A 28.

TRANSITION RELIEF FOR HSAs ESTABLISHED FOR CALENDAR YEAR 2004

For calendar year 2004, an HSA established by an eligible individual on or before April 15, 2005, may pay or reimburse on a tax-free basis an otherwise qualified medical expense if the qualified medical expense was incurred on or after the later of: (1) January 1, 2004, or (2) the first day of the first month that the individual became an eligible individual under section 223.

EFFECT ON OTHER DOCUMENTS

The rule in the second sentence of Notice 2004–2, Q&A 26, which states that, "The qualified medical expenses must be incurred only after the HSA has been established," is suspended and replaced by the transition relief in this notice. That rule continues to apply to HSAs established for calendar year 2005 and later years.

DRAFTING INFORMATION

The principal author of this notice is Shoshanna Tanner of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, contact Ms. Tanner at (202) 622–6080 (not a toll-free call).

Section 223.—Health Savings Accounts

Rev. Proc. 2004–22

SECTION 1. PURPOSE

This revenue procedure provides transition relief from Revenue Ruling 2004–38 for determining an "eligible individual" under section 223 who may make contributions to a Health Savings Account (HSA). The transition relief covers the months before January 1, 2006, in the case of an individual who is covered by both a high deductible health plan (HDHP) and by a separate plan or rider that provides prescription drug benefits before the minimum annual deductible of the HDHP is satisfied.

SECTION 2. BACKGROUND

Section 1201 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, Pub. L. No. 108–173, added section 223 to the Internal Revenue Code to permit eligible individuals to establish HSAs for taxable years beginning after December 31, 2003. Generally, an "eligible individual" is an individual who is covered by an HDHP and no health plan that is not an HDHP. Revenue Ruling 2004–38, clarifies that an individual who is covered by a health plan that provides prescription drug benefits before the minimum annual deductible of an HDHP has been satisfied, is not an "eligible individual" under section 223(c)(1)(A) and may not make contributions to an HSA. Because of the short period between the enactment of HSAs and the effective date of section 223, many employers and health insurance providers have been unable to modify the benefits provided under their existing health plans to conform to the statutory requirements for an HDHP. Thus, it is appropriate to provide transition relief to allow individuals to contribute to an HSA who would otherwise qualify as eligible individuals but for coverage by a prescription drug benefit provided under a separate plan or rider that is not an HDHP.

SECTION 3. APPLICATION

For months before January 1, 2006, an individual who would otherwise be an "eligible individual" under section 223(c)(1)(A), but is covered by both an HDHP that does not provide benefits for prescription drugs and by a separate health plan or rider that provides prescription drug benefits before the minimum annual deductible of the HDHP is satisfied (*i.e.*, the separate prescription drug plan is not an HDHP), will continue to be an "eligible individual" and may make contributions to an HSA based on the annual deductible of the HDHP.

SECTION 4. EFFECT ON OTHER DOCUMENTS

The holding of Revenue Ruling 2004–38 is suspended in part and replaced by the transition relief provided in this revenue procedure for months before January 1, 2006.

DRAFTING INFORMATION

The principal author of this revenue procedure is Shoshanna Tanner of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue procedure, contact Ms. Tanner at (202) 622–6080 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations

Loss Limitation Rules

REG–153172–03

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: 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. 9118) under sections 337(d) and 1502 of the Internal Revenue Code relating to the deductibility of losses recognized on dispositions of subsidiary stock by members of a consolidated group, the consequences of treating subsidiary stock as worthless, and when stock of a member of a consolidated group may be treated as worthless. The temporary regulations apply to corporations filing consolidated returns. The text of the temporary regulations published in this issue of the Bulletin also serves as the text of these proposed regulations.

DATES: Written or electronic comments must be received by June 16, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–153172–03), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–153172–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20044. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at *www.irs.gov/regs*.

FOR FURTHER INFORMATION CONTACT: Regarding the regulations under section 337(d), Mark Weiss (202–622–7790) of the Office of Associate Chief Counsel (Corporate), and regarding the regulations under section 1502, Lola L. Johnson (202–622–7550) of the Office of Associate Chief Counsel (Corporate); regarding submission of comments and/or requests for a hearing, Sonya M. Cruse (202–622–4693) of the Office of Procedure and Administration (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Temporary regulations in this issue of the Bulletin amend the Income Tax Regulations (26 CFR part 1) relating to section 337(d) and section 1502. The text of those regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the amendments.

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 these regulations will primarily affect affiliated groups of corporations, which tend to be larger businesses. Therefore a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested by any person who timely submits 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 the regulations under section 337(d) is Mark Weiss, Office of Associate Chief Counsel (Corporate). The principal author of the regulations under section 1502 is Lola L. Johnson, Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury participated in their development.

Proposed 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 as follows:

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

Par. 2. Section 1.337(d)–2(c)(2) is added to read as follows:

§1.337(d)–2 Loss limitation window period.

[The text of this proposed section is the same as the text of §1.337(d)–2T published elsewhere in this issue of the Bulletin].

Par. 3. Section 1.1502–35(f)(1) is added to read as follows:

§1.1502–35 Transfers of subsidiary member stock and deconsolidations of subsidiary members.

[The text of this proposed section is the same as the text of §1.1502–35T published elsewhere in this issue of the Bulletin].

Par. 4. In §1.1502–80, paragraph (c) is revised to read as follows:

§1.1502–80 Applicability of other provisions of law.

(c) [The text of this proposed §1.1502–80(c) is the same as the text

of §1.1502–80T(c) published elsewhere in this issue of the Bulletin].

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

(Filed by the Office of the Federal Register on March 17, 2004, 8:45 a.m., and published in the issue of the Federal Register for March 18, 2004, 69 F.R. 12811)

Notice of Proposed Rulemaking; Notice of Proposed Rulemaking by Cross Reference to Temporary Regulations

Guidance Under Section 1502; Application of Section 108 to Members of a Consolidated Group; Computation of Taxable Income When Section 108 Applies to a Member of a Consolidated Group

REG–167265–03

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking; notice of proposed rulemaking by cross reference to temporary regulations.

SUMMARY: This document contains proposed regulations under section 1502 that govern the timing of certain basis adjustments in respect of the realization of discharge of indebtedness income that is excluded from gross income and the reduction of attributes in respect of that excluded income. In addition, the text of the temporary regulations (T.D. 9117) published elsewhere in this issue of the Bulletin serves as the text of these proposed regulations with respect to the application of section 108 when a member of a consolidated group realizes discharge of indebtedness income. The proposed regulations affect corporations filing consolidated returns.

DATES: Written or electronic comments must be received by June 14, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–167265–03), room 5203, Internal Revenue Service, POB 7604 Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG–167265–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at *www.irs.gov/regs*.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Candace B. Ewell or Marie C. Milnes-Vasquez at (202) 622–7530; concerning submission of comments, Treena Garrett at (202) 622–3401 (not toll-free numbers).

Background and Explanation of Provisions

On September 4, 2003, the IRS and Treasury Department published in the **Federal Register** a notice of proposed rulemaking (REG–132760–03, 2003–43 I.R.B. 933 [68 FR 52542]) and temporary regulations (T.D. 9089, 2003–43 I.R.B. 906 [68 FR 52487]) under section 1502 of the Internal Revenue Code. The temporary regulations added §1.1502–28T, which provides guidance regarding the determination of the attributes that are available for reduction when a member of a consolidated group realizes discharge of indebtedness income that is excluded from gross income (excluded COD income) and the method for reducing those attributes.

The text of the temporary regulations published in this issue of the Bulletin amend the Income Tax Regulations (26 CFR part 1) relating to section 1502. The temporary regulations address certain issues related to the application of section 1245 and the matching rule of §1.1502–13, and the inclusion of excess loss accounts in cases in which excluded COD is not fully applied to reduce attributes. The text of those regulations also serves as the text of these proposed regulations with respect to those issues. The preamble to the temporary regulations explains those amendments.

These regulations also propose amendments to §§1.1502–28T and 1.1502–11 to address certain issues that have been raised regarding the computation of gain or loss on the disposition of member stock and regarding the computation of the portion of an excess loss account that must be taken into account when excluded COD income is not fully applied to reduce attributes. In particular, if the stock of the subsidiary that realizes excluded COD income is sold, the reduction of other members' attributes will cause an increase in the basis of the stock of the subsidiary, thus reducing the gain (or increasing the loss) on the stock sale that might otherwise have been offset by attributes and possibly making more attributes available for reduction. If the stock of a subsidiary other than one that realizes excluded COD income is sold, the reduction of such subsidiary's attributes in respect of the excluded COD income will cause a decrease in the basis of the sold subsidiary stock, thus increasing the gain (or reducing the loss) on the stock sale, possibly resulting in the absorption of more attributes and making fewer attributes available for reduction.

In addition, the amount of the excess loss account in the stock of a subsidiary that is required to be taken into account can only be determined after the computation of tax for the year of the discharge and the reduction of attributes. Pursuant to §1.1502–28T(b)(6)(ii), however, that excess loss account must be included on the group's tax return for the taxable year that includes the date on which the subsidiary realizes the excluded COD income. If that excess loss account were offset by losses that could be reduced in respect of the excluded COD income, the inclusion of that amount could result in fewer attributes available for reduction. The availability of fewer attributes for reduction might increase the excluded COD income that was not applied to reduce attributes and, therefore, the amount of the excess loss account in the subsidiary's stock required to be taken into account.

These regulations provide guidance regarding the timing of stock basis adjustments, the calculation of stock gain or loss (including the amount of an excess loss account required to be taken into account), and the reduction of attributes when a member (P) disposes of stock of a subsidiary (S) during a year in which a member realizes excluded COD income. In particular, these regulations propose the steps used to compute the group's consolidated taxable income and to effect the

reduction of attributes. In order to avoid circular calculations, these proposed regulations adopt an approach that limits the reduction of attributes in certain cases in which a disposition of subsidiary stock occurs during a year in which one or more members realize excluded COD income.

This methodology applies not only when there is an actual disposition of subsidiary stock, but also when there is a deemed disposition, including a disposition that results by reason of the application of §1.1502–19(c)(1)(iii)(B) when excluded COD income is not fully applied to reduce attributes. However, in order to know whether there has been a disposition of stock by reason of the application of §1.1502–19(c)(1)(iii)(B), the group must have computed its consolidated taxable income (or loss) and applied the rules of sections 108 and 1017 and §1.1502–28T. Therefore, as discussed below, a number of the steps proposed will have a slightly different application when there is such a deemed disposition of subsidiary stock rather than an actual disposition of subsidiary stock. The following paragraphs outline the proposed steps.

First, the extent to which S's deductions and losses for the tax year of the disposition (and its deductions and losses carried over from prior years) may offset income and gain is computed pursuant to the current rules of §1.1502–11(b)(2) and (3). Those rules require a tentative computation of the group's taxable income, without regard to the stock gain or loss. In the case of a disposition of subsidiary stock that results from the application of §1.1502–19(c)(1)(iii)(B) (which will only be apparent after the application of the sixth step described below), the application of §1.1502–11(b)(2) and (3) will not result in the imposition of a limitation on the use of S's deductions and losses.

Second, §§1.1502–32 and 1.1502–32T are tentatively applied to adjust the basis of the S stock to reflect the amount of S's unlimited deductions and losses that are absorbed in the tentative computation of taxable income (or loss) for the year of the disposition (and any prior years to which the deductions or losses may be carried) that is made pursuant to §1.1502–11(b)(2). The basis of the S stock is not adjusted to reflect the realization of excluded COD income and the reduction of attributes in respect thereof.

Third, in the case of a disposition of S stock that does not result from excluded COD income not being fully applied to reduce attributes, P's income, gain, or loss from the disposition of S stock is computed using the basis of such stock computed in the preceding step.

Fourth, taxable income (or loss) for the year of disposition (and any prior years to which the deductions or losses may be carried) is tentatively computed. For this purpose, in the case of a disposition of S stock that does not result from excluded COD income not being fully applied to reduce attributes, the tentative computations of taxable income (or loss) take into account P's income, gain, or loss from the disposition of S stock computed in the preceding step. Any excess loss account that is taken into account as a result of excluded COD income not being fully applied to reduce attributes is not included in this tentative computation of taxable income (or loss).

Fifth, the excluded COD income is tentatively applied to reduce attributes pursuant to the rules of sections 108 and 1017 and §1.1502–28T. Only those attributes that remain after the tentative computations of taxable income (or loss) in the fourth step are subject to reduction.

Sixth, §§1.1502–32 and 1.1502–32T are applied to adjust the basis of the S stock to reflect the amount of S's unlimited deductions and losses that are absorbed in the tentative computation of taxable income (or loss) for the year of the disposition (and any prior years to which the deductions or losses may be carried) made pursuant to the fourth step, and the excluded COD income that is applied to reduce attributes and the attributes reduced in respect of the excluded COD income pursuant to the fifth step.

Seventh, the group's actual gain or loss on the disposition of S stock is computed using the basis of such stock computed in the preceding step. At this point, whether and to what extent an excess loss account in the stock of a subsidiary that realizes excluded COD income must be taken into account is computed. In many cases, taking into account the basis consequences of the excluded COD income prior to computing the amount of an excess loss account required to be taken into account may be favorable to taxpayers because those consequences might decrease or even eliminate an excess loss account and, therefore, reduce the amount of excess loss account required to be taken into account. The IRS and Treasury Department are aware that taking into account the basis effects of the excluded COD income of all members of the group may increase the excess loss account in the subsidiary stock. This result may occur in a case in which the excluded COD income of one subsidiary (the first subsidiary) is not fully applied to reduce attributes and the excluded COD income of another subsidiary (the second subsidiary) is applied to reduce attributes in the first subsidiary's chain. The IRS and Treasury Department nevertheless believe that this result is not inappropriate as the reduction of an attribute in the first subsidiary's chain in respect of excluded COD income of the second subsidiary may avoid taking into account an excess loss account in the second subsidiary's stock.

Eighth, the taxable income (or loss) for the year of the disposition (and any prior years to which the deductions or losses may be carried) is computed. These amounts are calculated by applying the limitation on the use of S's deductions and losses to offset income computed pursuant to the first step, and by including the gain or loss recognized on the disposition of S stock computed pursuant to the preceding step. However, attributes that were tentatively used to offset income in the tentative computation of taxable income (or loss) in the fourth step and attributes that were tentatively reduced in the fifth step cannot offset any excess loss account taken into account as a result of excluded COD income not being fully applied to reduce attributes. This limitation gives effect to the requirement that the excess loss account be taken into account and avoids circular calculations. If an excess loss account that is taken into account as a result of excluded income could be offset by attributes that could be reduced in respect of the excluded COD income, the use of attributes to offset the excess loss account could result in fewer attributes available for reduction and a greater amount of excluded COD income that was not applied to reduce attributes, which, in turn, would increase the amount of the excess loss account required to be taken into account. Ultimately, the inclusion of the excess loss account and the realization of excluded COD income could have no effect on the

overall tax liability of the group, thereby rendering meaningless the requirement to take into account the excess loss account.

Ninth, the excluded COD income is actually applied to reduce attributes pursuant to the rules of sections 108 and 1017 and §1.1502–28T. Only those attributes remaining after the actual computations of taxable income (or loss) pursuant to the eighth step are subject to reduction in the ninth step. In certain cases, however, the reduction of attributes will be limited to prevent circular calculations. The proposed regulations include two rules in this regard.

The first rule provides that when S or a subsidiary of S realizes excluded COD income, the aggregate amount of excluded COD income that is applied to reduce attributes attributable to members other than S and any lower-tier corporation of S cannot exceed the aggregate amount of excluded COD income that is applied to reduce attributes attributable to members other than S and any lower-tier corporation of S pursuant to the fifth step (tentative reduction of attributes). Without this limitation, the amount of excluded COD income applied to reduce attributes could exceed the amount of excluded COD income applied to reduce attributes in the fifth step, which would result in a greater positive adjustment (or a lesser negative adjustment) to the basis of the S stock compared to that made in the sixth step, and reduce the gain (or increase the loss) recognized on the disposition of the S stock, which might increase the attributes available for reduction and the amount of excluded COD income applied to reduce attributes.

The second rule provides that when a member other than S or a subsidiary of S realizes excluded COD income, the aggregate amount of excluded COD income that is applied to reduce attributes (other than credits) attributable to S and any lower-tier corporation of S cannot exceed the aggregate amount of excluded COD income that is applied to reduce attributes (other than credits) attributable to S and any lower-tier corporation of S in the fifth step. Without this limitation, the amount of excluded COD income applied to reduce the attributes (other than credits) attributable to S or a subsidiary of S could exceed the amount of excluded COD income applied to reduce the attributes (other than credits) attributable to S or a subsidiary of S in the fifth step, which would result in a lesser positive adjustment (or a greater negative adjustment) to the basis of the S stock compared to that made in the sixth step, and increase the gain (or decrease the loss) recognized on the disposition of the S stock, which might decrease the attributes of S's shareholder available for reduction, increase the reduction of S's attributes, and result in a lesser positive adjustment (or a greater negative adjustment) to the basis of the S stock.

The IRS and Treasury Department are aware that the foregoing methodology does not prevent circular calculations in all cases, specifically certain cases in which there is a disposition of the stock of more than one subsidiary. The IRS and Treasury Department request comments regarding whether rules preventing circular calculations in these other cases are necessary. If such rules are necessary, the IRS and Treasury Department request comments regarding the approach that those rules should adopt.

Given the difficulty of the problem addressed by these regulations, the IRS and Treasury Department request comments regarding these rules prior to making them effective. Therefore, the rules described above are proposed. Before these rules are adopted as temporary or final regulations, taxpayers may rely on the rules proposed in these regulations.

Special Analysis

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. Further, 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 these regulations will primarily affect affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing 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 hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is Marie C. Milnes-Vasquez 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 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 1.1502–28 also issued under 26 U.S.C. 1502. * * *

Par. 2. Section 1.1502–11 is amended by:

1. Revising paragraph (b)(1).
2. Redesignating paragraph (c) as paragraph (d).
3. Adding new paragraph (c).

The revision and addition read as follows:

§1.1502–11 Consolidated taxable income.

* * * * *

(b) *Elimination of circular stock basis adjustments when there is no excluded*

COD income—(1) *In general*. If one member (P) disposes of the stock of another member (S), this paragraph (b) limits the use of S's deductions and losses in the year of disposition and the carryback of items to prior years. The purpose of the limitation is to prevent P's income or gain from the disposition of S's stock from increasing the absorption of S's deductions and losses, because the increased absorption would reduce P's basis (or increase its excess loss account) in S's stock under §1.1502–32 and, in turn, increase P's income or gain. See paragraph (b)(3) of this section for the application of these principles to P's deduction or loss from the disposition of S's stock, and paragraph (b)(4) of this section for the application of these principles to multiple stock dispositions. This paragraph (b) applies only when no member realizes discharge of indebtedness income that is excluded from gross income under section 108(a) (excluded COD income) during the taxable year of the disposition. See paragraph (c) of this section for rules that apply when a member realizes excluded COD income during the taxable year of the disposition. See §1.1502–19(c) for the definition of disposition.

* * * * *

(c) *Elimination of circular stock basis adjustments when there is excluded COD income*—(1) *In general*. If one member (P) disposes of the stock of another member (S) in a year during which any member realizes excluded COD income, this paragraph (c) limits the use of S's deductions and losses in the year of disposition and the carryback of items to prior years, the amount of the attributes of certain members that can be reduced in respect of excluded COD income of certain other members, and the attributes that can be used to offset an excess loss account taken into account by reason of the application of §1.1502–19(c)(1)(iii)(B). In addition to the purpose set forth in paragraph (b)(1) of this section, the purpose of these limitations is to prevent the reduction of tax attributes in respect of excluded COD income from affecting P's income, gain, or loss on the disposition of S stock (including a disposition of S stock that results from the application of §1.1502–19(c)(1)(iii)(B)) and, in turn, affecting the attributes available for reduction pursuant to sections 108 and 1017 and §1.1502–28T.

(2) *Computation of taxable income, reduction of attributes, and computation of limits on absorption and reduction of attributes*. If a member realizes excluded COD income in the taxable year during which P disposes of S stock, the steps used to compute taxable income (or loss), to effect the reduction of attributes, and to compute the limitations on the absorption and reduction of attributes are as follows. These steps also apply to determine whether and to what extent an excess loss account must be taken into account as a result of the application of §§1.1502–19(c)(1)(iii)(B) and 1.1502–19T(b)(1).

(i) *Limitation on deductions and losses to offset income or gain*. First, the determination of the extent to which S's deductions and losses for the tax year of the disposition (and its deductions and losses carried over from prior years) may offset income and gain is made pursuant to §1.1502–11(b)(2) and (3).

(ii) *Tentative adjustment of stock basis*. Second, §§1.1502–32 and 1.1502–32T are tentatively applied to adjust the basis of the S stock to reflect the amount of S's unlimited deductions and losses that are absorbed in the tentative computation of taxable income (or loss) for the year of the disposition (and any prior years to which the deductions or losses may be carried) that is made pursuant to §1.1502–11(b)(2), but not to reflect the realization of excluded COD income and the reduction of attributes in respect thereof.

(iii) *Tentative computation of stock gain or loss*. Third, in the case of a disposition of S stock that does not result from the application of §1.1502–19(c)(1)(iii)(B), P's income, gain, or loss from the disposition of S stock is computed. For this purpose, the result of the computation pursuant to paragraph (c)(2)(ii) of this section is treated as the basis of such stock.

(iv) *Tentative computation of taxable income (or loss)*. Fourth, taxable income (or loss) for the year of disposition (and any prior years to which the deductions or losses may be carried) is tentatively computed. For this purpose, in the case of a disposition of S stock that does not result from the application of §1.1502–19(c)(1)(iii)(B), the tentative computation of taxable income (loss) takes into account P's income, gain, or loss from the disposition of S stock computed pursuant to paragraph (c)(2)(iii) of this section. The tentative computation of taxable income (loss) is made without regard to whether all or a portion of an excess loss account in a share of S is required to be taken into account pursuant to §§1.1502–19(c)(1)(iii)(B) and 1.1502–19T(b)(1).

(v) *Tentative reduction of attributes*. Fifth, the rules of sections 108 and 1017 and §1.1502–28T are tentatively applied to reduce the attributes remaining after the tentative computation of taxable income (or loss) pursuant to paragraph (c)(2)(iv) of this section.

(vi) *Actual adjustment of stock basis*. Sixth, §§1.1502–32 and 1.1502–32T are applied to reflect the amount of S's unlimited deductions and losses that are absorbed in the tentative computation of taxable income (or loss) for the year of the disposition (and any prior years to which the deductions or losses may be carried) made pursuant to paragraph (c)(2)(iv) of this section, and the excluded COD income applied to reduce attributes and the attributes tentatively reduced in respect of the excluded COD income pursuant to paragraph (c)(2)(v) of this section.

(vii) *Actual computation of stock gain or loss*. Seventh, the group's actual gain or loss on the disposition of S stock (including a disposition that results from the application of §1.1502–19(c)(1)(iii)(B)) is computed. The result of the computation pursuant to paragraph (c)(2)(vi) of this section is treated as the basis of such stock.

(viii) *Actual computation of taxable income (or loss)*. Eighth, taxable income (or loss) for the year of the disposition (and any prior years to which the deductions or losses may be carried) is computed. The group's actual consolidated taxable income (or loss) for the year of the disposition is computed by applying the limitation computed pursuant to paragraph (c)(2)(i) of this section, and by including the gain or loss recognized on the disposition of S stock computed pursuant to paragraph (c)(2)(vii) of this section. However, attributes that were tentatively used to offset income pursuant to paragraph (c)(2)(iv) of this section and attributes that were tentatively reduced pursuant to paragraph (c)(2)(v) of this section cannot offset any excess loss account

taken into account as a result of the application of §§1.1502–19(c)(1)(iii)(B) and 1.1502–19T(b)(1).

(ix) *Actual reduction of attributes*. Ninth, the rules of sections 108 and 1017 and §1.1502–28T are actually applied to reduce the attributes remaining after the actual computation of taxable income (or loss) pursuant to paragraph (c)(2)(viii) of this section.

(A) *S or a lower-tier corporation realizes excluded COD income*. If S or a lower-tier corporation of S realizes excluded COD income, the aggregate amount of excluded COD income that is applied to reduce attributes attributable to members other than S and any lower-tier corporation of S pursuant to this paragraph (c)(2)(ix) shall not exceed the aggregate amount of excluded COD income that was tentatively applied to reduce attributes attributable to members other than S and any lower-tier corporation of S pursuant to paragraph (c)(2)(v) of this section. The amount of the actual reduction of attributes attributable to S and any lower-tier corporation of S that may be reduced in respect of the excluded COD income of S or a lower-tier corporation of S shall not be so limited.

(B) *A member other than S or a lower-tier corporation realizes excluded COD income*. If a member other than S or a lower-tier corporation of S realizes excluded COD income, the aggregate amount of excluded COD income that is applied to reduce attributes (other than credits) attributable to S and any lower-tier corporation of S pursuant to this paragraph (c)(2)(ix) shall not exceed the aggregate amount of excluded COD income that was tentatively applied to reduce attributes (other than credits) attributable to S and any lower-tier corporation of S pursuant to paragraph (c)(2)(v) of this section. The amount of the actual reduction of attributes attributable to any member other than S and any lower-tier corporation of S that may be reduced in respect of the excluded COD income of S or a lower-tier corporation of S shall not be so limited.

(3) *Special rules*. (i) If the reduction of attributes attributable to a member is prevented as a result of a limitation described in paragraph (c)(2)(ix)(B) of this section, the excluded COD income that would have otherwise been applied to reduce such attributes is applied to reduce the remaining attributes of the same type that are available for reduction under §1.1502–28T(a)(4), on a *pro rata* basis, prior to reducing attributes of a different type. The reduction of such remaining attributes, however, is subject to any applicable limitation described in paragraph (c)(2)(ix)(B) of this section.

(ii) To the extent S's deductions and losses in the year of disposition (or those of a lower-tier corporation of S) cannot offset income or gain because of the limitation under paragraph (b) of this section or this paragraph (c) and are not reduced pursuant to sections 108 and 1017 and §1.1502–28T, such items are carried to other years under the applicable provisions of the Internal Revenue Code and regulations as if they were the only items incurred by S (or a lower-tier corporation of S) in the year of disposition. For example, to the extent S incurs an operating loss in the year of disposition that is limited and is not reduced pursuant to section 108 and §1.1502–28T, the loss is treated as a separate net operating loss attributable to S arising in that year.

(4) *Definition of lower-tier corporation*. A corporation is a lower-tier corporation of S if all of its items of income, gain, deduction, and loss (including the absorption of deduction or loss and the reduction of attributes other than credits) would be fully reflected in P's basis in S's stock under §1.1502–32.

(5) *Examples*. For purposes of the examples in this paragraph (c), unless otherwise stated, the tax year of all persons is the calendar year, all persons use the accrual method of accounting, the facts set forth the only corporate activity, all transactions are between unrelated persons, tax liabilities are disregarded, and no election under section 108(b)(5) is made. The principles of this paragraph (c) are illustrated by the following examples:

Example 1. Departing member realizes excluded COD income. (i) *Facts*. P owns all of S's stock with a $90 basis. For Year 1, P has ordinary income of $30, and S has an $80 ordinary loss and $100 of excluded COD income from the discharge of non-intercompany indebtedness. P sells the S stock for $20 at the close of Year 1. As of the beginning of Year 2, S has Asset A with a basis of $0 and a fair market value of $20.

(ii) *Analysis*. The steps used to compute the group's consolidated taxable income, to effect the reduction of attributes, and to compute the limitations on the use and reduction of attributes are as follows:

(A) *Computation of limitation on deductions and losses to offset income or gain*. To determine the amount of the limitation under paragraph (c)(2)(i) of this section on S's loss and the effect of the absorption of S's loss on P's basis in S's stock under §1.1502–32(b), P's gain or loss from the disposition of S's stock is not taken into account. The group is tentatively treated as having a consolidated net operating loss of $50 (P's $30 of income minus S's $80 loss). Under the principles of §1.1502–21T(b)(2)(iv), all of such loss is attributable to S.

(B) *Tentative adjustment of stock basis*. Then, pursuant to paragraph (c)(2)(ii) of this section, §§1.1502–32 and 1.1502–32T are tentatively applied to adjust the basis of S stock. For this purpose, however, adjustments attributable to the excluded COD income and the reduction of attributes in respect thereof are not taken into account. Under §1.1502–32(b), the absorption of $30 of S's loss decreases P's basis in S's stock by $30 to $60.

(C) *Tentative computation of stock gain or loss*. Then, P's income, gain, or loss from the sale of S stock is computed pursuant to paragraph (c)(2)(iii) of this section using the basis computed in the previous step. Thus, P is treated as recognizing a $40 loss from the sale of S stock.

(D) *Tentative computation of taxable income (or loss)*. Pursuant to paragraph (c)(2)(iv) of this section, taxable income (or loss) for the year of disposition (and any prior years to which the deductions or losses may be carried) is then tentatively computed, taking into account P's $40 loss on the sale of the S stock computed pursuant to paragraph (c)(2)(iii) of this section. The group has a $50 consolidated net operating loss for Year 1 that, under the principles of §1.1502–21T(b)(2)(iv), is wholly attributable to S and a consolidated capital loss of $40 that, under the principles of §1.1502–21T(b)(2)(iv), is wholly attributable to P.

(E) *Tentative reduction of attributes*. Next, pursuant to paragraph (c)(2)(v) of this section, the rules of sections 108 and 1017 and §1.1502–28T are tentatively applied to reduce attributes remaining after the tentative computation of taxable income (or loss). Pursuant to §1.1502–28T(a)(2), the tax attributes attributable to S would first be reduced to take into account its $100 of excluded COD income. Accordingly, the consolidated net operating loss for Year 1 would be reduced by $50 to $0. Then, pursuant to §1.1502–28T(a)(4), S's remaining $50 of excluded COD income would reduce the consolidated capital loss attributable to P of $40 by $40 to $0. The remaining $10 of excluded COD income would have no effect.

(F) *Actual adjustment of stock basis*. Pursuant to paragraph (c)(2)(vi) of this section, §§1.1502–32 and 1.1502–32T are applied to reflect the amount of S's unlimited deductions and losses that are absorbed in the tentative computation of taxable income (or loss) for the year of the disposition (and any prior years to which the deductions or losses may be carried) and the excluded COD income tentatively applied to reduce attributes and the attributes reduced in respect of the excluded COD income pursuant to the previous step. Under §1.1502–32(b), the absorption of $30 of S's loss, the application of $90 of S's excluded COD income to reduce attributes of P and S, and the reduction of the $50 loss attributable to S in respect of the excluded COD income results in a positive adjust-

ment of $10 to P's basis in the S stock. P's basis in the S stock, therefore, is $100.

(G) *Actual computation of stock gain or loss.* Pursuant to paragraph (c)(2)(vii) of this section, P's actual gain or loss on the sale of the S stock is computed using the basis computed in the previous step. Accordingly, P recognizes an $80 loss on the disposition of the S stock.

(H) *Actual computation of taxable income (or loss).* Pursuant to paragraph (c)(2)(viii) of this section, taxable income (or loss) is computed by taking into account P's $80 loss from the sale of S stock. Before the application of §1.1502–28T, the group, therefore, has a consolidated net operating loss of $50 that is wholly attributable to S under the principles of §1.1502–21T(b)(2)(iv), and a consolidated capital loss of $80 that is wholly attributable to P under the principles of §1.1502–21T(b)(2)(iv).

(I) *Actual reduction of attributes.* Pursuant to paragraph (c)(2)(ix) of this section, sections 108 and 1017 and §1.1502–28T are then actually applied to reduce attributes remaining after the actual computation of taxable income (or loss). Pursuant to section 108(b)(4)(B) and §1.1502–28T(a), the consolidated net operating loss attributable to S under the principles of §1.1502–21T(b)(2)(iv) is reduced first. Accordingly, the operating loss for Year 1 that S would otherwise carry forward is reduced by $50 to $0. Then, pursuant to §1.1502–28T(a)(4), S's remaining $50 of excluded COD income reduces consolidated tax attributes. In particular, without regard to the limitation imposed by paragraph (c)(2)(ix)(A) of this section, the $80 consolidated capital loss, which under the principles of §1.1502–21T(b)(2)(iv) is attributable to P, would be reduced by $50 from $80 to $30. However, the limitation imposed by paragraph (c)(2)(ix)(A) of this section prevents the reduction of the consolidated capital loss attributable to P by more than $40. Therefore, the consolidated capital loss attributable to P is reduced by only $40 in respect of S's excluded COD income. The remaining $10 of excluded COD income has no effect.

Example 2. Member other than departing member realizes excluded COD income. (i) *Facts.* P owns all of S1's and S2's stock. P's basis in S2's stock is $600. For Year 1, P has ordinary income of $30, S1 has a $100 ordinary loss and $100 of excluded COD income from the discharge of non-intercompany indebtedness, and S2 has $200 of ordinary loss. P sells the S2 stock for $600 at the close of Year 1. As of the beginning of Year 2, S1 has Asset A with a basis of $0 and a fair market value of $10.

(ii) *Analysis.* The steps used to compute the group's consolidated taxable income, to effect the reduction of attributes, and to compute the limitations on the use and reduction of attributes are as follows:

(A) *Computation of limitation on deductions and losses to offset income or gain.* To determine the amount of the limitation under paragraph (c)(2)(i) of this section on S2's loss and the effect of the absorption of S2's loss on P's basis in S2's stock under §1.1502–32(b), P's gain or loss from the sale of S2 stock is not taken into account. The group is tentatively treated as having a consolidated net operating loss of $270 (P's $30 of income minus S1's $100 loss and S2's $200 loss). Consequently, $20 of S2's loss from Year 1 is unlimited and $180 of S2's loss from Year 1 is limited under paragraph (c)(2)(i) of this section.

(B) *Tentative adjustment of stock basis.* Then, pursuant to paragraph (c)(2)(ii) of this section, §§1.1502–32 and 1.1502–32T are tentatively applied to adjust the basis of S2 stock. For this purpose, however, adjustments to the basis of S2 stock attributable to the reduction of attributes in respect of S1's excluded COD income are not taken into account. Under §1.1502–32(b), the absorption of $20 of S2's loss decreases P's basis in S2's stock by $20 to $580.

(C) *Tentative computation of stock gain or loss.* Then, P's income, gain, or loss from the disposition of S2 stock is computed pursuant to paragraph (c)(2)(iii) of this section using the basis computed in the previous step. Thus, P is treated as recognizing a $20 gain from the sale of the S2 stock.

(D) *Tentative computation of taxable income (or loss).* Pursuant to paragraph (c)(2)(iv) of this section, taxable income (or loss) for the year of disposition (and any prior years to which the deductions or losses may be carried) is then tentatively computed, taking into account P's $20 gain from the sale of S2 stock. P's $20 gain from the sale of S2's stock is offset by $20 of S1's loss. Therefore, the group is tentatively treated as having a consolidated net operating loss of $250, $70 of which is attributable to S1 and $180 of which is attributable to S2 under the principles of §1.1502–21T(b)(2)(iv).

(E) *Tentative reduction of attributes.* Next, pursuant to paragraph (c)(2)(v) of this section, the rules of sections 108 and 1017 and §1.1502–28T are tentatively applied to reduce attributes remaining after the tentative computation of taxable income (or loss). Pursuant to §1.1502–28T(a)(2), the tax attributes attributable to S1 would first be reduced to take into account its $100 of excluded COD income. Accordingly, the consolidated net operating loss for Year 1 would be reduced by $70, the portion of the consolidated net operating loss attributable to S1 under the principles of §1.1502–21T(b)(2)(iv), to $0. Then, pursuant to §1.1502–28T(a)(4), S1's remaining $30 of excluded COD income would reduce the consolidated net operating loss attributable to S2 of $180 by $30 to $150.

(F) *Actual adjustment of stock basis.* Pursuant to paragraph (c)(2)(vi) of this section, §§1.1502–32 and 1.1502–32T are applied to reflect the amount of S2's unlimited deductions and losses that are absorbed in the tentative computation of taxable income (or loss) for the year of the disposition (and any prior years to which the deductions or losses may be carried) and the excluded COD income tentatively applied to reduce attributes and the attributes reduced in respect of the excluded COD income pursuant to the previous step. Under §1.1502–32(b), the absorption of $20 of S2's loss and the application of $30 of S1's excluded COD income to reduce attributes attributable to S2 results in a negative adjustment of $50 to P's basis in the S2 stock. P's basis in the S2 stock, therefore, is $550.

(G) *Actual computation of stock gain or loss.* Pursuant to paragraph (c)(2)(vii) of this section, P's actual gain or loss on the sale of the S2 stock is computed using the basis computed in the previous step. Therefore, P recognizes a $50 gain on the disposition of the S2 stock.

(H) *Actual computation of taxable income (or loss).* Pursuant to paragraph (c)(2)(viii) of this section, taxable income (or loss) is computed by taking into account P's $50 gain from the disposition of the S2 stock. Before the application of §1.1502–28T, therefore, the group has a consolidated net operating loss of $220, $40 of which is attributable to S1 and $180 of which is attributable to S2 under the principles of §1.1502–21T(b)(2)(iv).

(I) *Actual reduction of attributes.* Pursuant to paragraph (c)(2)(ix) of this section, sections 108 and 1017 and §1.1502–28T are then actually applied to reduce attributes remaining after the actual computation of taxable income (or loss). Pursuant to §1.1502–28T(a)(2), the tax attributes attributable to S1 must first be reduced to take into account its $100 of excluded COD income. Accordingly, pursuant to section 108(b)(4)(B) and §1.1502–28T(a), the net operating loss attributable to S1 under the principles of §1.1502–21T(b)(2)(iv) is reduced first. The consolidated net operating loss for Year 1 is reduced by $40, the portion of the consolidated net operating loss attributable to S1 under the principles of §1.1502–21T(b)(2)(iv), to $0. Then, pursuant to §1.1502–28T(a)(4), without regard to the limitation imposed by paragraph (c)(2)(ix)(B) of this section, S1's remaining $60 of excluded COD income would reduce S2's net operating loss of $180 to $120. However, the limitation imposed by paragraph (c)(2)(ix)(B) of this section prevents the reduction of S2's loss by more than $30. Therefore, S2's loss of $180 is reduced by $30 to $150 in respect of S1's excluded COD income. The remaining $30 of excluded COD income has no effect.

Example 3. Lower-tier corporation of departing member realizes excluded COD income. (i) *Facts.* P owns all of S1's stock, S2's stock, and S3's stock. S1 owns all of S4's stock. P's basis in S1's stock is $50 and S1's basis in S4 stock is $50. For Year 1, P has $50 of ordinary loss, S1 has $100 of ordinary loss, S2 has $150 of ordinary loss, S3 has $50 of ordinary loss, and S4 has $50 of ordinary loss and $80 of excluded COD income from the discharge of non-intercompany indebtedness. P sells the S1 stock for $100 at the close of Year 1. As of the beginning of Year 2, S4 has Asset A with a basis of $0 and a fair market value of $10.

(ii) *Analysis.* The steps used to compute the group's consolidated taxable income, to effect the reduction of attributes, and to compute the limitations on the use and reduction of attributes are as follows:

(A) *Computation of limitation on deductions and losses to offset income or gain.* To determine the amount of the limitation under paragraph (c)(2)(i) of this section on S1's and S4's losses and the effect of the absorption of S1's and S4's losses on P's basis in S1's stock under §1.1502–32(b), P's gain or loss from the disposition of S1's stock is not taken into account. The group is tentatively treated as having a consolidated net operating loss of $400. Consequently, $100 of S1's loss and $50 of S4's loss is limited under paragraph (c)(2)(i) of this section.

(B) *Tentative adjustment of stock basis.* Then, pursuant to paragraph (c)(2)(ii) of this section, §§1.1502–32 and 1.1502–32T are tentatively applied to adjust the basis of S stock. For this purpose, adjustments to the basis of S1 stock attributable to S4's realization of excluded COD income and the reduction of attributes in respect of such excluded COD income are not taken into account. There is no adjustment under §1.1502–32 to the basis of the S1 stock. Therefore, P's basis in the S1 stock for this purpose is $50.

(C) *Tentative computation of stock gain or loss*. Then, P's income, gain, or loss from the sale of S1 stock is computed pursuant to paragraph (c)(2)(iii) of this section using the basis computed in the previous step. Thus, P is treated as recognizing a $50 gain from the sale of the S1 stock.

(D) *Tentative computation of taxable income (or loss)*. Pursuant to paragraph (c)(2)(iv) of this section, taxable income (or loss) for the year of disposition (and any prior years to which the deductions or losses may be carried) is tentatively computed, taking into account P's $50 gain from the sale of the S1 stock computed pursuant to the previous step. P's $50 gain from the sale of the S1 stock is offset by $10 of P's loss, $30 of S2's loss, and $10 of S3's loss. Therefore, the group is tentatively treated as having a consolidated net operating loss of $350, $40 of which is attributable to P, $100 of which is attributable to S1, $120 of which is attributable to S2, $40 of which is attributable to S3, and $50 of which is attributable to S4 under the principles of §1.1502–21T(b)(2)(iv).

(E) *Tentative reduction of attributes*. Next, pursuant to paragraph (c)(2)(v) of this section, the rules of sections 108 and 1017 and §1.1502–28T are tentatively applied to reduce attributes remaining after the tentative computation of taxable income (or loss). Pursuant to §1.1502–28T(a)(2), the tax attributes attributable to S4 would first be reduced to take into account its excluded COD income in the amount of $80. Accordingly, the consolidated net operating loss attributable to S4 would be reduced by $50 to $0. Then, pursuant to §1.1502–28T(a)(4), S4's remaining $30 of excluded COD income would reduce the consolidated net operating loss for Year 1 that is attributable to other members. Therefore, the consolidated net operating loss for Year 1 would be reduced by $30. Of that amount, $4 is attributable to P, $10 is attributable to S1, $12 is attributable to S2, and $4 is attributable to S3.

(F) *Actual adjustment of stock basis*. Pursuant to paragraph (c)(2)(vi) of this section, §§1.1502–32 and 1.1502–32T are applied to reflect the amount of S1's and S4's unlimited deductions and losses that are absorbed in the tentative computation of taxable income (or loss) for the year of the disposition (and any prior years to which the deductions or losses may be carried) and the excluded COD income tentatively applied to reduce attributes and the attributes reduced in respect of the excluded COD income pursuant to the previous step. Under §1.1502–32(b), the application of $80 of S4's excluded COD income to reduce attributes, and the reduction of S4's loss in the amount of $50 and S1's loss in the amount of $10 in respect of the excluded COD income results in a positive adjustment of $20 to P's basis in the S1 stock. Accordingly, P's basis in S1 stock is $70.

(G) *Actual computation of stock gain or loss*. Pursuant to paragraph (c)(2)(vii) of this section, P's actual gain or loss on the sale of the S1 stock is computed using the basis computed in the previous step. Accordingly, P recognizes a $30 gain on the disposition of the S1 stock.

(H) *Actual computation of taxable income (or loss)*. Pursuant to paragraph (c)(2)(viii) of this section, the group's taxable income or loss is then computed by taking into account P's $30 gain from the sale of S1 stock. Before the application of §1.1502–28T, therefore, the group has a consolidated net operating loss of $370, $44 of which is attributable to P, $100 of which is attributable to S1, $132 of which is attributable to S2, $44 of which is attributable to S3, and $50 of which is attributable to S4.

(I) *Actual reduction of attributes*. Pursuant to paragraph (c)(2)(ix) of this section, sections 108 and 1017 and §1.1502–28T are then actually applied to reduce attributes remaining after the actual computation of taxable income (or loss). Pursuant to §1.1502–28T(a)(2), the tax attributes attributable to S4 must first be reduced to take into account its $80 of excluded COD income. Accordingly, the consolidated net operating loss attributable to S4 is reduced by $50 to $0. Then, pursuant to §1.1502–28T(a)(4), S4's remaining $30 of excluded COD income reduces the consolidated net operating loss for Year 1. Therefore, without regard to the limitation imposed by paragraph (c)(2)(ix)(B) of this section, the consolidated net operating loss for Year 1 would be reduced by $30 ($4.12 of the consolidated net operating loss attributable to P, $9.38 of the consolidated net operating loss attributable to S1, $12.38 of the consolidated net operating loss attributable to S2, and $4.12 of the consolidated net operating loss attributable to S3) to $290. However, the limitation imposed by paragraph (c)(2)(ix)(B) of this section prevents the reduction of the consolidated net operating loss attributable to P, S2, and S3 by more than $4, $12, and $4 respectively. The $.62 of excluded COD income that would have otherwise reduced the consolidated net operating loss attributable to P, S2, and S3 is applied to reduce the consolidated net operating loss attributable to S1. Therefore, S1 carries forward $90 of loss.

Example 4. Excess loss account taken into account. (i) *Facts*. P is the common parent of a consolidated group. On Day 1 of Year 2, P acquired all of the stock of S1. As of the beginning of Year 2, S1 had a $30 net operating loss carryover from Year 1, a separate return limitation year. A limitation under §1.1502–21(c) applies to the use of that loss by the P group. For Years 1 and 2, the P group had no consolidated taxable income or loss. On Day 1 of Year 3, S1 acquired all of the stock of S2 for $10. In Year 3, P had ordinary income of $10, S1 had ordinary income of $25, and S2 had an ordinary loss of $50. In addition, in Year 3, S2 realized $20 of excluded COD income from the discharge of non-intercompany indebtedness. After the discharge of this indebtedness, S2 had no liabilities. As of the beginning of Year 4, S2 had Asset A with a basis of $0 and a fair market value of $10. S2 had no taxable income (or loss) for Year 1 and Year 2.

(ii) *Analysis*. The steps used to compute the group's consolidated taxable income, to effect the reduction of attributes, and to compute the limitations on the use and reduction of attributes are as follows:

(A) *Computation of limitation on deduction and losses to offset income or gain, tentative basis adjustments, tentative computation of stock gain or loss*. Because it is not initially apparent that there has been a disposition of stock, paragraph (c)(2)(i) of this section does not limit the use of deductions to offset income or gain, no adjustments to the basis are required pursuant to paragraph (c)(2)(ii) of this section, and no stock gain or loss is computed pursuant to paragraph (c)(2)(iii) of this section or taken into account in the tentative computation of taxable income pursuant to paragraph (c)(2)(iv) of this section.

(B) *Tentative computation of taxable income (or loss)*. Pursuant to paragraph (c)(2)(iv) of this section, the group's taxable income (or loss) for Year 3 (and any prior years to which the deductions or losses may be carried) is tentatively computed. For Year 3, the P group has a consolidated taxable loss of $15, all of which is attributable to S2 under the principles of §1.1502–21T(b)(2)(iv).

(C) *Tentative reduction of attributes*. Next, pursuant to paragraph (c)(2)(v) of this section, the rules of sections 108 and 1017 and §1.1502–28T are tentatively applied to reduce attributes remaining after the tentative computation of consolidated taxable loss. Pursuant to §1.1502–28T(a)(2), the tax attributes attributable to S2 would first be reduced to take into account its excluded COD income of $20. Accordingly, the net operating loss attributable to S2 under the principles of §1.1502–21T(b)(2)(iv) is reduced first. Therefore, the consolidated net operating loss for Year 3 is reduced by $15, the portion of the consolidated net operating loss attributable to S2, to $0. The remaining $5 of excluded COD income is not applied to reduce attributes as there are no remaining attributes that are subject to reduction.

(D) *Actual adjustment of stock basis*. Pursuant to paragraph (c)(2)(vi) of this section, §§1.1502–32 and 1.1502–32T are applied to reflect the amount of S2's unlimited deductions and losses that are absorbed in the tentative computation of taxable income (or loss) for the year of the disposition (and any prior years to which the deductions or losses may be carried) and the excluded COD income tentatively applied to reduce attributes and the attributes reduced in respect of the excluded COD income pursuant to the previous step. Pursuant to §§1.1502–32 and 1.1502–32T, the absorption of $35 of S2's loss, the application of $15 in respect of S2's excluded COD income to reduce attributes, and the reduction of $15 in respect of the loss attributable to S2 reduced in respect of the excluded COD income results in a negative adjustment of $35 to the basis of the S2 stock. Therefore, S1 has an excess loss account of $25 in the S2 stock.

(E) *Actual computation of stock gain or loss*. Pursuant to paragraph (c)(2)(vii) of this section, S1's actual gain or loss, if any, on the S2 stock is computed. Because S2 realized $5 of excluded COD income that was not applied to reduce attributes, pursuant to §§1.1502–19(c)(1)(iii)(B) and 1.1502–19T(b)(1), S1 is required to take into account $5 of its excess loss account in the S2 stock.

(F) *Actual computation of taxable income (or loss)*. Pursuant to paragraph (c)(2)(viii) of this section, the group's taxable income or loss is computed taking into account the $5 of the excess loss account in the S2 stock required to be taken into account. See §1.1502–28T(b)(6) (requiring an excess loss account that is required to be taken into account as a result of the application of §1.1502–19(c)(1)(iii)(B) to be included in the group's consolidated taxable income for the year that includes the date of the debt discharge). However, pursuant to paragraph (c)(2)(viii) of this section, such amount may not be offset by any of the consolidated net operating loss attributable to S2. It may, however, subject to applicable limitations, be offset by the separate net operating loss of S1 from Year 1.

(G) *Actual reduction of attributes*. Pursuant to paragraph (c)(2)(ix) of this section, sections 108 and 1017 and §1.1502–28T are then actually applied to

reduce attributes remaining after the actual computation of taxable income (or loss). Attributes will be actually reduced in the same way that they were tentatively reduced.

(6) *Additional rules for multiple dispositions*. [Reserved].

(7) *Effective date*. This paragraph (c) applies to dispositions of subsidiary stock that occur after the date these regulations are published as temporary or final regulations in the **Federal Register**. Taxpayers may apply this paragraph (c), as contained in these proposed regulations, in whole, but not in part, to any disposition of subsidiary stock that occurs before the date these regulations are published as temporary or final regulations in the **Federal Register**.

Par. 3. Section 1.1502–13 is revised to read as follows:

§1.1502–13 Intercompany transactions.

[The text of this proposed section is the same as the text of §1.1502–13T(g)(3)(ii)(B) published elsewhere in this issue of the Bulletin].

Par. 4. Section 1.1502–28 is amended to read as follows:

1. Adding paragraphs (b)(4), (b)(5), (b)(6) and (b)(7).

2. Revising paragraph (d).

3. The additions and revision read as follows:

§1.1502–28 Consolidated section 108.

* * * * *

(b)(4) and (5) [The text of paragraphs (b)(4) and(5) is the same as the text of §1.1502–28T(b)(4) and (5) published elsewhere in this issue of the Bulletin].

(6) *Taking into account of excess loss account*—(i) *Determination of inclusion*. The determination of whether any portion of an excess loss account in a share of stock of a subsidiary that realizes excluded COD income is required to be taken into account as a result of the application of §1.1502–19(c)(1)(iii)(B) is made after the determination of taxable income (or loss) for the year during which the member realizes excluded COD income (without regard to whether any portion of an excess loss account in a share of the subsidiary is required to be taken into account) and any prior years to which the deductions or losses of the subsidiary may be carried, after the reduction of tax attributes pursuant to sections 108 and 1017, and this section, and after the adjustment of the basis of the share of stock of the subsidiary pursuant to §1.1502–32 to reflect the amount of the subsidiary's deductions and losses that are absorbed in the computation of taxable income (or loss) for the year of the disposition and any prior years to which the deductions or losses may be carried, and the excluded COD income applied to reduce attributes and the attributes reduced in respect thereof. See §1.1502–11(c) for special rules related to the computation of taxable income (or loss) that apply when an excess loss account is required to be taken into account.

(ii) [The text of paragraph (b)(6)(ii) is the same as the text of §1.1502–28T(b)(6)(ii) published elsewhere in this issue of the Bulletin].

* * * * *

(7) *Dispositions of stock*. See §1.1502–11(c) for limitations on the reduction of tax attributes when a member disposes of stock of another member (including dispositions that result from the application of §1.1502–19(c)(1)(iii)(B)) during a taxable year in which any member realizes excluded COD income.

* * * * *

(d) *Effective dates*. (1) This section, other than paragraphs (a)(4), (b)(4), (b)(5), (b)(6), and (b)(7) of this section, applies to discharges of indebtedness that occur after August 29, 2003.

(2) Paragraph (a)(4) of this section applies to discharges of indebtedness that occur after August 29, 2003, but only if the discharge occurs during a taxable year the original return for which is due (without regard to extensions) after December 11, 2003. However, groups may apply paragraph (a)(4) of this section to discharges of indebtedness that occur after August 29, 2003, and during a taxable year the original return for which is due (without regard to extensions) on or before December 11, 2003. For discharges of indebtedness that occur after August 29, 2003, and during a taxable year the original return for which is due (without regard to extensions) on or before December 11, 2003, paragraph (a)(4) of this section shall apply as in effect on August 29, 2003.

(3) Paragraphs (b)(4), (b)(5), and (b)(6)(ii) of this section apply to discharges of indebtedness that occur after August 29, 2003, but only if the discharge occurs during a taxable year the original return for which is due (without regard to extensions) after March 12, 2004. However, groups may apply paragraphs (b)(4), (b)(5), and (b)(6)(ii) of this section to discharges of indebtedness that occur after August 29, 2003, and during a taxable year the original return for which is due (without regard to extensions) on or before March 12, 2004.

(4) Paragraphs (b)(6)(i) and (b)(7) of this section apply to discharges of indebtedness that occur after August 29, 2003, but only if the discharge occurs during a taxable year the original return for which is due (without regard to extensions) after the date these regulations are published as temporary or final regulations in the **Federal Register**. However, groups may apply paragraphs (b)(6)(i) and (b)(7) of this section to discharges of indebtedness that occur after August 29, 2003, and during a taxable year the original return for which is due (without regard to extensions) on or before the date these regulations are published as temporary or final regulations in the **Federal Register**.

* * * * *

Par. 5. The last sentence of paragraph (c) of §1.1502–80 is revised to read as follows:

§1.1502–80 Applicability of other provisions of law.

* * * * *

(c) * * * See §§1.1502–11(d) and 1.1502–35T for additional rules relating to stock loss.

* * * * *

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

(Filed by the Office of the Federal Register on March 12, 2004, 8:45 a.m., and published in the issue of the Federal Register for March 15, 2004, 69 F.R. 12091)

Foundations Status of Certain Organizations

Announcement 2004–25

The following organizations have failed to establish or have been unable to maintain their status as public charities or as op-

erating foundations. Accordingly, grantors and contributors may not, after this date, rely on previous rulings or designations in the Cumulative List of Organizations (Publication 78), or on the presumption arising from the filing of notices under section 508(b) of the Code. This listing does *not* indicate that the organizations have lost their status as organizations described in section 501(c)(3), eligible to receive deductible contributions.

Former Public Charities. The following organizations (which have been treated as organizations that are not private foundations described in section 509(a) of the Code) are now classified as private foundations:

1–2–3 Health Access, Inc., Milwaukee, WI
31st December Womens Movement, Washington, DC
1898 Foundation, Inc., Rockville, MD
ABC XXI-Child Awareness Program for Poland, Inc., Alexandria, VA
Academy of Missouri Educational Network of Graduate Dogs, Inc., Warrenton, MO
Accept the Challenge, Inc., Minneapolis, MN
Achievements Worldwide, Inc., Waldorf, MD
Adopt a Grandparent Foundation, Fairfield, IA
AFD Foundation, Inc., Southfield, MI
African American Institute for Empowerment, Inc., Waterbury, CT
African Heritage Foundation, Inc., Washington, DC
African Wholistic Health Association, Washington, DC
Afrikan Rites of Passage Delaware Kollective, Inc., Wilmington, DE
Alva Consortium, Inc., Washington, DC
Amani Clergy Coalition, Milwaukee, WI
America-China International Exchange Foundation, Inc., Washington, DC
American Charities Research Institute, Lincoln, NE
American Heritage Rivers Alliance, Inc., Washington, DC
American Recreational Services Association, Inc., Twin Falls, ID
American Service Dog Association, Manchester, MO
American Submarine Memorial Restoration Foundation, Inc., Fairfax, VA
Americans for Self Determination, Inc., Arlington, VA
Angels for Children Foundation, Incorporated, Northfield, MN
Apex Booster Club, Roseland, KS
Apocalypse Outreach Center, Inc., White Pigeon, MI
Apostolic Ministerial Alliance, Inc., Randallstown, MD
Ariadne Press of Maryland, Inc., Rockville, MD
Ark of Safety Center, Inc., St. Louis, MO
Arka Ballet, Takoma Park, MD
Arrowhead Regional Entrepreneurship Project, Inc., Duluth, MN
Artist on the Edge Ice Theater Company, Minneapolis, MN
Asnew Disability Support Services, Ames, IA
Association for Children and Infants With Digestive Disorders, Newark, DE
B. Tate Hibschman Memorial Scholarship Fund, Inc., Abingdon, MD
Backroads for Books, Olathe, KS
Baldwin City Clear Foundation, Baldwin City, KS
Baltimore Committee for International Wrestling, Inc., Cockeysville, MD
Baltimore Select, Inc., Baltimore, MD
Baltimore Teacher Network, Baltimore, MD
Bandoneon Association, Incorporated, Bethesda, MD
Bangladeshi-American Foundation, Inc., Potomac, MD
Baraboo Firefighters Fundraising Association, Inc., Baraboo, WI
Bea Gaddy Human Resources Center, Inc., Baltimore, MD
Beer Museum, Ltd., Oconomowoc, WI
Beginning Environment for Addiction Recovery, Fargo, ND
Bel Sogno, Inc., Waleska, GA
Benevolence Alliance International, Inc., West Union, IA
Benjamin Welch Owens Monument Fund, Inc., Upper Marlboro, MD
Berkley Community League, Inc., Norfolk, VA
Bertha Hughes Concert Series, Inc., Topeka, KS
Bethel A M E Church Foundation, Inc., Ann Arbor, MI
Better Community Foundation, Clayton, MO
Bible Search Publications, Inc., Winona, MN
Bigga Enterprises, Inc., St. Louis, MO
Bishop Bush Home Care, Clinton, MD
Black College Information Network, Inc., Washington, DC
Black West Presentations, Inc., Harrisonville, MO
Bobby Zipper Foundation, Inc., Baltimore, MD
Bolling View Corporation, Inc., Washington, DC
Boys and Girls Club of Dane County, Inc., Madison, WI
Branson Gospel Music Association, Branson, MO
Bread of Life Ministries International, Inc., Burnsville, MN
Brice Transitional Care Home, Inc., Baltimore, MD
Brighton Lions Community Den, Brighton, MI
Buchanan County Humane Society, Vansant, VA
Buffalo KS Historical Society, Inc., Buffalo, KS
Building Eminence Schools for Tomorrow, Eminence, MO
Busy Bee Early Learning Center, Inc., Linden, NJ
Butler County Veterans Memorial Fund, Poplar Bluff, MO
Butler Youth Wrestling Club, Butler, MO
C D E O, Laytonsville, MD
Cadott Hunter-Education Association, Inc., Cadott, WI
Calumet County Tourism Association, Inc., Chilton, WI
Cameras for Students, Silver Spring, MD
Camp Crystal Foundation, St. Louis, MO
Camp Grayling Historical Society, Camp Grayling, MI
Cannon Vermillion Watersheds Protection League, Welch, MN
Capital Area Astronomy Association, Potterville, MI
Capital Press Club, Washington, DC
Carlton Corporation I, Milwaukee, WI
Carpenter Medical Publishing, Inc., Washington, DC
Carroll County Genealogical Association, Carrollton, MO
Carrollsburg Residence Council, Inc., Washington, DC
Caryl Proud Horty Scholarship Fund Tr., Wilmington, DE
Cat Wrestling Club, Inc., Cedar Falls, IA
Cedar Vale Teen Center, Inc., Cedar Vale, KS
Celebration of Life Art Program, Minneapolis, MN

Center for Humanity, Montgomery Village, MD
Center for Patient Advocacy Foundation, McLean, VA
Center for Timett, Inc., Howell, NJ
Center for Workers Compensation Studies, Inc., Lacey, WA
Champbuilder Amateur Wrestling, Inc., Middleton, WI
Changing Faces, Inc., Baltimore, MD
Charles County Community Youth Center, Inc., Bryantown, MD
Chesapeake Deep Creek Hornets AAU Baseball Club, Chesapeake, VA
Chesapeake Dispute Resolution Center, Inc., Annapolis, MD
Chesapeake Habit Restoration Trust, Silver Spring, MD
Child Access Center, Inc., Baltimore, MD
Child Care Development, Inc., Wichita, KS
Child Intervention Center, Superior, WI
Childrens Book Bank, Kalamazoo, MI
Childrens Community Foundation, Shawnee Mission, KS
Childrens Rainbow Foundation, Parkville, MO
Childs Eyes Ministries, Hart, MI
Chilton Youth Football Association, Inc., Hilbert, WI
Choice Leaders of Tomorrow, Inc., St. Louis, MO
Christ the King Institute Women Auxiliary and Legionary Group, Silver Spring, MD
Christian Foundation, Inc., Madison, WI
Christian Law Enforcement Fellowship, Ann Arbor, MI
Citizens for Learning Everything-Amoco Negligence & Underground Clean Up, Sugar Creek, MO
Coldwater Scholarship Bowling, Inc., Coldwater, MI
Colesville Sports Association, Silver Spring, MD
Combat Disabled American Veterans, Stacy, MN
Community Care Programs, Inc., Middleton, WI
Community Caring for People, Inc., Sterling, VA
Community Credit Counseling Services, Inc., Beltsville, MD
Community Development Corporation of Benton Harbor, Benton Harbor, MI
Community Institute for Family Resources, Inc., Milwaukee, WI
Community Stabilization, Los Angeles, CA
Comparative Government Forum, Washington, DC
Conrath Housing, Inc., Almena, WI
Contemplative Outreach of Metropolitan Washington, Inc., Washington, DC
Core City Planning Group, Des Moines, IA
Council for Global Education, Kingstowne, VA
Crayon, Inc., Milwaukee, WI
Creative Writing Education Foundation, Inc., Green Bay, WI
Crime Victims for a Just Society, Mason, MI
Cross Border Network for Justice and Solidarity, Kansas City, MO
Cross Foundation, Inc., Baltimore, MD
Crossing Ministries, St. Paul, MN
Crow River BMX, Inc., Saint Michael, MN
CSE Foundation Corporation, New Berlin, WI
Cuyuna Range Fire Chiefs Association, Brainerd, MN
CWE Housing Corporation, St. Louis, MO
D C Parents for School Choice, Washington, DC
D L Youth Wrestling Organization, Inc., Detroit Lakes, MN
Damali, Inc., Capitol Heights, MD
Daniel Boone Baseball Association, St. Peters, MO
Danville Soccer Club, Inc., Danville, VA
David Goliath Foundation, Inc., Saint Louis, MO
Daystar Commission, Des Moines, IA
Deaf Choices, Inc., Minneapolis, MN
Deaf Services Foundation, Inc., Grand Island, NE
Derrick Hale Foundation, Detroit, MI
Dining on the Word Ministries, Houston, MS
Direct Impact 10–40, South St. Paul, MN
Directors of Continuation Services, Inc., Milwaukee, WI
Dwayne Friend Crusades, Inc., Rogersville, MO
East Buchanan Parent Teacher Organization PTO, Winthrop, IA
East Troy Area Lakes Land Trust, Inc., East Troy, MI
Economic Development Forum, Southfield, MI
Edina Youth Softball Association, Edina, MN
Educational Discovery Programming, Washington, DC
Elishas Rock Educational, Inc., Columbia, MO
Emmanuel Ministries International, Inc., Baltimore, MD
Enter the Walls Ministry, Ltd., Suitland, MD
Environment Development and Educational Fund, Washington, DC
Ethiopian Gospel Mission Association NC, Arlington, VA
Excellence in Catholic & Christian Education, Inc., Alexandria, VA
Exodus, Isanti, MN
Experiential Endeavors, Inc., Columbia, MO
Faith Builders S D A International Corp., Metairie, LA
Family Harbor, Omaha, NE
Family Recreational Park of Georgetown, Georgetown, DE
Family Violence Council of the City of St. Louis, St. Louis, MO
Family Watch, Alexandria, VA
First Presbyterian Church of Ferguson Transitional Housing Corp., Ferguson, MO
First Promise Foundation, Inc., Pawleys, SC
First State YHEC Program, Inc., Hockessin, DE
Fish Rod, Inc., Washington, DC
Fishes & Loaves from Jesus Christ, Inc., Fargo, ND
Fleming Huner Foundation, Inc., Randallstown, MD
Florida Avenue Renaissance Project, Inc., Washington, DC
Fort Dodge Senior High Choir Boosters, Inc., Fort Dodge, IA
Foundation for Global Catholic Communications, Washington, DC
Foundation for Sustainable Development With Human Values, Inc., Washington, DC
Four Chaplains Foundation, Minneapolis, MN
Franciscan Servants of Jesus, Prescott, WI
Franklin County Youth Athletic Association, Inc., Washington, MO
Freedom Fest Celebration, Inc., Earlham, IA
Friends Foundation, Annapolis, MD
Friends of Carter Rockwell Museum, New Hope, MN
Friends of Governor Nelson State Park, Inc., Madison, WI

Friends of India, Inc., Hyattsville, MD
Friends of Quivira National Wildlife Refuge, Inc., St. John, KS
Friends of Takoma Recreation Center, Washington, DC
Friends of the Babbitt Public Library, Inc., Babbitt, MN
Friends of the Collins Public Library, Collins, IA
Friends of the Madison County Fair, Madison, NE
Friends of the National Institute of Dental & Craniofacial Research, Washington, DC
Friends of the Saline Area Fire Department, Inc., Ypsilanti, MI
Friends of Thomas G. Pullen K-8 Arts Magnet School, Inc., Bethesda, MD
Friends of Wilderness Park, Inc., Lincoln, NE
Friends Project, Inc., Washington, DC
From House to Home, Inc., Baltimore, MD
Frontier Wild, Ankeny, IA
Future Foundation Home, Inc., Milwaukee, WI
Garden Community Development, Inc., Wilmington, DE
Gathered in His Name, Perryville, MO
Genesis Company USA, Lebanon, MO
Genesis Ministries, Inc., St. Albans, WV
Georgetown MBA Community Service Fund, Washington, DC
German Shepherd Rescue of Maryland, Inc., Riverdale, MD
Ghana Health Foundation, Washington, DC
Gibson-Chestnut Eney Memorial Tournament, Inc., Arlington, VA
Gibson Network, Inc., Minneapolis, MN
Glenville-Emmons School & Community Foundation, Inc., Glenville, MN
Global Development Center, Washington, DC
Global Youth Development, Inc., Kansas City, MO
Glorious Light Christian Foundation, Newark, DE
Gods Wheels, Inc., Kansas City, MO
Good Samaritan Assisted Living, Inc., St. Louis, MO
Good Samaritan Independent Living, Inc., Valley Park, MO
Good Samaritan Network of Maryland, Front Royal, VA
Goshen Staff Alumni Association, Inc., Gaithersburg, MD
Gospel Music Arts Coalition, St. Louis, MO
Government Training Institute Foundation, Inc., Alexandria, VA
Granville Sharpe Institute, Inc., Lanham, MD
Great Lakes Ancient Field Musick, Ray, MI
Greater Harvest Housing Corp., Baltimore, MD
Green Central Safe Haven, Minneapolis, MN
Greenmount Computer Center, Inc., Baltimore, MD
Gretna Gro Foundation, Gretna, NE
Grodno Genealogy Group, Inc., Minneapolis, MN
Ground Zero Foundation, Bear, DE
Gwendolyn, Inc., Salisbury, NC
Hallsville Community Betterment, Hallsville, MO
Hampton Roads Youth Foundation, Alexandria, VA
Harpers Ferry Conservancy, Harpers Ferry, WV
Haven of Hope, Kansas City, MO
Hayman House, Inc., New Castle, DE
Health and Wealth Group of Maryland, Columbia, MD
Healthcare Roundtable Institute, Westlake Village, CA
Heartland Peony Society, Kansas City, MO
Helping Hand of Goodwill Industries of Kansas, Inc., Topeka, KS
Heritage Achievement Foundation, Centreville, VA
Herlihy Resident Council, Inc., Wilmington, DE
Hesperia Fire Department Auxiliary, Hesperia, MI
Hesston Area Teens, Inc., Hesston, KS
Historic Educational Concepts, Inc., Salem, MO
Historic Fell Point Foundation, Inc., Baltimore, MD
Hospitality Center for Renewed Hope, Inc., Timonium, MD
Humanitarian Relief Foundation of the Am Cham Dominican Republic, Washington, DC
HWS Therapy, Inc., Wichita, KS
Impact Twin Cities, Inc., St. Paul, MN
Inca Imports Corp., Warrenton, VA
Independence Neighborhood Watch, Inc., Independence, MO
Independent Demining Assessment Center, Inc., Washington, DC
India Forum for Liberty & Justice, Inc., Takoma Park, MD
Indigenous Games Sports and Events Management, Fargo, ND
Indigenous Stewardship Systems, Manderson, SD
Inter-Agency Council on Child Abuse and Neglect, Columbia, MO
Intercollegiate Taiwanese American Students Association, Providence, RI
Interfacing, Sewickley, PA
International Charitable Assistance Council, Inc., Rockville, MD
International Fund for the 21st Century, Southgate, MI
International Society of Agile Manufacturing, Lafayette, LA
Intersection, Maple Grove, MN
Islamic Knowledge Services, Inc., Chesterfield, MO
Iyas Community House, Detroit, MI
Jacobs Ladder, Inc., St. Louis, MO
James Madison Project, Washington, DC
Jasper County Youth Fair Foundation, Inc., Joplin, MO
Joshua M. Gordon SMA Foundation, Inc., Rockville, MD
Journeymakers, Urbandale, IA
Juma Trust, Inc., New York, NY
Kansans Respond, Topeka, KS
Kansas City Arts Initiative, Inc., Kansas City, MO
Kansas City International Art Museum, Inc., Kansas City, MO
Kansas Mental Health Association, Topeka, KS
Karl Potach Foundation, Austin, MN
KC Fury, Inc., De Soto, KS
Kendall Burrows Foundation, Inc., Lutherville, MD
Kickapoo Color Guard Booster Club, Springfield, MO
Kids N Bits Therapeutic Riding Program, Teays, WV
Kidsway Booster Club, Coffeyville, KS
Kidzarts, Inc., Manitowoc, WI
KK and Friends, Inc., Rockville, MD
Kujichagulia, Inc., Baltimore, MD
L Eagles, Inc., Olathe, KS
Lakes Area Not for Profit Council, Branson W, MO
Langston Dwelling Resident Council Foundation, Silver Spring, MD
Last Call Ministries, Lincoln, NE
Lavista West Parent Auxiliary Wolf Staff, Lavista, NE
Leading Image Development Corporation, Clinton, MD

Lean on Me Community Services and Outreach, Dallas, TX
Life Changers, Inc., Newport, DE
Lift for Life, Peculiar, MO
Light Up the Bridges, Inc., Charleston, WV
Lincoln Park Historical Foundation, Inc., Rockville, MD
Linn County Community Foundation, La Cygne, KS
Literacy Roundtable, St. Louis, MO
Logan Community Foundation, Logan, IA
Lome Foundation, Inc., Gaithersburg, MD
Lord & Svensen, Inc., Delavan, WI
Loudoun Heritage Farm Museum, Leesburg, VA
Madison Idea Foundation, Inc., Madison, WI
Madison Revitalization and Community Development Corporation, Madison, WI
Magic City Junior Golf Association, Minot, ND
Mahkato Mdewakanton Association, St. Paul, MN
Main Street Revue, Inc., Coleman, WI
Manhattan Area Football Association, Manhattan, KS
Marko Foundation, Ltd., Clinton Township, MI
Martial Arts Serving Kids, Excelsior, MN
Maryland Family Christian Center Church, Capitol Heights, MD
Mayo Island Cultural and Recreational Association, Inc., Richmond, VA
McDowell County F A C E S, Welch, WV
Meca Foundation, Bowie, MD
Medasyst Caring Foundation, Inc., Ottumwa, IA
Mercers Mills, Inc., Newark, DE
Message of the Heart, Inc., Richfield, MN
Messiah Ministries International, Inc., Front Royal, VA
Metro Western Trailriders, Washington, DC
Metropolitan A M E Church Community Development Corporation, Washington, DC
Michigan School Board Leaders Association, Davison, MI
Michigan Spartans Boys & Girls Basketball Association, Inc., Lathrup Vlg, MI
Michigan Urban Search & Rescue Training Foundation, Inc., Ann Arbor, MI
Midwest Media Arts Foundation, Kansas City, MO
Mihan Foundation, New York, NY
Mills Godwin Honorary Foundation, Norfolk, VA
Milwaukee Allstar Basketball & Youth Development Association, Milwaukee, WI
Milwaukee National Organization for Women Education Fund, Inc., Milwaukee, WI
Minnesota Men of Color, Minneapolis, MN
Minnesota Policy Forum, St. Paul, MN
Miracle of Women, Washington, DC
Missourians for Clean Government, Saint Louis, MO
Mobile Care for Africa, Inc., McLean, VA
Monitors Foundation, Eagan, MN
Mothers Touch, Minneapolis, MN
MS Wheelchair Maryland, Inc., Chevy Chase, MD
Mt. Horeb Professional Police Association, Inc., Mt. Horeb, WI
Multilateral Middle East Initiative, Bloomington, MN
Mzuzu Womens and Childrens Health Center USA, Inc., Silver Spring, MD
National Capital Community Service Academy, Washington, DC
National Public Health Forum, Inc., Columbia, MD
Native American Development Association, Incorporated, Keshena, WI
Nautic Sceptor, Brownstown, MI
Nebraska Youth Sports Organization, Inc., Omaha, NE
Neighbors Concerned About Yacht Club Expansion, Grosse Pointe Shores, MI
Neutral Zone, Inc., Ewing, VA
New Beginnings Family Development Centre, Inc., Willard, MO
New Cornerstone, Inc., St. Louis, MO
New Generation Training & Learning Center, Washington, DC
New Promise Home for Children, Olathe, KS
Nice Shot Tennis Association, Kalamazoo, MI
Ninth Street Phyllis Wheatley Association, Wichita, KS
No More Victims, Grand Rapids, MI
Nomads of Annapolis, Inc., Ellicott City, MD
North Basketball Association, Inc., Rapid City, SD
North Dakota Labor Education Council, Bismarck, ND
Northeast Community Development Corporation, Wilmington, DE
Northern Flight Assist, Inc., Shawano, WI
Northern Waters Library Foundation, Inc., Ashland, WI
Northland Family & Children Support Council, Inc., Kansas City, MO
Northside Inner City Environmental Task Force, Minneapolis, MN
Northwest Middle Schools Cheerleading Association, High Ridge, MO
Not Failing at Life, Arthurdale, WV
Olrayma, Inc., St. Louis, MO
Omaha Elite Girls Fastpitch Association, Omaha, NE
Omaha World Herald Branching Out Charitable Foundation, Omaha, NE
Ondo Grammar School Old Students Association, Washington, DC
One Step Ahead Day Care, Inc., Racine, WI
Open Word Teaching Ministries, Maryland Heights, MO
Our Savior Lutheran Church Foundation, Wayne, NE
Outside the Walls Foundation, Eagan, MN
Ozark Competition Soccer League, Inc., Webb City, MO
Ozarks Angels Basketball, Inc., Springfield, MO
Page County Senior Alliance, Inc., Luray, VA
Pamaro Arts Society, Overland Park, KS
Parenting 2000, Inc., Clayton, MO
Parish Net, Inc., Kensington, MD
Parish Nurse Institute, Minneapolis, MN
Paws for People, Blaine, MN
Penelope 38 Charitable Tr., Elkhart, IA
Peoples Alternative Service System, Inc., Baltimore, MD
Philantrotech, Inc., Lowell, MI
Pinckney Community Center, Pinckney, MI
Pine Island Union for Youth, Inc., Pine Island, MN
Pioneer Acres Lodge, Inc., Appleton, WI
Play for Peace, Washington, DC
Playmates Christian Learning Center, Fargo, ND
Plymouth Westside Players, Plymouth, MN
Polish Heritage Society of Nebraska, Inc., Papillion, NE
Pop Sustainability, Inc., New York, NY
Prairie Haven, Inc., Sioux City, IA
Preservation Management Institute, Monticello, MN
Pro K9, Inc., Omaha, NE
Professor Pockets Ministries, Inc., Poca, WV

Progressive Advocacy Support Services, Traverse City, MI
Project for Helping Other People Evolve, Inc., Washington, DC
Project on Liberty and the Workplace, Washington, DC
Project Taney, Inc., Hollister, MO
Project Tough, Inc., Baltimore, MD
Providers at Midnight Organization, Maplewood, MN
Pulaski County Library Building Corporation, Lebanon, MO
Quaker Workcamps International, Washington, DC
Radiant Ministries, Westphalia, KS
Radio Fair America, Washington, DC
Raemar Early Childhood Services, Inc., Parkersburg, WV
Rails on Wheels, Saline, MI
Rainbow Academy, Inc., Ft. Washington, MD
Rainbow Refuge, Inc., St. Louis, MO
Rainforest Cafe Friends of the Future Foundation, Houston, TX
Raymore-Peculiar Soccer Club, Raymore, MO
Recovered Wishes, Inc., Springfield, MO
Research Institutes Faculty of Arch Museology Relics of Bejing University, Inc., Washington, DC
Resident Council of the James Building, Washington, DC
Resources, Inc., Houston, TX
Restoration House of America, Inc., Rancho Santa Margari, CA
Rich Recovery, Inc., Madison, WI
Richard Allen Housing Corporation, Milwaukee, WI
Richard L. Danforth Foundation, Inc., Lenexa, KS
Rise Zing Akh Unsickle Cell Corp., Norfolk, VA
Road Home Ministries, Inc., Baltimore, MD
Rockwood Summit In-Line Hockey Club, Fenton, MO
Sadoi, Inc., Ann Arbor, MI
Safety-ID, Inc., Rockville, MD
Saints Wrestling Club, Inc., Sioux City, IA
Salina Rescue Mission Foundation, Salina, KS
Saline Area Fibromyalgia Syndrome & Chronic Fatigue Syndrome, Salina, KS
School Choice Michigan, Midland, MI
Second Chance Dobes, Clinton, MI
Second Chance Saint Bernard Rescue, Inc., Andover, MN
Self Reliance Foundation, Greendale, WI
Senior Objective Foundation, Washington, DC
Sentinel the Guarded Place, Inc., Baltimore, MD
Sevastopol Community Auditorium Foundation, Inc., Sturgeon Bay, WI
Shared Housing, Inc., Poynette, WI
Sheepgate Ministries, Richmond, VA
Sherman Street Community Empowerment Center, Grand Rapids, MI
Shield of Faith Full Gospel Baptist Church, St. Louis, MO
Sig Jacobson Museum, Brocket, ND
Silex Improvement Program, Silex, MO
Small Wonders Foundation, Lincoln, NE
Smithville Arts Council, Smithville, MO
Somali Bravan Community of Minnesota, Inc., Minneapolis, MN
Somali Resource Center, Minneapolis, MN
South Dakota Nonprofit Association, Sioux Falls, SD
Space Business Archives, Alexandria, VA
Speaking in Tongues, Maple Grove, MN
Spirituality Resource Center, Salina, KS
Sportsworks, Inc., High Ridge, MO
St. Louis Archaeology, Inc., St. Louis, MO
St. Louis German Golf Classic, St. Louis, MO
St. Louis Lightning Fastpitch Softball Club, Inc., Chesterfield, MO
St. Louis Stars, Chesterfield, MO
St. Louis Torah Federation, St. Louis, MO
Storybook Farms, Inc., Montgomery, MO
Sudanese Community Center, Inc., Falls Church, VA
Support Centers of America, McLean, VA
Sweet Springs Community Food Pantry, Sweet Springs, MO
Systems, Inc., Kansas City, MO
Teen Centers, Inc., Wichita, KS
Tender Loving Care, Inc., Pacific Jct., IA
TLC Respite Care, Sparta, VA
Topeka Siamese Rescue of Kansas, Inc., Topeka, KS
Total Debt Management, Inc., Pikesville, MD
Tour Bandits Inline Hockey Club, Inc., Saint Charles, MO
Traditional African Peoples Institute, Inc., Kansas City, MO
Transitional Concepts, St. Paul, MN
Treat, Inc., Washington, DC
Tri-State Office of Juvenile Justice & Delinquency Prevention, Inc., Huntington, WV
Twin Bridges Development Corporation, Crane, MO
Umjima Prison Adoption, Incorporated, St. Louis, MO
United Parents, Inc., Wichita, KS
Upenzi Kwetu Here There is Love, St. Paul, MN
Valley Community Foundation for Lifelong Learning, Inc., Elgin, IA
Vietnam Center for Community Activity, Chesterfield, MO
Virginia Forward, Inc., Arlington, VA
Virtual Association of Lotus Users Across the Enterprise, Inc., Wayne, PA
Visually Impaired Students Congressional Internship Program, Washington, DC
WACIF Initiatives, Inc., Washington, DC
Walkers in Darkness, Inc., Columbia, MD
Waokiye, Inc., Wilmington, DE
Washington D C African American Museum, Washington, DC
Waterbearer Missions International, Inc., Beckley, WV
WCOE Resource Center, Inc., Washington, DC
Web of Time, Inc., Williamsburg, VA
West Anne Arundel County Chamber Foundation, Inc., Odenton, MD
West End Business Revitalization Corporation, St. Paul, MN
West Virginia Celtic Society, Ltd., Hurricane, WV
West Virginia Youth Basketball Corporation, Dunbar, WV
Westside Warrior Basketball Club, Omaha, NE
White Buffalo Gazette, Inc., Haysville, KS
Wholeness Center, Richfield, MN
Wilderness Kingdom Zoo, Inc., Bloomfield, IA
Winterset Quarterback Club, Inc., Winterset, IA
Women on a Mission, Kansas City, MO
Women With Hope, Incorporated, Falls Church, VA
Womens Prison Chapel Foundation, Mitchellville, IA
World Evangelism Association, Inc., Urbandale, IA
Worldwide Coalition for the Spiritual Development of African Church, Washington, DC
Wyandotte County Grief Resources and Information Program, Inc., Kansas City, KS
Yes Lord Community Development Corporation, Inc., Newark, NJ

Young Peoples Center, Inc., Point Pleasant, WV
Youth Basketball Association, Gordon, NE
Youth Outreach, Inc., Blue Springs, MO
Youth Performance Concepts, Inc., Lynchburg, VA
Youth Sports Initiative, Inc., Kansas City, MO
Youthway Ministries, Blaine, MN

If an organization listed above submits information that warrants the renewal of its classification as a public charity or as a private operating foundation, the Internal Revenue Service will issue a ruling or determination letter with the revised classification as to foundation status. Grantors and contributors may thereafter rely upon such ruling or determination letter as provided in section 1.509(a)–7 of the Income Tax Regulations. It is not the practice of the Service to announce such revised classification of foundation status in the Internal Revenue Bulletin.

Announcement and Report Concerning Advance Pricing Agreements

Announcement 2004–26

March 30, 2004

This Announcement is issued pursuant to § 521(b) of Pub. L. 106–170, the Ticket to Work and Work Incentives Improvement Act of 1999, which requires the Secretary of the Treasury to report annually to the public concerning Advance Pricing Agreements (APAs) and the APA Program. The first report covered calendar years 1991 through 1999. Subsequent reports covered calendar years 2000, 2001, and 2002. This fifth report describes the experience, structure and activities of the APA Program during calendar year 2003. It does not provide guidance regarding the application of the arm's length standard.

Matthew W. Frank
Director, Advance Pricing Agreement Program

Background

Internal Revenue Code (IRC) § 482 provides that the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among two or more commonly controlled businesses if necessary to reflect clearly the income of such businesses. Under the regulations, the standard to be applied in determining the true taxable income of a controlled business is that of a business dealing at arm's length with an unrelated business. The arm's length standard also has been adopted by the international community and is incorporated into the transfer pricing guidelines issued by the Organization for Economic Cooperation and Development (OECD). OECD, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATORS (1995). Transfer pricing issues by their nature are highly factual and have traditionally been one of the largest issues identified by the IRS in its audits of multinational corporations. The APA Program is designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional examination process. An APA is a binding contract between the IRS and a taxpayer by which the IRS agrees not to seek a transfer pricing adjustment under IRC § 482 for a covered transaction if the taxpayer files its tax return for a covered year consistent with the agreed transfer pricing method (TPM). In 2003, the IRS and taxpayers executed 58 APAs and amended 4 APAs.

Since 1991, with the issuance of Rev. Proc. 91–22, 1991–1 C.B. 526, the IRS has offered taxpayers through the APA Program the opportunity to reach an agreement in advance of filing a tax return on the appropriate TPM to be applied to related party transactions. In 1996, the IRS issued internal procedures for processing APA requests. Chief Counsel Directives Manual (CCDM), ¶¶ 42.10.10 - 42.10.16 (November 15, 1996). Also in 1996, the IRS updated Rev. Proc. 91–22 with the release of Rev. Proc. 96–53, 1996–2 C.B. 375. The APA Program continues to operate under the provisions of Rev. Proc. 96–53, which provides taxpayers with instructions of how to apply for an APA, and what to expect in the processing of the case. In addition, in 1998, the IRS published Notice 98–65, 1998–2 C.B. 803, which set forth streamlined APA procedures for Small Business Taxpayers (SBTs). That Notice also expanded the availability of the lowest APA user fee in an effort to attract taxpayers who may not have the resources to do the sophisticated economic studies normally required in APA submissions.

Advance Pricing Agreements

An APA generally combines an agreement between a taxpayer and the IRS on an appropriate TPM for the transactions at issue (Covered Transactions) with an agreement between the U.S. and one or more foreign tax authorities (under the authority of the mutual agreement process of our income tax treaties) that the TPM is correct. With such a "bilateral" APA, the taxpayer ordinarily is assured that the income associated with the Covered Transactions will not be subject to double taxation by the IRS and the foreign tax authority. It is the policy of the United States, as reflected in § 7 of Rev. Proc. 96–53 to encourage taxpayers that enter the APA program to seek bilateral or multilateral APAs when competent authority procedures are available with respect to the foreign country or countries involved. However, the IRS may execute an APA with a taxpayer without reaching a competent authority agreement (a "unilateral" APA).

A unilateral APA is an agreement between a taxpayer and the IRS establishing an approved TPM for U.S. tax purposes. A unilateral APA binds the taxpayer and the IRS, but obviously does not prevent foreign tax administrations from taking different positions on the appropriate TPM for a transaction. As stated in Rev. Proc. 96–53, should a transaction covered by a unilateral APA be subject to double taxation as the result of an adjustment by a foreign tax administration, the taxpayer may seek relief by requesting that the U.S. Competent Authority consider initiating a mutual agreement proceeding, provided there is an applicable income tax treaty in force with the other country.

When a unilateral APA involves taxpayers operating in a country that is a treaty partner, information relevant to the APA (including a copy of the APA and APA annual reports) may be provided to the treaty partner under normal rules and principles governing the exchange of information under income tax treaties.

The APA Program

An IRS team headed by an APA team leader is responsible for the consideration of each APA. As of December 31, 2003, the APA program had 18 team leaders. The team leader is responsible for organizing the IRS APA team. The IRS APA team arranges meetings with the taxpayer, secures whatever information is necessary from the taxpayer to analyze the taxpayer's related party transactions and the available facts under the arm's length standard of IRC § 482 and the regulations thereunder (Treas. Reg.), and leads the discussions with the taxpayer.

The APA team generally includes an economist, an international examiner, LMSB field counsel, and, in a bilateral case, a U.S. Competent Authority analyst who leads the discussions with the treaty partner. The economist may be from the APA Program or the IRS field organization. As of December 31, 2003, the APA Program had 7 economists. The APA team may also include an LMSB International Technical Advisor, other LMSB exam personnel, and an Appeals officer.

The APA Process

The APA process is voluntary. Taxpayers submit an application for an APA, together with a user fee as set forth in Rev. Proc. 96–53. The APA process can be broken into five phases: (1) application; (2) due diligence; (3) analysis; (4) discussion and agreement; and (5) drafting, review, and execution.

(1) *Application*

In many APA cases, the taxpayer's application is preceded by a pre-file conference with the APA staff in which the taxpayer can solicit the informal views of the APA Program. Pre-file conferences can occur on an anonymous basis, although a taxpayer must disclose its identity when it applies for an APA. Taxpayers must file the appropriate user fee on or before the due date of the tax return for the first taxable year that the taxpayer proposes to be covered by the APA. Many taxpayers file a user fee first and then follow up with a full application later. The procedures for pre-file conferences, user fees, and applications can be found in Rev. Proc. 96–53.

The APA application can be a relatively modest document for a small business taxpayer. Notice 98–65 describes the special APA procedures for small businesses. For most taxpayers, however, the APA application is a substantial document filling several binders. The APA Program makes every effort to reach agreement on the basis of the information provided in the taxpayer's application.

The application is assigned to an APA team leader who is responsible for the case. The APA team leader's first responsibility is to organize the APA team. This involves contacting the appropriate LMSB International Territory Manager to secure the assignment of an international examiner to the APA case and the LMSB Counsel's office to secure a field counsel lawyer. In a bilateral case, the U.S. Competent Authority will assign a U.S. Competent Authority analyst to the team. In a large APA case, the international examiner may invite his or her manager and other LMSB personnel familiar with the taxpayer to join the team. When the APA may affect taxable years in Appeals, the appropriate appellate conferee will be invited to join the team. In all cases, the team leader contacts the Manager, LMSB International Technical Advisors, to determine whether to include a technical advisor on the team. The IRS APA team will generally include a technical advisor if the APA request concerns cost-sharing, intangibles or services. The APA team leader then distributes copies of the APA application to all team members and sets up an opening conference with the taxpayer. The APA office strives to hold this opening conference within 45 days of the assignment of the case to a team leader. At the opening conference, the APA team leader proposes a case plan designed to complete the recommended U.S. negotiating position for a bilateral APA within 9 months from the date the full application was filed and to complete a unilateral APA within 12 months from the application date. In 2003, the median for completing negotiating positions was 15.2 months (average 15.3), and the median for completing unilateral APAs was 9.2 months (average 20.0).

(2) *Due Diligence*

The APA team must satisfy itself that the relevant facts submitted by the taxpayer are complete and accurate. This due diligence aspect of the APA is vital to the process. It is because of this due diligence that the IRS can reach advance agreements with taxpayers in the highly factual setting of transfer pricing. Due diligence can proceed in a number of ways. Typically, the taxpayer and the APA team will agree to dates for future meetings during the opening conference. In advance of the opening conference, the APA team leader will submit a list of questions to the taxpayer for discussion. The opening conference may result in a second set of questions. These questions are developed by the APA team and provided to the taxpayer through the APA team leader. It is important to note that this due diligence is not an audit and is focused on the transfer pricing issues associated with the transactions in the taxpayer's application, or such other transactions that the taxpayer and the IRS may agree to add.

(3) *Analysis*

A significant part of the analytical work associated with an APA is done typically by the APA or IRS field economist assigned to the case. The analysis may result in the need for additional information. Once the IRS APA team has completed its due diligence and analysis, it begins negotiations with the taxpayer over the various aspects of the APA including the selection of comparable transactions, asset intensity and other adjustments, the TPM, which transactions to cover, the appropriate critical assumptions, the APA term, and other key issues. The APA team leader will discuss particularly difficult issues with his or her managers, but generally the APA team leader is empowered to negotiate the APA.

(4) *Discussion and Agreement*

This phase differs for bilateral and unilateral cases. In a bilateral case, the discussions proceed in two parts and involve two IRS offices — the APA Program and the U.S. Competent Authority. In the first part, the APA team will attempt to reach a consensus with the taxpayer regarding the recommended position that the U.S. Competent Authority should take in negotiations with its treaty partner. This recommended U.S. negotiating position is a paper drafted by the APA team leader and signed by the APA Director that provides the APA Program's view of the best TPM for the covered transaction, taking into account IRC § 482 and the regulations thereunder, the relevant tax treaty, and the U.S. Competent Authority's experience with the treaty partner.

The experience of the APA office and the U.S. Competent Authority is that APA negotiations are likely to proceed more rapidly with a foreign competent authority if the U.S. negotiating position is fully supported by the taxpayer. Consequently, the APA Office works together with the taxpayer in developing the recommended U.S. negotiating position. On occasion, the APA team will agree to disagree with a taxpayer. In these cases, the APA office will send a recommended U.S. negotiating position to the U.S. Competent Authority that includes elements with which the taxpayer does not agree. This disagreement is noted in the paper. The APA team leader also solicits the views of the field members of the APA team, and, in the vast majority of APA cases, the international examiner, LMSB field counsel, and other IRS field team members concur in the position prepared by the APA team leader.

Once the APA Program completes the recommended U.S. negotiating position, the APA process shifts from the APA Program to the U.S. Competent Authority. The U.S. Competent Authority analyst assigned to the APA takes the recommended U.S. negotiating position and prepares the final U.S. negotiating position, which is then transmitted to the foreign competent authority. The negotiations with the foreign competent authority are conducted by the U.S. Competent Authority analyst, most often in face-to-face negotiating sessions conducted periodically throughout the year. At the request of the U.S. Competent Authority analyst, the APA team leader may continue to assist the negotiations.

In unilateral APA cases, the discussions proceed solely between the APA Program and the taxpayer. In a unilateral case, the taxpayer and the APA Program must reach agreement to conclude an APA. Like the bilateral cases, the APA team leader almost always will achieve a consensus with the IRS field personnel assigned to the APA team regarding the final APA. The APA Program has a procedure in which the IRS field personnel are solicited formally for their concurrence in the final APA. This concurrence, or any items in disagreement, is noted in a cover memorandum prepared by the APA team leader that accompanies the final APA sent forward for review and execution.

(5) *Drafting, Review, and Execution*

Once the IRS and the taxpayer reach agreement, the drafting of the final APA generally takes little time because the APA Program has developed standard language that is incorporated into every APA. The current version of this language is found in Attachment A. APAs are reviewed by the Branch Chief and the APA Director. In addition, the team leader prepares a summary memorandum for the Associate Chief Counsel (International) (ACC(I)). On March 1, 2001, the ACC(I) delegated to the APA Director the authority to execute APAs on behalf of the IRS. *See* Chief Counsel Notice CC–2001–016. The APA is executed for the taxpayer by an appropriate corporate officer.

Model APA at Attachment A

[§ 521(b)(2)(B)]

Attachment A contains the current version of the model APA language. As part of its continuing effort to improve its work product, the APA Program has revised the model language to reflect the program's collective experience with substantive and drafting issues.

The Current APA Office Structure, Composition, and Operation

In 2003, the APA Office consisted of four branches with Branches 1 and 3 staffed with APA team leaders and Branch 2 staffed with economists and a paralegal. Branch 4, the APA West Coast branch, is headquartered in Laguna Niguel, California, with an additional office in San Francisco, and is presently staffed with both team leaders and an economist.

Overall, the APA staff increased from 34 to 36. The APA Program hired a new APA Director and a new team leader. In addition, one team leader transferred to the APA Office from another Chief Counsel function, and one team leader transferred from the APA Office to another Chief Counsel function. The number of APA team leaders increased from 17 to 18, while the number of economists remained constant at 7.

As of December 31, 2003, the APA staff was as follows:

Director's Office 1 Director 1 Special Counsel to the Director 1 Secretary to the Director			
Branch 1 1 Branch Chief 1 Secretary 8 Team Leaders	*Branch 2* 1 Branch Chief 1 Paralegal 6 Economists	*Branch 3* 1 Branch Chief 1 Secretary 8 Team Leaders	*Branch 4* 1 Branch Chief 1 Secretary 2 Team Leaders 1 Economist

APA Training

In 2003, the APA Office continued to emphasize training as a high priority. Training sessions regarded APA-related current developments, new APA office practices and procedures, and international tax law issues. The APA New Hire Training materials were updated, as necessary, throughout the year. The updated materials are available to the public through the APA internet site on the IRS Digital Daily (*www.irs.gov*). These materials do not constitute guidance on the application of the arm's length standard.

APA Program Statistical Data

[§ 521(b)(2)(C) and (E)]

The statistical information required under § 521(b)(2)(C) is contained in Tables 1 and 9 below; the information required under § 521(b)(2)(E) is contained in Tables 2 and 3 below:

TABLE 1: APA APPLICATIONS, EXECUTED APAs, AND PENDING APAs[1]

	Unilateral	Bilateral	Multilateral	Year Total	Cumulative Total
APA applications filed during year 2003	44	46		90	766
APAs executed					
• Year 2003	21	37		58	492
• 1991–2002	206	221	7	434	
APA renewals executed during year 2003	8	9		17	108
Revised or Amended APAs executed during year 2003	3	1		4	25
Pending requests for APAs	67	162		229	
• Pending Requests for new APAs	46	109		155	
• Pending requests for renewal APAs	21	53		74	
APAs canceled or revoked	0	0		0	5
APAs withdrawn	2	1		3	83

TABLE 2: MONTHS TO COMPLETE APAs[2]

Months to Complete Advance Pricing Agreements in Year 2003					
Combined Unilateral, Bilateral, Multilateral: Average					33.7
Combined Unilateral, Bilateral, Multilateral: Median					32.0
Unilateral New		**Unilateral Renewal**		**Unilateral Combined**	
Average	22.3	Average	16.2	Average	20.0
Median	8.5	Median	9.8	Median	9.2
Bilateral/Multilateral New		**Bilateral/Multilateral Renewal**		**Bilateral/Multilateral Combined**	
Average	41.2	Average	42.3	Average	41.5
Median	35.4	Median	50.2	Median	39.4

[1] In 2003:

- The APA Office and taxpayers agreed to amend four APAs (three unilateral and one bilateral). In one of these, the taxpayer reorganized its business. In three, the changes reflected technical corrections or modifications to minor aspects of the APA.
- Reasons for withdrawals included settling principal issues through other venues, jurisdictional issues, taxpayer reorganizations, and changes in facts and circumstances.

[2] The average time required to conclude a bilateral APA has historically been split roughly equally between the APA and U.S. Competent Authority Offices.

TABLE 3: APA COMPLETION TIME – MONTHS PER APA

Months	Number of APAs	Months	Number of APAs	Months	Number of APAs	Months	Number of APAs
1	0	**26**	0	**51**	3	**76**	0
2	0	**27**	1	**52**	2	**77**	0
3	0	**28**	1	**53**	1	**78**	1
4	0	**29**	0	**54**	0	**79**	0
5	1	**30**	1	**55**	2	**80**	0
6	2	**31**	3	**56**	0	**81**	0
7	5	**32**	0	**57**	0	**82**	0
8	1	**33**	1	**58**	0	**83**	0
9	2	**34**	3	**59**	1	**84**	0
10	4	**35**	1	**60**	1	**85**	0
11	0	**36**	1	**61**	0	**86**	0
12	0	**37**	1	**62**	0	**87**	0
13	1	**38**	0	**63**	0	**88**	0
14	0	**39**	1	**64**	1	**89**	0
15	1	**40**	2	**65**	0	**90**	0
16	1	**41**	0	**66**	0	**91**	0
17	0	**42**	1	**67**	0	**92**	1
18	1	**43**	0	**68**	0	**93**	0
19	1	**44**	0	**69**	0	**94**	1
20	0	**45**	1	**70**	0	**95**	0
21	1	**46**	0	**71**	0	**96**	0
22	1	**47**	1	**72**	0	**97**	0
23	0	**48**	0	**73**	0	**98**	1
24	0	**49**	0	**74**	0	**99**	0
25	1	**50**	1	**75**	0	**100**	0

TABLE 4: RECOMMENDED NEGOTIATING POSITIONS

Recommended Negotiating Positions Completed in Year 2003	19

TABLE 5: MONTHS TO COMPLETE RECOMMENDED NEGOTIATING POSITIONS

New		**Renewal**		**Combined**	
Average	14.5	Average	15.3	Average	15.3
Median	15.2	Median	13.1	Median	15.2

TABLE 6: RECOMMENDED NEGOTIATING POSITIONS COMPLETION TIME – MONTHS PER APA

Months	Number of APAs	Months	Number of APAs	Months	Number of APAs	Months	Number of APAs
1	0	**11**	1	**21**	0	**31**	0
2	0	**12**	0	**22**	1	**32**	0
3	0	**13**	2	**23**	0	**33**	0
4	0	**14**	1	**24**	2	**34**	0
5	1	**15**	3	**25**	0	**35**	0
6	2	**16**	0	**26**	1	**36**	0
7	1	**17**	1	**27**	1	**37**	0
8	0	**18**	0	**28**	0	**38**	0
9	1	**19**	1	**29**	0	**39**	0
10	0	**20**	0	**30**	0	**40**	0

TABLE 7: SMALL BUSINESS TAXPAYER APAs[3]

Small Business Taxpayer APAs Completed in Year 2003	**12**
Renewals	8
New	4
Unilateral	8
Bilateral	4

TABLE 8: MONTHS TO COMPLETE SMALL BUSINESS TAXPAYER APAs

Months to Complete Small Business Taxpayer APAs in Year 2003					
New		**Renewal**		**Combined**	
Average	12.5	Average	13.8	Average	13.0
Median	11.5	Median	11.9	Median	11.5

[3] Small Business Taxpayer APAs are processed under the special procedures set forth in Notice 98–65.

TABLE 9: INDUSTRIES COVERED[4]

Industry Involved – NAICS Codes	Number
Electronic equipment, appliance and component manufacturing – 335	7–9
Wholesale trade, nondurable goods – 422	4–6
Chemical manufacturing – 325	4–6
Wholesale trade, durable goods – 421	4–6
Credit intermediation and related activities – 522	4–6
Computer and electronic product manufacturing – 334	4–6
Machinery manufacturing – 333	1–3
Broadcasting and telecommunications – 513	1–3
Information service and data processing services – 514	1–3
Securities, commodity contracts and other intermediary and related activities – 523	1–3
Oil and gas extraction – 212	1–3
Motor vehicle and parts dealers – 441	1–3
Food manufacturing – 311	1–3
Apparel manufacturing – 315	1–3
Beverage and tobacco manufacturing – 312	1–3
Fabricated metal manufacturing – 332	1–3
Transportation equipment manufacturing – 336	1–3
Miscellaneous manufacturing – 339	1–3
Sporting goods, hobby, book and music stores – 451	1–3
Air transportation – 481	1–3
Accommodation – 721	1–3
Food services and drinking places – 722	1–3

Trades or Businesses

[§ 521(b)(2)(D)(i)]

The nature of the relationships between the related organizations, trades, or businesses covered by APAs executed in 2003 is set forth in Table 10 below:

TABLE 10: NATURE OF RELATIONSHIPS BETWEEN RELATED ENTITIES

Relationship	Number of APAs
Foreign Parent – U.S. Subsidiary (-ies)	31
U.S. Parent – Foreign Subsidiary (-ies)	23
Foreign Company and U.S. branch(es)	4

[4] The categories in this table are drawn from the North American Industry Classification System (NAICS), which has replaced the U.S. Standard Industrial Classification (SIC) system. NAICS was developed jointly by the U.S., Canada, and Mexico to provide new comparability in statistics about business activity across North America.

Covered Transactions
[§ 521(b)(2)(D)(ii)]

The controlled transactions covered by APAs executed in 2003 are set forth in Table 11 and Table 12 below:

TABLE 11: TYPES OF COVERED TRANSACTIONS

Transaction Type	Number
Sale of tangible property into the U.S.	23
Performance of services by Non-U.S. entity	16
Performance of services by U.S. entity	12
Sale of tangible property from the U.S.	9
Use of intangible property by U.S. entity	7
Use of intangible property by Non-U.S. entity	6
Financial products - Non-U.S. parent	2
Financial products - U.S. branch of foreign company	2
Other	11

TABLE 12: TYPES OF SERVICES INCLUDED IN COVERED TRANSACTIONS

Intercompany Services Involved in the Covered Transactions	Number
Administrative	10
Accounting	9
Marketing	9
Distribution	9
Manufacturing services	8
Management	7
Research and development	7
Legal	6
Technical support services	6
Product support	5
Logistical support	5
Headquarters costs	4
Communication service	3
Contract research & development	3
Billing services	3
Purchasing	3
License administration services	2
Assembly	2

Business Functions Performed and Risks Assumed
[§ 521(b)(2)(D)(ii)]

The general descriptions of the business functions performed and risks assumed by the organizations, trades, or businesses whose results are tested in the covered transactions in the APAs executed in 2003 are set forth in Tables 13 and 14 below:

TABLE 13: FUNCTIONS PERFORMED BY THE TESTED PARTY

Functions Performed	Number
Manufacturing	33
Distribution functions	28
Marketing functions	23
Transportation and warehousing	12
Managerial, legal, accounting, finance, personnel, and other support services	11
Research and development	10
Product assembly and/or packaging	9
Trading and risk management of financial products	7
Purchasing and materials management	7
Product design and engineering	6
Licensing of intangibles	6
Technical training and tech support for sales staff (including sub-distributors)	5
Product testing and quality control	4
Process engineering	3
Telecom services	2

TABLE 14: RISKS ASSUMED BY THE TESTED PARTY

Risks Assumed	Number
General business risks (*e.g.*, related to ownership of PP&E)	57
Market risks, including fluctuations in costs, demand, pricing, & inventory	52
Credit and collection risks	37
Financial risks, including interest rates & currency	31
Product liability risks	22
R&D risks	21

Discussion

The vast majority of APAs have covered transactions that involve numerous business functions and risks. For instance, with respect to functions, companies that manufacture products have typically conducted research and development, engaged in product design and engineering, manufactured the product, marketed and distributed the product, and performed support functions such as legal, finance, and human resources services. Regarding risks, companies have been subject to market risks, R&D risks, financial risks, credit and collection risks, product liability risks, and general business risks. In the APA evaluation process a significant amount of time and effort is devoted to understanding how the functions and risks are allocated amongst the controlled group of companies that are party to the covered transactions.

In its APA submission, the taxpayer must provide a functional analysis. The functional analysis identifies the economic activities performed, the assets employed, the economic costs incurred, and the risks assumed by each of the controlled parties. The importance of the functional analysis derives from the fact that economic theory posits that there is a positive relationship between risk and expected return and that different functions provide different value and have different opportunity costs associated with them. It is important that the functional analysis go beyond simply categorizing the tested party as, say, a distributor. It should provide more specific information since, in the example of distributors, not all distributors undertake similar functions and risks.

Thus, the functional analysis is critical in determining the TPM (including the selection of comparables). Although functional comparability is an essential factor in evaluating the reliability of the TPM (including the selection of comparables), the APA evaluation process also involves consideration of economic conditions such as the economic condition of the particular industry.

In evaluating the functional analysis, the APA program considers contractual terms between the controlled parties and the consistency of the conduct of the parties with respect to the allocation of risk. In accord with the section 482 regulations, the APA program also gives consideration to the ability of controlled parties to fund losses that might be expected to occur as the result of the assumption of risk. Another relevant factor considered in evaluating the functional analysis is the extent to which each controlled party exercises managerial or operational control over the business activities that directly influence the amount of income or loss realized. The section 482 regulations posit that parties at arm's length will ordinarily bear a greater share of those risks over which they have relatively more control.

Related Organizations, Trades, or Businesses Whose Prices or Results are Tested to Determine Compliance with APA Transfer Pricing Methods

[§ 521(b)(2)(D)(iii)]

The related organizations, trades, or businesses whose prices or results are tested to determine compliance with TPMs prescribed in APAs executed in 2003 are set forth in Table 15 below:

TABLE 15: RELATED ORGANIZATIONS, TRADES, OR BUSINESSES WHOSE PRICES OR RESULTS ARE TESTED[5]

Type of Organization	Number
U.S. distributor	20
Multiple tested parties	16
U.S. provider of services	11
Non-U.S. provider of services	9
Non-U.S. manufacturer	8
U.S. manufacturer	7
U.S. licensor of intangible property	4
Non-U.S. distributor	4
U.S. dealer in financial products	3

[5] "Multiple tested parties" includes covered transactions that utilize profit splits, CUPs, and CUTs.

Type of Organization	Number
Non-U.S. dealer in financial products	2
Other	4

Transfer Pricing Methods and the Circumstances Leading to the Use of Those Methods
[§ 521(b)(2)(D)(iv)]

The TPMs used in APAs executed in 2003 are set forth in Tables 16–20 below:

TABLE 16: TRANSFER PRICING METHODS USED FOR TRANSFERS OF TANGIBLE AND INTANGIBLE PROPERTY[6]

TPM Used	Number
CPM: PLI is operating margin	9
CPM: PLI is markup on total costs	7
Unspecified method	6
CUT (intangibles only)	4
CPM: PLI is gross margin	3
CPM: PLI is return on assets or capital employed	3
CPM: PLI is Berry ratio	3
CPM: PLI is other PLI	3
Resale Price Method (tangibles only)	3
Other profit split	3
Residual profit split	2
CUP (tangibles only) – not based on published market data	2
Cost Plus Method (tangibles only)	2
Other	2

TABLE 17: TRANSFER PRICING METHODS USED FOR SERVICES

TPM Used	Number
Cost plus a markup	12
CPM: PLI is markup on total costs	7
Cost with no markup	5
CPM: PLI is Berry ratio	3
Other	3

[6] Profit Level Indicators ("PLIs") used with the Comparable Profit Method of Treas. Reg. § 1.482–5, and as used in these TPM tables, are as follows: (1) operating margin (ratio of operating profit to sales); (2) markup on total costs (comparative markup on total costs); (3) gross margin (ratio of gross profit to sales); (4) rate of return on assets or capital employed (ratio of operating profit to operating assets); and (5) Berry ratio (gross profit to operating expenses).

TABLE 18: TRANSFER PRICING METHODS USED FOR FINANCIAL PRODUCTS

TPM Used	Number
Interbranch allocation (using indirect evidence of CUPs)	3
Profit split	2

Discussion

The TPMs used in APAs completed during 2003 were based on the section 482 regulations. Under Treas. Reg. § 1.482–3, the arm's length amount for controlled transfers of tangible property may be determined using the Comparable Uncontrolled Price (CUP) method, the Resale Price Method, the Cost Plus Method, the Comparable Profits Method (CPM), or the Profit Split method. Under Treas. Reg. § 1.482–4, the arm's length amount for controlled transfers of intangible property may be determined using the Comparable Uncontrolled Transaction (CUT) method, CPM, or the Profit Split Method. An "Unspecified Method" may be used for both tangible and intangible property if it provides a more reliable result than the enumerated methods under the best method rule of Treas. Reg. § 1.482–1(c). For transfers involving the provision of services, Treas. Reg. § 1.482–2(b) provides that services performed for the benefit of another member of a controlled group should bear an arm's length charge, either deemed to be equal to the cost of providing the services (when non-integral, see Treas. Reg. § 1.482–2(b)(3)) or which should be an amount that would have been charged between independent parties.

In addition, Treas. Reg. § 1.482–2(a) provides rules concerning the proper treatment of loans or advances, and Treas. Reg. § 1.482–7 provides rules for qualified cost sharing arrangements under which the parties agree to share the costs of development of intangibles in proportion to their shares of reasonably anticipated benefits. APAs involving cost sharing arrangements generally address both the method of allocating costs among the parties as well as determining the appropriate amount of the "buy-in" payment due for the transfer of intangibles to the controlled participants.

In reviewing the TPMs applicable to transfers of tangible and intangible property reflected in Table 16, the majority of the APAs followed the specified methods. However, there are several distinguishing points that should be made. The Regulations note that for transfers of tangible property, the Comparable Uncontrolled Price (CUP) method will generally be the most direct and reliable measure of an arm's length price for the controlled transaction if sufficiently reliable comparable transactions can be identified. Treas. Reg. § 1.482–3(b)(2)(ii)(A). It was the experience of the APA Program in 2003 that in the cases that came into the APA Program, sufficiently reliable CUP transactions were difficult to find. In APAs executed in 2003, there were two covered transactions that used the CUP method; both used internal data on transactions between the taxpayer and unrelated parties.

Similar to the CUP method, for transfers of intangible property, the CUT method will generally provide the most reliable measure of an arm's length result if sufficiently reliable comparables may be found. Treas. Reg. § 1.482–4(c)(2)(ii). It has generally been difficult to identify external comparables, and APAs using the CUT method tend to rely on internal transactions between the taxpayer and unrelated parties. In 2003, there were four covered transactions that utilized the CUT TPM.

The Cost Plus Method (tangibles only) and Resale Price Method were applied in 2003 in two and three APAs respectively. See Treas. Reg. § 1.482–3(c), (d).

The CPM is frequently applied in APAs. This is because reliable public data on comparable business activities of independent companies may be more readily available than potential CUP data, and comparability of resources employed, functions, risks, and other relevant considerations is more likely to exist than comparability of product. The CPM also tends to be less sensitive than other methods to differences in accounting practices between the tested party and comparable companies, *e.g.*, classification of expenses as cost of goods sold or operating expenses. Treas. Reg. § 1.482–3(c)(3)(iii)(B), and –3(d)(3)(iii)(B). In addition, the degree of functional comparability required to obtain a reliable result under the CPM is generally less than required under the Resale Price or Cost Plus methods, because differences in functions performed often are reflected in operating expenses, and thus taxpayers performing different functions may have very different gross profit margins but earn similar levels of operating profit. Treas. Reg. § 1.482–5(c)(2).

Table 16 reflects 28 uses of the CPM (with varying PLIs) in covered transactions involving tangible or intangible property. The CPM was also used in some APAs concurrently with other methods.

The CPM has proven to be versatile in part because of the various PLIs that can be used in connection with the method. Reaching agreement on the appropriate PLI has been the subject of much discussion in many of the cases, and it depends heavily on the facts and circumstances. Some APAs have called for different PLIs to apply to different parts of the covered transactions or with one PLI used as a check against the primary PLI.

The CPM also was used regularly with services as the covered transactions in APAs executed in 2003. There were a total of 10 services covered transactions using the CPM method with various PLIs according to the specific facts of the taxpayers involved. Table 17 reflects the methods used to determine the arm's length results for APAs involving services transactions.

In 2003, there were two APAs involving tangible or intangible property that used the residual profit split, Treas. Reg. § 1.482–6(c)(3). In residual profit split cases, routine contributions by the controlled parties are allocated routine market returns, and the residual income is allocated among the controlled taxpayers based upon the relative value of their contributions of intangible property to the relevant business activity.

Profit splits have also been used in a number of financial product APAs in which the primary income-producing functions are performed in more than one jurisdiction. Two APAs executed in 2003 applied such a profit split.

There were three financial product APAs involving interbranch allocations. These involve a single taxpayer with branches that act autonomously with respect to the covered transactions, generally involving foreign currency exchanges. These particular APAs determine the appropriate amount of profits attributable to each branch from the activity by reference to the branches' internal accounting methods. The results take into account all trades, and test the arms length results using statistical tests to verify that controlled trades are priced the same as uncontrolled trades.

Critical Assumptions

[§ 521(b)(2)(D)(v)]

Critical Assumptions used in APAs executed in 2003 are described in Table 19 below:

TABLE 19: CRITICAL ASSUMPTIONS

Critical Assumptions involving the following:	Number of APAs
Material changes to the business	57
Material changes to tax and/or financial accounting practices	57
Assets will remain substantially same	16
Catastrophic events	9
No discounts or rebates	6
Use of Mark-to-Market method	4
Other financial ratio	3
Major regulatory changes	2
Changes in affiliated companies	2
Variation in budgeted v. actual expenses	2
Changes in market shares	2
Ratio of R&D to sales	2
Material sales fluctuations	2
Other	13

Discussion

APAs include critical assumptions upon which their respective TPMs depend. A critical assumption is any fact (whether or not within the control of the taxpayer) related to the taxpayer, a third party, an industry, or business and economic conditions, the continued existence of which is material to the taxpayer's proposed TPM. Critical assumptions might include, for example, a particular mode of conducting business operations, a particular corporate or business structure, or a range of expected business volume. Rev. Proc. 96–53, § 5.07. Failure to meet a critical assumption may render an APA inappropriate or unworkable.

A critical assumption may change (and/or fail to materialize) due to uncontrollable changes in economic circumstances, such as a fundamental and dramatic change in the economic conditions of a particular industry. In addition, a critical assumption may change (and/or fail to materialize) due to a taxpayer's actions that are initiated for good faith business reasons, such as a change in business strategy, mode of conducting operations, or the cessation or transfer of a business segment or entity covered by the APA.

If a critical assumption has not been met, the APA may be revised by agreement of the parties. If such agreement cannot be achieved, the APA may be canceled. If a critical assumption has not been met, it requires taxpayer's notice to and discussion with the Service, and, in the case of a bilateral APA, competent authority consideration. Rev. Proc. 96–53, § 11.07.

Sources of Comparables, Selection Criteria, and the Nature of Adjustments to Comparables and Tested Parties
[§ 521(b)(2)(D)(v), (vi), and (vii)]

The sources of comparables, selection criteria, and rationale used in determining the selection criteria for APAs executed in 2003 are described in Tables 20 through 22 below. Various formulas for making adjustments to comparables are included as Attachment B.

TABLE 20: SOURCES OF COMPARABLES

Comparable Sources	Number of Times This Source Used
Compustat	44
Disclosure	14
Moody's	5
Japan Company Handbook	4
Worldscope	4
Dun & Bradstreet	3
Other	8

TABLE 21: COMPARABLE SELECTION CRITERIA

Selection Criteria Considered	Number of Times This Criterion Used
Comparable functions	57
Comparable risks	43
Comparable industry	38
Comparable products	25
Comparable intangibles	21
Comparable terms	4

TABLE 22: ADJUSTMENTS TO COMPARABLES OR TESTED PARTIES

Adjustment	Number of Times Used
Balance sheet adjustments	
Inventory	35
Payables	33
Receivables	33
Property, plant, equipment	10
Accounting adjustments	
LIFO to FIFO inventory accounting	11
Accounting reclassifications (*e.g.*, from COGS to operating expenses)	9
Other	1
Profit level indicator adjustments (used to "back into" one PLI from another)	
Operating expense	2
Other	5
Miscellaneous adjustments	
Foreign exchange	3
Goodwill value or amortization	2
Other	4

Discussion

At the core of most APAs are comparables. The APA program works closely with taxpayers to find the best and most reliable comparables for each covered transaction. In some cases, CUPs or CUTs can be identified. In other cases, comparable business activities of independent companies are utilized in applying the CPM or residual profit split methods. Generally, in the APA Program's experience since 1991, CUPs and CUTs have been most often derived from the internal transactions of the taxpayer.

For profit-based methods in which comparable business activities or functions of independent companies are sought, the APA Program typically has applied a three-part process. First, a pool of potential comparables has been identified through broad searches. From this pool, companies having transactions that are clearly not comparable to those of the tested party have been eliminated through the use of quantitative and qualitative analyses, *i.e.*, quantitative screens and business descriptions. Then, based on a review of available descriptive and financial data, a set of comparable transactions or business activities of independent companies has been finalized. The comparability of the finalized set has then been enhanced through the application of adjustments.

Sources of Comparables

Comparables used in APAs can be U.S. or foreign. This depends on the relevant market, the type of transaction being evaluated, and the results of the functional and risk analyses. In general, comparables have been located by searching a variety of databases that provide data on U.S. publicly traded companies and on a combination of public and private non-U.S. companies. Table 20 shows the various databases and other sources used in selecting comparables for the APAs executed in 2003.

Although comparables were most often identified from the databases cited in Table 20, in some cases comparables were found from other sources, such as comparables derived internally from taxpayer transactions with third parties.

Selecting Comparables

Initial pools of potential comparables generally are derived from the databases using a combination of industry and keyword identifiers. Then, the pool is refined using a variety of selection criteria specific to the transaction or business activity being tested and the TPM being used.

The listed databases allow for searches by industrial classification, by keywords, or by both. These searches can yield a number of companies whose business activities may or may not be comparable to those of the entity being tested. Therefore, comparables based solely on industry classification or keyword searches are rarely used in APAs. Instead, the pool of comparables is examined closely, and companies are selected based on a combination of screens, business descriptions, and other information found in the companies' Annual Reports to shareholders and filings with the U.S. Securities and Exchange Commission (SEC).

Business activities are required to meet certain basic comparability criteria to be considered comparables. Functions, risks, economic conditions, and the property (product or intangible) and services associated with the transaction must be comparable. Determining comparability can be difficult — the goal has been to use comparability criteria restrictive enough to eliminate business activities that are not comparable, but yet not so restrictive as to have no comparables remaining. The APA Program normally has begun with relatively strict comparability criteria and then has relaxed them slightly if necessary to derive a pool of reliable comparables. A determination on the appropriate size of the comparables set, as well as the business activities that comprise the set, is highly fact specific and depends on the reliability of the results.

In addition, the APA Program, consistent with the section 482 regulations, generally has looked at the results of comparables over a multi-year period. Sometimes this has been a three-year period, but it has been more or less, depending on the circumstances of the controlled transaction. Using a shorter period might result in the inclusion of comparables in different stages of economic development or use of atypical years of a comparable due to cyclical fluctuations in business conditions.

Many covered transactions have been tested with comparables that have been chosen using additional criteria and/or screens. These include sales level criteria and tests for financial distress and product comparability. These common selection criteria and screens have been used to increase the overall comparability of a group of companies and as a basis for further research. The sales level screen, for example, has been used to remove companies that, due to their size, might face fundamentally different economic conditions from those of the transaction or business activities being tested. In addition, APA analyses have incorporated selection criteria related to removing companies experiencing "financial distress" due to concerns that companies in financial distress often have experienced unusual circumstances that render them not comparable to the business activity being tested. These criteria include: an unfavorable auditor's opinion, bankruptcy, and, in certain circumstances, operating losses in a given number of years.

An additional important class of selection criteria is the development and ownership of intangible property. In some cases in which the business activity being tested is a manufacturer, several criteria have been used to ensure, for example, that if the controlled entity does not own significant manufacturing intangibles or conduct research and development (R&D), then neither will the comparables. These selection criteria have included determining the importance of patents to a company or screening for R&D expenditures as a percentage of sales. Again, quantitative screens related to identifying comparables with significant intangible property generally have been used in conjunction with an understanding of the comparable derived from publicly available business information.

Selection criteria relating to asset comparability and operating expense comparability have also been used at times. A screen of property, plant, and equipment (PP&E) as a percentage of sales or assets, combined with a reading of a company's SEC filings, has been used to help ensure that distributors (generally lower PP&E) were not compared with manufacturers (generally higher PP&E), regardless of their industry classification. Similarly, a test involving the ratio of operating expenses to sales has helped to determine whether a company undertakes a significant marketing and distribution function.

Table 23 shows the number of times various screens were used in APAs executed in 2003:

TABLE 23: COMPARABILITY SCREENS

Comparability/Financial Distress Screen	Time Used
Comparability screens used	
Sales	15
R&D/ sales	11
Foreign sales/ total sales	5
Operating expenses/ sales	2
SG&A/ sales	4
Non-startup or start-up	2
Financial distress	
Bankruptcy	16
Unfavorable auditor's opinion	13
Losses in one or more years	9

Adjusting Comparables

After the comparables have been selected, the regulations require that "[i]f there are material differences between the controlled and uncontrolled transactions, adjustments must be made if the effect of such differences on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results." Treas. Reg. § 1.482–1(d)(2). In almost all cases involving income-statement-based PLIs, certain "asset intensity" or "balance sheet" adjustments for factors that have generally agreed-upon effects on profits are calculated. In addition, in specific cases, additional adjustments are performed to improve reliability.

The most common balance sheet adjustments used in APAs are adjustments for differences in accounts receivable, inventories, and accounts payable. The APA Program generally has required adjustments for receivables, inventory, and payables based on the principle that there is an opportunity cost for holding assets. For these assets it is generally assumed that the cost is a short-term debt interest rate.

To compare the profits of two business activities with different relative levels of receivables, inventory, or payables, the APA Program estimates the carrying costs of each item and adjusts profits accordingly. Although different formulas have been used in specific APA cases, Attachment B presents one set of formulas used in many APAs. Underlying these formulas are the notions that (1) balance sheet items should be expressed as mid-year averages, (2) formulas should try to avoid using data items that are being tested by the TPM (for example, if sales are controlled, then the denominator of the balance sheet ratio should not be sales), (3) a short-term interest rate should be used, and (4) an interest factor should recognize the average holding period of the relevant asset.

The APA Program also requires that data be compared on a consistent accounting basis. For example, although financial statements may be prepared on a first-in first-out (FIFO) basis, cross-company comparisons are less meaningful if one or more of the comparables use LIFO inventory accounting methods. This adjustment directly affects costs of goods sold and inventories, and therefore affects both profitability measures and inventory adjustments.

Still important in some cases is the adjustment for differences in relative levels of PP&E between a tested business activity and the comparables. Ideally, comparables and the business activity being tested will have fairly similar relative levels of PP&E, since major differences can be a sign of fundamentally different functions and risks. Typically, the PP&E adjustment is made using a medium term interest rate.

Additional adjustments used less frequently include those for differences in other balance sheet items, operating expenses, R&D, or currency risk. Accounting adjustments, such as reclassifying items from cost of goods sold to operating expenses, for example, are also made when warranted to increase reliability. Often, data is not available for both the controlled and uncontrolled transactions in sufficient detail to allow for these types of adjustments.

The adjustments made to comparables or tested parties in APAs executed in 2003 are reflected in Table 22 above.

Nature of Ranges and Adjustment Mechanisms
[§ 521(b)(2)(D)(viii)-(ix)]

The types of ranges and adjustment mechanisms used in APAs executed in 2003 are described in Table 24 and 25 below.

TABLE 24: TYPES OF RANGES[7]

Type of Range	Number
Interquartile range	31
Specific point (royalty)	8
Floor (*i.e.*, result must be no less than x)	6
Specific point within CPM range (not floor or ceiling)	3
Financial products - statistical confidence interval to test against internal CUPs	2
Ceiling (*i.e.*, result must be no more than x)	2
Other	7

TABLE 25: ADJUSTMENTS WHEN OUTSIDE OF THE RANGE

Adjustment mechanism	Number
Taxpayer makes an adjustment: to closest edge of single year	15
Taxpayer makes an adjustment: to specified point	11
Taxpayer makes an adjustment: to closest edge of multi-year average	9
Taxpayer makes an adjustment: to median of current year	7
Taxpayer makes an adjustment: to other	6
Taxpayer makes an adjustment: to median of multi-year average	3
Other	3

Discussion

Treas. Reg. § 1.482–1(e)(1) states that sometimes a pricing method will yield "a single result that is the most reliable measure of an arm's length result." Sometimes, however, a method may yield "a range of reliable results," called the "arm's length range." A taxpayer whose results fall within the arm's length range will not be subject to adjustment.

Under Treas. Reg. § 1.482–1(e)(2)(i), such a range is normally derived by considering a set of more than one comparable uncontrolled transaction of similar comparability and reliability. If these comparables are of very high quality, as defined in the Regulations, then under Treas. Reg. § 1.482–1(e)(2)(iii)(A), the arm's length range includes the results of all of the comparables (from the least to the greatest). However, the APA Program has only rarely identified cases meeting the requirements for the full range. If the comparables are of lesser quality, then under Treas. Reg. § 1.482–1(e)(2)(iii)(B), "the reliability of the analysis must be increased, when it is possible to do so, by adjusting the range through application of a valid statistical method to the results of all of the uncontrolled comparables." One such method, the "interquartile range," is ordinarily acceptable, although a different statistical method "may be applied if it provides a more reliable measure." The "interquartile range" is defined as, roughly, the range from the 25th to the 75th percentile of the comparables' results. See Treas. Reg. § 1.482–1(e)(2)(iii)(C). The interquartile range was used 31 times in 2003.

[7] Numbers do not include TPMs with cost or cost-plus methodologies.

Nineteen covered transactions reflected on Table 24 specified a single, specific result, or "point." Three of these covered transactions involved a CPM in which the taxpayer agreed to a specific result. Some APAs specify not a point or a range, but a "floor" or a "ceiling". When a floor is used, the tested party's result must be greater than or equal to some particular value. When a ceiling is used, the tested party's result must be less than or equal to some particular value. Six APAs executed in 2003 used a floor and two used a ceiling.

Some APAs look to a tested party's results over a period of years (multi-year averaging) to determine whether a taxpayer has complied with the APA. In 2003, rolling multi-year averaging was used for 10 covered transactions. Seven of those used three-year averages, one used a four-year average, and the other two used five-year averages. Cumulative multi-year averages were used for three covered transactions. Additionally, six covered transactions used term averages, and one covered transaction used a partial term average.

Adjustments

Under Treas. Reg. § 1.482–1(e)(3), if a taxpayer's results fall outside the arm's length range, the Service may adjust the result "to any point within the arm's length range." Accordingly, an APA may permit or require a taxpayer and its related parties to make an adjustment after the year's end to put the year's results within the range, or at the point specified by the APA. Similarly, to enforce the terms of an APA, the Service may make such an adjustment. When the APA specifies a range, the adjustment is sometimes to the closest edge of the range, and sometimes to another point such as the median of the interquartile range. Depending on the facts of each case, such automatic adjustments are not always permitted. APAs may specify that in such a case there will be a negotiation between the competent authorities involved to determine whether and to what extent an adjustment should be made. APAs may permit automatic adjustments unless the result is far outside the range specified in the APA. Thus APAs provide flexibility and efficiency, permitting adjustments when normal business fluctuations and uncertainties push the result somewhat outside the range.

In order to conform the taxpayer's books to these tax adjustments, the APA usually permits a "compensating adjustment" as long as certain requirements are met. Such compensating adjustments may be paid between the related parties with no interest, and the amount transferred will not be considered for purposes of penalties for failure to pay estimated tax. See § 11.02 Rev. Proc. 96–53.

APA Term and Rollback Lengths
[§ 521(b)(2)(D)(x)]

The various term lengths for APAs executed in 2003 are set forth in Table 26 below:

TABLE 26: TERMS OF APAs

APA Term in Years	Number of APAs
1	1
2	0
3	3
4	11
5	29
6	5
7	5
8	3
9	0
10	0
11	1

Number of rollback years to which an APA TPM was applied in 2003 is set forth in Table 27 below:

TABLE 27: NUMBER OF YEARS COVERED BY ROLLBACK OF APA TPM

Number of Rollback Years	Number of APAs
1	3
2	1
3	3
4	2
5 or more	4

Nature of Documentation Required
[§ 521(b)(2)(D)(xi)]

APAs executed in 2003 required that taxpayers provide various documents with their annual reports. These documents are described in Table 28 below:

TABLE 28: NATURE OF DOCUMENTATION REQUIRED[8]

Documentation	Number of Times Required
Statement identifying all material differences between Taxpayer's business operations during APA Year and description of Taxpayer's business operations contained in Taxpayer's request for APA, or if there have been no such material differences, a statement to that effect	57
Description of any failure to meet Critical Assumptions or, if there have been none, a statement to that effect	57
Statement identifying all material changes in Taxpayer's accounting methods and classifications, and methods of estimation, from those described or used in Taxpayer's request for APA, or if there have been none, statement to that effect	57
Financial analysis demonstrating Taxpayer's compliance with TPM	57
Description of, reason for, and financial analysis of, any Compensating Adjustments with respect to APA Year, including means by which any Compensating Adjustment has been or will be satisfied	57
Organizational chart	51
Financial statements as prepared in accordance with US GAAP	50
Certified public accountant's opinion that financial statements present fairly financial position of Taxpayer and the results of its operations, in accordance with US GAAP	49
Financial statements as prepared in accordance with a foreign GAAP	15
Certified public accountant's opinion that financial statements present fairly financial position of Taxpayer and the results of its operations, in accordance with a foreign GAAP	14
Various work papers	10
Book to tax reconciliations	10
Profit & Loss statement	6
Schedule of costs and expenses (*e.g.*, intercompany allocations)	6
Certified public accountant's review of financial statements	3

[8] The first eight categories of documentation listed in this table were drawn from the standard APA language used in 2003. The facts and circumstances of some APAs may eliminate the need for some standard documentation requirements.

Documentation	Number of Times Required
Description of any matters economically or substantively related to the covered transactions, but that are not subject to the APA	2
Other	16

Approaches for Sharing of Currency or Other Risks
[§ 521(b)(2)(D)(xii)]

During 2003, there were 31 tested parties that faced financial risks, including interest rate and currency risks. Three APAs provide specific approaches for dealing with currency risk, including adjustment mechanisms and critical assumptions.

Efforts to Ensure Compliance with APAs
[§ 521(b)(2)(F)]

As described in Rev. Proc. 96–53, section 11, APA taxpayers are required to file annual reports to demonstrate compliance with the terms and conditions of the APA. The filing and review of annual reports is a critical part of the APA process. Through annual report review, the APA program monitors taxpayer compliance with the APA on a contemporaneous basis. Annual report review provides current information on the success or problems associated with the various TPMs adopted in the APA process.

All reports received by the APA Office are tracked by one designated APA team leader who also has the primary responsibility for annual report review. One of the economists also spends a significant amount of time reviewing annual reports. Other APA team leaders also assist in this review, especially when the team leader who negotiated the case is available, since that person will already be familiar with the relevant facts and terms of the agreement. Once received by the APA Office, the annual report is sent out to the district personnel with exam jurisdiction over the taxpayer.

The statistics for the review of APA annual reports are reflected in Table 29 below. As of December 31, 2003, there were 222 pending annual reports. In 2003, there were 303 reports closed.

TABLE 29: STATISTICS OF ANNUAL REPORTS

Number of APA annual reports pending as of December 31, 2003	222
Number of APA annual reports closed in Year 2003	303[9]
Number of APA annual reports requiring adjustment in Year 2003	11
Number of taxpayers involved in adjustments	5
Number of APA annual reports required to be filed in Year 2003	235
Number of APA annual reports actually filed in Year 2003	235
Number of APA annual report cases over one year old	66

[9] This number differs from previously published figures because of annual reports closed but not yet entered on the system used to compile those statistics.

ATTACHMENT A

ADVANCE PRICING AGREEMENT
between
[*Insert Taxpayer's Name*]
and
THE INTERNAL REVENUE SERVICE

PARTIES

The Parties to this Advance Pricing Agreement (APA) are the Internal Revenue Service (IRS) and [*Insert Taxpayer's Name*], EIN _____ (Taxpayer).

RECITALS

Taxpayer's principal place of business is [*City, State*]. [*Insert general description of taxpayer and other relevant parties*] .

This APA contains the Parties' agreement on the best method for determining arm's-length prices of the Covered Transactions under I.R.C. section 482, any applicable tax treaties, and the Treasury Regulations.

Unless otherwise specified, terms in the plural include the singular and vice versa. Appendix D contains definitions for capitalized terms not elsewhere defined in this APA.

{If renewal, add} [Taxpayer and IRS previously entered into an APA covering taxable years ending _____ to _____, executed on _____.]

AGREEMENT

The Parties agree as follows:

1. *Covered Transactions*. This APA applies to the Covered Transactions, as defined in Appendix A.

2. *Transfer Pricing Method*. Appendix A sets forth the Transfer Pricing Method (TPM) for the Covered Transactions.

3. *Term*. This APA applies to Taxpayer's taxable years ending _____ through _____ (APA Term).

4. *Operation*.

a. Revenue Procedure 96–53 governs the interpretation, legal effect, and administration of this APA.

b. Nonfactual oral and written representations, within the meaning of sections 10.04 and 10.05 of Revenue Procedure 96–53 (including any proposals to use particular TPMs), made in conjunction with the APA Request constitute statements made in compromise negotiations within the meaning of Rule 408 of the Federal Rules of Evidence.

5. *Compliance*.

a. For each taxable year covered by this APA (APA Year), if Taxpayer complies with the terms and conditions of this APA, then the IRS will not make or propose any allocation or adjustment under I.R.C. section 482 to the Covered Transactions.

b. If Taxpayer does not comply, then the IRS may:

i. enforce the terms and conditions of this APA and make or propose allocations or adjustments under I.R.C. section 482 consistent with this APA;

ii. cancel or revoke this APA under section 11.05 or 11.06 of Revenue Procedure 96–53; or

iii. revise this APA, if the Parties agree.

c. Taxpayer must timely file an Annual Report for each APA Year in accordance with Appendix C and section 11.01 of Revenue Procedure 96–53. Taxpayer must file an original and four copies of the Annual Report by the later of (a) 90 days after the time prescribed by law (including extensions) for filing its federal income tax return for the APA Year covered by the report, or (b) 90 days after the effective date of this APA. [*The Service and the Taxpayer may agree to alternative filing dates*.] The IRS may request additional information reasonably necessary to clarify or complete the Annual Report. Taxpayer will provide all requested information within 30 days. Additional time may be allowed for good cause.

d. The IRS will determine whether Taxpayer has complied with this APA based on Taxpayer's U.S. Returns, Financial Statements, and other APA Records, for the APA Term and any other year necessary to verify compliance. For Taxpayer to comply with this APA, an independent certified public accountant must {*use the following or an alternative*} render an opinion that the Taxpayer's Financial Statements present fairly, in all material respects, Taxpayer's financial position under U.S. GAAP.

e. In accordance with section 11.04 of Revenue Procedure 96–53, Taxpayer will (1) maintain its APA Records, and (2) make them available to IRS in connection with an examination under section 11.03. Compliance with this subparagraph constitutes compliance with the record-maintenance provisions of I.R.C. sections 6038A and 6038C for the Covered Transactions for any taxable year during the APA Term.

f. If Taxpayer's actual transactions do not result in compliance with the TPM, Taxpayer:

i. Must report its taxable income in an amount that is consistent with the TPM and all other requirements of this APA on its timely filed U.S. Return. However, for any APA Year, if Taxpayer's timely filed U.S. Return is filed no later than 60 days after the effective date of this APA, then Taxpayer may instead report its taxable income in an amount that is consistent with the TPM and all other requirements of this APA on an amended U.S. Return filed no later than 120 days after the effective date of this APA.

ii. May make compensating adjustments under Revenue Procedure 96–53, section 11.02, subject to any modifications or restrictions in Appendix A or elsewhere in this APA.

g. {*Insert when U.S. Group or Foreign Group contains more than one member.*} [This APA addresses the arm's-length nature of prices charged or received in the aggregate between Taxpayer[s] and Foreign Participants. Except as explicitly provided, this APA does not address and does not bind the IRS with respect to prices charged or received, or the relative amounts of income or loss realized, by particular legal entities that are members of U.S. Group or that are members of Foreign Group.]

h. The True Taxable Income within the meaning of Treasury Regulations section 1.482–1(a)(1) of a member of an affiliated group filing a U.S. consolidated return will be determined under the I.R.C. section 1502 Treasury Regulations.

i. *{Optional for US Parent Signatories}* To the extent that Taxpayer's compliance with this APA depends on certain acts of Foreign Group members, Taxpayer will ensure that each Foreign Group member will perform such acts.

6. *Critical Assumptions*. This APA's critical assumptions, within the meaning of Revenue Procedure 96–53, section 5.07, appear in Appendix B. Revenue Procedure 96–53, section 11.07, governs if any critical assumption has not been met.

7. *Disclosure*. This APA, and any background information related to this APA or the APA Request, are: (1) considered "return information" under I.R.C. section 6103(b)(2)(C); and (2) not subject to public inspection as a "written determination" under I.R.C. section 6110(b)(1). Section 521(b) of Pub. L. 106–170 provides that the Secretary of the Treasury must prepare a report for public disclosure that includes certain specifically designated information concerning all APAs, including this APA, in a form that does not reveal taxpayers' identities, trade secrets, and proprietary or confidential business or financial information.

8. *Disputes*. If a dispute arises concerning the interpretation of this APA, the Parties will seek a resolution by the IRS Associate Chief Counsel (International), to the extent reasonably practicable, before seeking alternative remedies. If any dispute arises that is not related to interpreting this APA, the Parties will seek to resolve the dispute in a manner consistent with Revenue Procedure 96–53, section 11.03(4).

9. *Materiality*. In this APA the terms "material" and "materially" will be interpreted consistently with the definition of "material facts" in Revenue Procedure 96–53, section 11.05(1).

10. *Section Captions*. This APA's section captions, which appear in *italics*, are for convenience and reference only. The captions do not affect in any way the interpretation or application of this APA.

11. *Entire Agreement and Severability*. This APA is the complete statement of the Parties' agreement. The Parties will sever, delete, or reform any invalid or unenforceable provision in this APA to approximate the Parties' intent as nearly as possible.

12. *Successor in Interest*. This contract binds, and inures to the benefit of, any successor in interest to Taxpayer.

13. *Notice*. Any notices required by this APA or Revenue Procedure 96–53 must be in writing. Taxpayer will send notices to the IRS at the address and in the manner set forth in Revenue Procedure 96–53, section 5.13(2). The IRS will send notices to:

Taxpayer Corporation
Attn: Jane Doe, Sr. Vice President (Taxes)
1000 Any Road
Any City, USA 10000
(phone: _____)

14. *Effective date and Counterparts*. This APA is effective starting on the date, or later date of the dates, upon which all Parties execute this APA. The Parties may execute this APA in counterparts, with each counterpart constituting an original.

WITNESS,

The Parties have executed this APA on the dates below.

[Taxpayer Name in all caps]

By: _____ Date: _____, 20 _____
Jane Doe
Sr. Vice President (Taxes)

IRS

By: _____ Date: _____, 20 _____
Matthew W. Frank
Director, Advance Pricing Agreement Program

APPENDIX A

COVERED TRANSACTIONS AND TRANSFER PRICING METHOD (TPM)

1. Covered Transactions.

[*Define the Covered Transactions*.]

2. TPM.

{Note: If appropriate, adapt language from the following examples.}

• **CUP Method**

The TPM is the comparable uncontrolled price (CUP) method. The price charged for _____ must equal between _____ and _____ (the Arm's Length Range). Taxpayer must realize, recognize, and report results on its U.S. Returns that clearly reflect such pricing.

• **Resale Price Method (RPM)**

The TPM is the resale price method (RPM). Taxpayer must realize, recognize, and report results on its U.S. Returns that clearly reflect a gross margin (defined as gross profit divided by sales revenue as those terms are defined in Treasury Regulations sections 1.482–5(d)(1) and (2)) of between _____% and _____% (the Arm's Length Range) for the Covered Transactions.

• **Cost Plus Method**

The TPM is the cost plus method. Taxpayer must realize, recognize, and report results on its U.S. Returns that clearly reflect a ratio of gross profit to production costs (within the meaning of Treasury Regulations sections 1.482–3(d)(1) and (2)) of between _____% and _____% (the Arm's Length Range) for the Covered Transactions.

• **CPM with Berry Ratio PLI**

The TPM is the comparable profits method (CPM). Taxpayer must realize, recognize, and report results on its U.S. Returns that clearly reflect a gross profit to operating expenses ratio (as those terms are defined in Treasury Regulations sections 1.482–5(d)(2) and (3)) of between _____ and _____ (the Arm's Length Range) for the Covered Transactions.

• CPM using an Operating Margin PLI

The TPM is the comparable profits method (CPM). The profit level indicator is an operating margin. Taxpayer's reported operating profit (within the meaning of Treasury Regulations sections 1.482–5(d)(5)) must clearly reflect an operating margin (defined as the ratio of operating profit to sales revenue as those terms are defined in Treasury Regulations section 1.482–5(d)(1) and (4)) of between _____% and _____% (the Arm's Length Range) for the Covered Transactions.

• CPM using a Three-year Rolling Average Operating Margin PLI

The TPM is the comparable profits method (CPM). The profit level indicator is an operating margin. Taxpayer's Three-Year Rolling Average operating margin is defined as follows for any APA Year: the sum of Taxpayer's reported operating profit (within the meaning of Treasury Regulations section 1.482–5(d)(5)) for that APA Year and the two preceding years, divided by the sum of Taxpayer's sales revenue (within the meaning of Treasury Regulations section 1.482–5(d)(1)) for that APA Year and the two preceding years. Taxpayer's Three-Year Rolling Average operating margin must be between _____% and _____% (the Arm's Length Range.)

• Residual Profit Split Method

The TPM is the residual profit split method. Taxpayer must realize, recognize, and report results on its U.S. Returns that clearly reflect the following: [*insert description of profit-split mechanism*].

[*Insert additional provisions as needed*.]

3. Adjustments.

{For use with a CPM}

For each APA Year, if Taxpayer's year-end [Three-Year Rolling Average] *{specify PLI used}* for the Covered Transactions is not in compliance with the TPM, Taxpayer will make an adjustment that brings its [Three-Year Rolling Average] *{specify PLI used}* to *{if the TPM specifies a point value, use that; if the TPM specifies an Arm's Length Range, use the nearest edge of the Arm's Length Range or a point such as the median within the Arm's Length Range}*.

[*Insert additional provisions as needed*.]

APPENDIX B

CRITICAL ASSUMPTIONS

This APA's critical assumptions are:

1. The business activities, functions performed, risks assumed, assets employed, and financial and tax accounting methods and classifications [and methods of estimation] of Taxpayer in relation to the Covered Transactions will remain materially the same as described or used in Taxpayer's APA Request. A mere change in business results will not be a material change.

[*Insert additional provisions as needed.*]

APPENDIX C

APA RECORDS AND ANNUAL REPORT

APA RECORDS

The APA Records will consist of:

1. All documents listed below for inclusion in the Annual Report, as well as all documents, notes, work papers, records, or other writings that support the information provided in such documents.

2. [Insert here other records as required.]

ANNUAL REPORT

The Annual Report will include a cover sheet and a table of contents. The cover sheet will specify:

i. the Parties to the APA;

ii. the APA Term (defined in section 3 of this APA);

iii. the APA's effective date (defined in section 14 of this APA);

iv. whether the APA is a renewal, and if so the term of the prior APA;

v. whether the APA has been amended, and if so the amendment's effective date;

vi. any information needed to distinguish the APA at issue from any other APAs involving the same parties;

vii. any changes to the Taxpayer notice information in section 13 of this APA.

The table of contents and the Annual Report will be organized as listed below. Taxpayer must include the following items in its Annual Report for each APA Year.

1. Statements that fully identify, describe, analyze, and explain:

a. All material differences between any of Taxpayer's business operations (including functions, risks, markets, contractual terms, economic conditions, property or services, and assets employed) during the APA Year and the description of the business operations contained in the APA Request. If there have been no material differences, the Annual Report will include a statement to that effect.

b. All material changes in Taxpayer's accounting methods and classifications, and methods of estimation, from those described or used in Taxpayer's request for this APA. If there have been no such material changes, the Annual Report will include a statement to that effect.

c. Any failure to meet any critical assumption. If there have been no failures, the Annual Report will include a statement to that effect.

d. Any change to any entity classification for federal income tax purposes (including any change that causes an entity to be disregarded for federal income tax purposes) of any Worldwide Group member that is a party to the Covered Transactions or is otherwise relevant to the TPM.

e. Any changes to Taxpayer's financial accounting methods that were made to conform to U.S. GAAP changes and that affect the Covered Transactions.

f. The amount, reason for, and financial analysis of any compensating adjustments under paragraph 5(f)(ii) of this APA for the APA Year, including but not limited to:

i. the amounts paid or received by each affected entity;

ii. the character (such as capital, ordinary, income, expense) and country source of the funds transferred, and the specific affected line item(s) of any affected U.S. Return; and

iii. the date(s) and means by which the payments are or will be made.

g. The amounts, description, reason for, and financial analysis of any book-tax differences relevant to the TPM for the APA Year, as reflected on Schedule M–1 of the U.S. Return for the APA Year.

2. The Financial Statements, and any necessary account detail to show compliance with the TPM, with a copy of the independent certified public accountant's opinion required by paragraph 5(d) of this APA.

3. A financial analysis that reflects Taxpayer's TPM calculations for the APA Year. The calculations must reconcile with and reference the Financial Statements in sufficient account detail to allow the IRS to determine whether Taxpayer has complied with the TPM.

4. An organizational chart for the Worldwide Group, revised annually to reflect all ownership or structural changes of entities that are parties to the Covered Transactions or are otherwise relevant to the TPM.

APPENDIX D

DEFINITIONS

The following definitions control for all purposes of this APA. The definitions appear alphabetically below:

Term	Definition
Annual Report	A report within the meaning of Revenue Procedure 96–53, section 11.
APA	This Advance Pricing Agreement, which is an "advance pricing agreement" within the meaning of Revenue Procedure 96–53, section 1.
APA Records	The records specified in Appendix C.
APA Request	Taxpayer's request for this APA dated _____, including any amendments or supplemental or additional information thereto.
Covered Transaction	This term is defined in Appendix A.
Financial Statements	The financial statements prepared in accordance with U.S. GAAP and stated in U.S. dollars.
Foreign Group	Worldwide Group members that are not U.S. persons.
Foreign Participants	[name the foreign entities involved in Covered Transactions].
I.R.C.	The Internal Revenue Code of 1986, 26 U.S.C., as amended.
Pub. L. 106–170	The Ticket to Work and Work Incentives Improvement Act of 1999.
Revenue Procedure 96–53	Rev. Proc. 96–53, 1996–2 C.B. 375.
Transfer Pricing Method (TPM)	A transfer pricing method within the meaning of Treasury Regulations section 1.482–1(b) and Revenue Procedure 96–53, section 3.02.
U.S. GAAP	U.S. generally-accepted accounting principles.
U.S. Group	Worldwide Group members that are U.S. persons.
U.S. Return	For each taxable year, the "returns with respect to income taxes under subtitle A" that Taxpayer must "make" in accordance with I.R.C. section 6012. {*Or substitute for partnership:* For each taxable year, the "return" that Taxpayer must "make" in accordance with I.R.C. section 6031.}
Worldwide Group	Taxpayer and all organizations, trades, businesses, entities, or branches (whether or not incorporated, organized in the United States, or affiliated) owned or controlled directly or indirectly by the same interests.

ATTACHMENT B

FORMULAS FOR BALANCE SHEET ADJUSTMENTS

Definitions of Variables:

AP	=	average accounts payable
AR	=	average trade accounts receivable, net of allowance for bad debt
cogs	=	cost of goods sold
INV	=	average inventory, stated on FIFO basis
opex	=	operating expenses (general, sales, administrative, and depreciation expenses)
PPE	=	property, plant, and equipment, net of accumulated depreciation
sales	=	net sales
tc	=	total cost (cogs + opex, as defined above)
h	=	average accounts payable or trade accounts receivable holding period, stated as a fraction of a year
i	=	interest rate
t	=	entity being tested
c	=	comparable

Equations:

If Cost of Goods Sold is controlled (generally, sales in denominator of PLI):

Receivables Adjustment ("RA"): $RA = \{[(AR_t / sales_t) \times sales_c] - AR_c\} \times \{i/[1+(i \times h_c)]\}$

Payables Adjustment ("PA"): $PA = \{[(AP_t / sales_t) \times sales_c] - AP_c\} \times \{i/[1+(i \times h_c)]\}$

Inventory Adjustment ("IA"): $IA = \{[(INV_t / sales_t) \times sales_c] - INV_c\} \times i$

PP&E Adjustment ("PPEA"): $PPEA = \{[(PPE_t / sales_t) \times sales_c] - PPE_c\} \times i$

If Sales are controlled (generally, costs in the denominator of PLI):[10]

Receivables Adjustment ("RA"): $RA = \{[(AR_t / tc_t) \times tc_c] - AR_c\} \times \{i/[1+(i \times h_c)]\}$

Payables Adjustment ("PA"): $PA = \{[(AP_t / tc_t) \times tc_c] - AP_c\} \times \{i/[1+(i \times h_c)]\}$

Inventory Adjustment ("IA"): $IA = \{[(INV_t / tc_t) \times tc_c] - INV_c\} \times i$

PP&E Adjustment ("PPEA"): $PPEA = \{[(PPE_t / tc_t) \times tc_c] - PPE_c\} \times i$

Then Adjust Comparables as Follows:

$\text{adjusted sales}_c = \text{sales}_c + RA$

$\text{adjusted cogs}_c = \text{cogs}_c + PA - IA$

$\text{adjusted opex}_c = \text{opex}_c - PPEA$

[10] Depending on the specific facts, the equations below may use total costs ("tc") or cost of goods sold ("cogs").

Application of Circular 230 to Municipal Bond Opinions

Announcement 2004–29

On December 30, 2003, the Treasury Department published a notice of proposed rulemaking in the Federal Register (REG–122379–02, 2004–5 I.R.B. 392) proposing modifications to rules governing practice before the Internal Revenue Service (Circular 230). Section 10.35 (Requirements for certain tax shelter opinions) of the proposed regulations is proposed to be effective for opinions rendered after the date that final regulations are published in the Federal Register.

The Treasury Department and the IRS are continuing to consider all comments on the proposed regulations. In the meantime, the Treasury Department and the IRS announce that, in final regulations, the definition of tax shelter opinion for purposes of section 10.35 will not apply, if at all, to written advice concerning municipal bonds rendered less than 120 days after the publication of such final regulations in the Federal Register. Conforming changes, if necessary, will be made to section 10.36(b).

The principal author of this notice is Heather L. Dostaler of the Office of the Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division, but other personnel from the IRS and Treasury Department participated in its development. For further information regarding this notice, contact Heather L. Dostaler at (202) 622–4940 (not a toll-free number).

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.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D. —Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z —Corporation.

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