Internal Revenue
bulletin

Bulletin No. 2004-6
February 9, 2004

HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

Rev. Rul. 2004–9, page 428.

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 642, 1274, 1288, and other sections of the Code, tables set forth the rates for February 2004.

T.D. 9104, page 406.

Final regulations under section 41 of the Code clarify the definition of qualified research contained in the credit for increasing research activities. In addition, the regulations adopt the recordkeeping requirements and the rules for excluded activities as set forth in the 2001 proposed regulations.

T.D. 9105, page 419.
REG–126459–03, page 437.

Final, temporary, and proposed regulations under sections 167, 446, and 1016 of the Code provide rules for changes in determining depreciation or amortization. The regulations also provide guidance as to whether certain changes in depreciation or amortization are changes in methods of accounting. The regulations apply to changes made for taxable years ending on or after December 30, 2003. A public hearing on the proposed regulations is scheduled for April 7, 2004.

T.D. 9108, page 429.

Final regulations under section 6011 of the Code modify and clarify the rules relating to confidential transactions under regulations section 1.6011–4(b)(3), and make minor conforming changes to the list maintenance rules under regulations section 301.6112–1.

Notice 2004–11, page 434.

This notice announces a pilot program that permits large and mid-size business taxpayers to enter into research credit recordkeeping agreements.

Announcement 2004–9, page 441.

This advance notice of proposed rulemaking (REG–153656–03) under section 41 of the Code invites comments relating to the definition of internal-use software contained in the credit for increasing research activities. In addition, the document provides guidance for taxpayers regarding the interim effective dates of the internal-use software rules.

EMPLOYEE PLANS

Rev. Rul. 2004–4, page 414.

Employee stock ownership plans; S corporations; listed transactions. A finding of synthetic equity owned by a disqualified person in a nonallocation year of an ESOP, as those terms are defined in section 409(p) of the Code and regulations section 1.409(p)–1T, takes place in three distinct situations. In addition, the transactions described in this ruling, as well as substantially similar transactions, are designated as "listed transactions."

Notice 2004–10, page 433.

Electronic delivery of Form 1099 and Form 5498 payee statements. This notice permits the electronic delivery of Form 1099–R, Form 1099–MSA, Form 1099–Q, Form 5498, Form 5498–ESA, and Form 5498–MSA payee statements by their respective due dates.

(Continued on the next page)

Announcements of Disbarments and Suspensions begin on page 439.
Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

EXEMPT ORGANIZATIONS

Notice 2004–10, page 433.

Electronic delivery of Form 1099 and Form 5498 payee statements. This notice permits the electronic delivery of Form 1099–R, Form 1099–MSA, Form 1099–Q, Form 5498, Form 5498–ESA, and Form 5498–MSA payee statements by their respective due dates.

ADMINISTRATIVE

T.D. 9108, page 429.

Final regulations under section 6011 of the Code modify and clarify the rules relating to confidential transactions under regulations section 1.6011–4(b)(3), and make minor conforming changes to the list maintenance rules under regulations section 301.6112–1.

Notice 2004–10, page 433.

Electronic delivery of Form 1099 and Form 5498 payee statements. This notice permits the electronic delivery of Form 1099–R, Form 1099–MSA, Form 1099–Q, Form 5498, Form 5498–ESA, and Form 5498–MSA payee statements by their respective due dates.

Announcement 2004–8, page 441.

This announcement corrects the user fee in Appendix A of Rev. Proc. 2004–1 for a letter ruling request involving an extension of time to file Form 3115, *Application for Change in Accounting Method*. The correct user fee is $1,200, not $1,500.

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 consolidated 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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*** Beginning with Internal Revenue Bulletin 2003–43**, we are publishing the index at the end of the month, rather than at the beginning.

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

Section 41.—Credit for Increasing Research Activities

26 CFR 1.41–4: Qualified research for expenditures paid or incurred in taxable years ending on or after December 31, 2003.

T.D. 9104

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 602

Credit for Increasing Research Activities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the definition of qualified research under section 41(d) for the credit for increasing research activities. These final regulations reflect changes to section 41(d) made by the Tax Reform Act of 1986.

DATES: *Effective Dates*: These regulations are effective January 2, 2004.

Applicability Dates: For dates of applicability of these regulations, see §1.41–4 (e) and Effective Dates under SUPPLEMENTARY INFORMATION.

FOR FURTHER INFORMATION CONTACT: Nicole R. Cimino at (202) 622–3120 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On December 2, 1998, the Treasury Department and the IRS published in the **Federal Register** a notice of proposed rulemaking (REG–105170–97, 1998–2 C.B. 729 [63 FR 66503]) under section 41 (1998 proposed regulations) relating to the credit for increasing research activities (research credit). The 1998 proposed regulations addressed, in relevant part, (1) the definition of qualified research under section 41(d), (2) the application of the exclusions from the definition of qualified research, and (3) the application of the shrinking-back rule. Comments responding to the 1998 proposed regulations were received and a public hearing was held on April 29, 1999.

On January 3, 2001, the Treasury Department and the IRS published in the **Federal Register** final regulations relating, in relevant part, to the definition of qualified research under section 41(d) (T.D. 8930, 2001–1 C.B. 433 [66 FR 280]). In response to taxpayer concerns regarding T.D. 8930, on January 31, 2001, the Treasury Department and the IRS published Notice 2001–19, 2001–1 C.B. 784, announcing that the Treasury Department and the IRS would review T.D. 8930 and reconsider comments previously submitted in connection with the finalization of T.D. 8930. Notice 2001–19 also provided that, upon the completion of the review, the Treasury Department and the IRS would announce changes to the regulations, if any, in the form of proposed regulations.

On December 26, 2001, the Treasury Department and the IRS published in the **Federal Register** a notice of proposed rulemaking (REG–112991–01, 2002–1 C. B. 404 [66 FR 66362]) reflecting the Treasury Department and the IRS' review of T.D. 8930 (2001 proposed regulations). Comments responding to the 2001 proposed regulations were received and a public hearing was held on March 27, 2002. After considering the comments received and the statements made at the public hearing, portions of the 2001 proposed regulations are adopted as revised by this Treasury Decision.

Explanation of Provisions

This document amends 26 CFR part 1 to provide revised rules for the research credit under section 41. These final regulations generally retain the provisions of the 2001 proposed regulations but clarify the provisions relating to the requirement in section 41(d)(1)(C) that qualified research be research "substantially all of the activities of which constitute elements of a process of experimentation." These final regulations, however, do not contain final rules for research with respect to computer software "which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer" for purposes of section 41(d)(4)(E).

Process of Experimentation—In General

The Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2085) (the 1986 Act), which narrowed the definition of the term *qualified research*, amended the definition of qualified research by adding a process of experimentation requirement. Section 41(d)(1) provides that in order to constitute qualified research, substantially all of the activities of the research must constitute elements of a process of experimentation related to a new or improved function, performance, or reliability or quality. The legislative history to the 1986 Act explained that "[t]he determination of whether research is undertaken for the purpose of discovering information that is technological in nature depends on whether the process of experimentation utilized in the research fundamentally relies on principles of the physical or biological sciences, engineering, or computer science." H.R. Conf. Rep. No. 99–841, at II–71 (1986). The legislative history further explained that the term *process of experimentation* means, "a process involving the evaluation of more than one alternative designed to achieve a result where the means of achieving that result is uncertain at the outset." *Id.*, at II–72. In addition, a process of experimentation may involve developing one or more hypotheses, testing and analyzing those hypotheses (through, for example, modeling or simulation), and refining or discarding the hypotheses as part of a sequential design process to develop the overall component. *Id.*

The 1998 proposed regulations defined a process of experimentation as "a process to evaluate more than one alternative designed to achieve a result where the means of achieving that result are uncertain at the

outset." Further, the 1998 proposed regulations specified that a process of experimentation is a four-step process requiring that the taxpayer: (i) develop one or more hypotheses designed to achieve the intended result; (ii) design a scientific experiment (that, where appropriate to the particular field of research, is intended to be replicable with an established experimental control) to test and analyze those hypotheses (through, for example, modeling, simulation, or a systematic trial and error methodology); (iii) conduct the experiment and record the results; and (iv) refine or discard the hypotheses as part of a sequential design process to develop or improve the business component. Commentators generally objected to this prescribed four-step test arguing that it would not be appropriate for evaluating the qualification of certain commercial and industrial research activities.

In response to these comments, the Treasury Department and the IRS in T.D. 8930 provided that taxpayers conducting a process of experimentation may, but were not required to, engage in the four-step process described in the 1998 proposed regulations, but eliminated, for this purpose, the specific recordation requirement. (As an addition to the general recordkeeping requirement under section 6001, T.D. 8930 instead included a contemporaneous documentation requirement that was intended to be less burdensome than the specific recordation requirement. The contemporaneous documentation requirement in T.D. 8930 was eliminated in the 2001 proposed regulations.) Consistent with the legislative history, however, T.D. 8930 retained the underlying process of experimentation requirement in the 1998 proposed regulations by providing that a process of experimentation "is a process to evaluate more than one alternative designed to achieve a result where the capability or method of achieving that result is uncertain at the outset."

The 2001 proposed regulations further clarified the definition of a process of experimentation and provided, in relevant part, that "a process of experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities." More specifically, however, the general requirement was modified in the 2001 proposed regulations to provide, first, that "a process of experimentation is a process *designed* to evaluate *one or more* alternatives to achieve a result." (Emphasis added). The 2001 proposed regulations also provided that a process of experimentation may exist if a taxpayer performs research to establish the appropriate design of a business component even when the capability and method for developing or improving the business component are not uncertain. The 2001 proposed regulations further stated that a taxpayer's activities do not constitute elements of a process of experimentation where the capability and method of achieving the desired new or improved business component, and the appropriate design of the desired new or improved business component, are readily discernible and applicable as of the beginning of the taxpayer's research activities so that true experimentation in the scientific or laboratory sense would not have to be undertaken to test, analyze, and choose among viable alternatives. Finally, the 2001 proposed regulations emphasized that the determination of whether a taxpayer has engaged in a process of experimentation was dependent on the facts and circumstances of the taxpayer's research activities and, for this purpose, contained three non-dispositive and non-exclusive factors that tend to indicate that a taxpayer has engaged in a process of experimentation.

In response to the 2001 proposed regulations, a number of commentators expressed concern with the rules for the process of experimentation requirement, and, in particular, stated that the rules and terms used (including *uncertainty*, *appropriate design*, and *readily discernible and applicable*) did not provide clear guidance for the requirement. More specifically, commentators stated that the term *readily discernible and applicable* was highly subjective in nature, and thus arguably could be construed as a variant of the discovery test of T.D. 8930. In addition, one commentator expressed concern regarding the meaning and scope of the term *uncertain* and suggested adding examples illustrating the factors that tend to indicate that a taxpayer has engaged in a process of experimentation. Another commentator also noted that the 2001 proposed regulations appeared to allow the inclusion of all design costs as qualified research expenditures to the extent that the appropriate design of the desired result is never certain at the outset of the typical design process.

The Treasury Department and the IRS continue to believe that the process of experimentation test requires an evaluation of the facts and circumstances of a taxpayer's research activities. As reflected by the changes made in the 2001 proposed regulations, this requirement is not intended to be inflexible or overly narrow. Nevertheless, the Treasury Department and the IRS continue to believe that the requirement in the 2001 proposed regulations that a process of experimentation is "a *process* designed to evaluate one or more alternatives to achieve a result" (emphasis added) implies that research activities must contain certain core elements in order to constitute a process of experimentation within the meaning of section 41(d)(1)(C). These final regulations, therefore, make the following clarifications relating to the process of experimentation requirement in the 2001 proposed regulations.

Process of Experimentation—Requirements

The final regulations retain, but further clarify, the requirement in the 2001 proposed regulations that "a process of experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities." Further, the final regulations emphasize that the taxpayer's activities must be directed at resolving uncertainty regarding the taxpayer's development or improvement of a business component, and that the process of experimentation must fundamentally rely on the principles of the physical or biological sciences, engineering, or computer science in attempting to resolve the uncertainty. Although these concepts are stated explicitly in the 1986 legislative history and are implicit in the statute, they may not have been given appropriate or necessary weight in prior proposed or final guidance on the process of experimentation requirement.

The final regulations, therefore, set out what the Treasury Department and the IRS have concluded to be the core elements of a process of experimentation for purposes of the research credit. As noted above and consistent with the statute's wording which requires purposeful activity (*i.e.*, "undertaken for the purpose of discovering information"), a taxpayer is required to identify the uncertainty regarding the development or improvement of a business component that is the object of the taxpayer's research activities. A taxpayer is also required to identify one or more alternatives intended to eliminate that uncertainty. Additionally, a taxpayer is required to identify and to conduct a process of evaluating the alternatives. The final regulations provide that such a process may involve, for example, modeling, simulation, or a systematic trial and error methodology.

The final regulations further provide that a process of experimentation "*must* be an evaluative process and generally *should* be capable of evaluating more than one alternative." (Emphasis added). Although the identification and evaluation of more than a single alternative is not required to satisfy the process of experimentation requirement, the Treasury Department and the IRS believe that a taxpayer's activities, in order to qualify for the research credit, generally should be capable of evaluating more than one alternative and, in any event, must be designed to evaluate the alternative, or alternatives, being considered.

The final regulations state that the mere existence of uncertainty regarding the development or improvement of a business component does not indicate that all of a taxpayer's activities undertaken to achieve that new or improved business component constitute a process of experimentation, even if the taxpayer, in fact, does achieve the new or improved business component. The Treasury Department and the IRS believe that the inclusion of a separate process of experimentation requirement in the statute makes this proposition clear. However, the Treasury Department and the IRS have included this clarification in the final regulations out of concern that taxpayers have not been giving sufficient weight to the requirement that a taxpayer engage in a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities. In particular, this clarification is intended to indicate that merely demonstrating that uncertainty has been eliminated (*e.g.*, the achievement of the appropriate design of a business component when such design was uncertain as of the beginning of a taxpayer's activities) is insufficient to satisfy the process of experimentation requirement. A taxpayer bears the burden of demonstrating that its research activities additionally satisfy the process of experimentation requirement.

As noted above, all of the facts and circumstances of a taxpayer's research activities are taken into account to determine whether the taxpayer identified uncertainty concerning the development or improvement of a business component, identified one or more alternatives intended to eliminate that uncertainty, and identified and conducted a process of evaluating the alternatives. Although the final regulations set out the core elements of a process of experimentation, how a taxpayer's qualified research activities will reflect these core elements will depend on the facts and circumstances. These core elements will not necessarily occur in a strict, sequential order. A process of experimentation is an evaluative process, and as such, often involves refining throughout much of the process the taxpayer's understanding of the uncertainty the taxpayer is trying to address, modifying the alternatives being evaluated to eliminate that uncertainty, or modifying the process used to evaluate those alternatives.

Accordingly, the final regulations do not provide detailed guidance as to how the regulatory provisions are to be applied to a given factual situation. Rather, the Treasury Department and the IRS have concluded that the application of these provisions will depend on the specific activities being claimed by a taxpayer as qualified research, the nature of the taxpayer's business and industry, and the uncertainties being addressed by the taxpayer's research activities. The Treasury Department and the IRS believe that additional, industry-specific guidance may be appropriate and request comments on the form of such guidance.

The final regulations do not include the rule contained in the 2001 proposed regulations that a taxpayer's activities do not constitute a process of experimentation where the capability and method of achieving the desired new or improved business component, and the appropriate design of the desired new or improved business component, are readily discernible and applicable as of the beginning of the taxpayer's research activities. A number of commentators expressed concern that this rule was too vague and susceptible to conflicting interpretations. In light of the clarifications made in these final regulations, the Treasury Department and the IRS have concluded that this rule is no longer necessary because such activities do not constitute a process of experimentation under the final regulations.

As noted above, the 2001 proposed regulations do not contain a specific recordkeeping requirement beyond the requirements set out in section 6001 and the regulations thereunder. No change regarding recordkeeping is being made in these final regulations. The clarifications being made to the process of experimentation requirement do not impose any recordkeeping requirement on taxpayers beyond the requirements set out in section 6001 and the regulations thereunder.

Process of Experimentation—Substantially all Requirement

The 2001 proposed regulations retained the rule in T.D. 8930 that the "substantially all" requirement of section 41(d)(1)(C) is satisfied only if 80 percent or more of the research activities, measured on a cost or other consistently applied reasonable basis (and without regard to §1.41–2(d)(2)), constitute elements of a process of experimentation for a purpose described in section 41(d)(3). This requirement is applied separately to each business component.

The Treasury Department and the IRS requested comments on the application of the substantially all rule and, in particular, whether research expenses incurred for non-qualified purposes (*i.e.*, relating to style, taste, cosmetic, or seasonal design factors) are includible in the credit computation provided that substantially all of the research activities constitute elements of a process of experimentation for a qualified

purpose. After consideration of the comments received, the Treasury Department and the IRS have concluded that the substantially all requirement can be satisfied even if some portion of a taxpayer's activities are not for a qualified purpose.

Accordingly, these final regulations clarify the substantially all rule and provide that the substantially all requirement is satisfied if 20 percent or less of a taxpayer's research activities do not constitute elements of a process of experimentation for a purpose described in section 41(d)(3), so long as these remaining activities satisfy the requirements of section 41(d)(1)(A) and are not otherwise excluded under section 41(d)(4). Example (6) of §1.41–4(a)(8) of the 2001 proposed regulations has been modified to illustrate the application of this rule, and appears as example (4) in these final regulations.

Other Issues

Patent Safe Harbor

Section 1.41–4(a)(3)(iii) of the 2001 proposed regulations generally provided that the issuance of certain patents is conclusive evidence that a taxpayer has discovered information that is technological in nature that is intended to eliminate uncertainty concerning the development or improvement of a business component. Some commentators requested that this patent safe harbor be expanded to cover all requirements contained in sections 41(d)(1) and (3). After consideration of these comments, and in light of the clarifications being made in these final regulations to the provisions relating to the process of experimentation requirement, the Treasury Department and the IRS continue to believe that the patent safe harbor is appropriately limited and, therefore, have not changed the patent safe harbor provision.

Shrinking-Back Rule

Some commentators expressed concern that the language of the shrinking-back rule in §1.41–4(b)(2) of the 2001 proposed regulations implied that not all of a taxpayer's qualified research expenses would be eligible for the research credit as a result of the application of the rule. This provision has been revised in these final regulations to clarify that the rule is not intended to exclude qualified research expenses from the credit, but rather is intended to ensure that expenses attributable to qualified research activities are eligible for the research credit for purposes of section 41(d)(1).

Research After Commercial Production

Some commentators requested additional clarification regarding the scope of the research after commercial production, adaptation, and duplication exclusions set out in section 41(d)(4)(A), (B) and (C), and §1.41–4(c)(2), (3) and (4) of the 2001 proposed regulations. After consideration of these comments, the Treasury Department and the IRS believe that the multitude of factual situations to which these exclusions might apply make it impractical to provide additional clarification that is both meaningful and of broad application. The Treasury Department and the IRS believe these three specific exclusions do not cover research activities that otherwise satisfy the requirements for qualified research. Taxpayers, however, should carefully review (including, as appropriate, the application of the shrinking-back rule) research activities that might otherwise fall within these exclusions to ensure that only eligible activities are being included in their credit computations.

One commentator expressed concern that the language of §1.41–4(c)(2)(iv), relating to the clinical testing of pharmaceutical products, could exclude from credit eligibility clinical trials performed under an arrangement where the Food and Drug Administration has granted conditional approval for a pharmaceutical product contingent upon the results of additional clinical trials. Another commentator expressed concern that the language would exclude otherwise qualifying activities because the research was not required to be approved by the Food and Drug Administration. Section 1.41–4(c)(2)(iv) is not a rule of exclusion. As stated above, the Treasury Department and the IRS believe that the research after commercial production exclusion (as well as the adaptation and duplication exclusions) do not cover research activities, including these additional clinical trials, so long as such trials satisfy the requirements for qualified research.

Gross Receipts

These final regulations retain the broad definition of gross receipts contained in T.D. 8930. In response to Notice 2001–19, a number of commentators reiterated earlier comments that this definition was overly broad. As stated in the preamble to the 2001 proposed regulations, the Treasury Department and the IRS continue to believe that the definition of gross receipts should be construed broadly, and, accordingly, no change has been made in these final regulations to the definition contained in T.D. 8930.

Examples

The examples in the regulations have been changed to remove references to "readily discernible and applicable." While the Treasury Department and the IRS continue to believe that the activities in *Examples 4* and *5* of §1.41–4(a)(8) of the 2001 proposed regulations would not qualify under the final regulations, these examples were removed as the only purpose of these examples was to illustrate the "readily discernable and applicable" standard. Minor changes to the facts in *Example 4* of §1.41–4(a)(8) in the final regulations (*Example 6* of §1.41–4(a)(8) of the 2001 proposed regulations) were made to illustrate more clearly the application of the substantially all requirement of §1.41–4(a)(6). These changes do not indicate that the Treasury Department and the IRS believe that the integration activities removed from the example, as contained in the 2001 proposed regulations, are or are not qualified activities standing alone. The determination of whether activities are qualified research is based on the specific facts and circumstances of those activities.

Additionally, minor changes were made to the examples in §1.41–4(c)(10) to remove references to "readily discernable and applicable" and to make some clarifications based on comments received. *Example 1* of §1.41–4(c)(10) was modified to remove the conclusion regarding qualification of expenses under section 174. Although the Treasury Department and the IRS continue to believe that the conclusion in the 2001 proposed regulations is correct, the Treasury Department and the IRS believe that the point illustrated in the removed portion of the example would be

more appropriately addressed in guidance issued under section 174, rather than in guidance under section 41.

Effective Date

Notice 2001–19 stated, in relevant part, that the provisions of T.D. 8930, including any changes to T.D. 8930, would be effective no earlier than the date when the completion of the Treasury Department and the IRS' review of T.D. 8930 was announced. The 2001 proposed regulations provided, in relevant part, that final regulations would apply to taxable years ending on or after December 26, 2001, the date the proposed regulations were published in the **Federal Register**.

Because these final regulations only clarify the provisions of the 2001 proposed regulations, these final regulations apply to taxable years ending on or after December 31, 2003. For taxable years ending before December 31, 2003, the IRS will not challenge return positions that are consistent with these final regulations.

Special Analyses

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

Drafting Information

The principal author of these regulations is Nicole R. Cimino of the Office of Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, personnel from other offices of the IRS and the Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART I—INCOME TAXES

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

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

Par. 2. Section 1.41–0 is amended by revising the entries for §1.41–4 to read as follows:

The revisions and additions read as follows:

§1.41–0 Table of contents.

* * * * *

§1.41–4 Qualified research for expenditures paid or incurred in taxable years ending on or after December 31, 2003.

(a) Qualified research.
(1) General rule.
(2) Requirements of section 41(d)(1).
(3) Undertaken for the purpose of discovering information.
(i) In general.
(ii) Application of the discovering information requirement.
(iii) Patent safe harbor.
(4) Technological in nature.
(5) Process of experimentation.
(i) In general.
(ii) Qualified purpose.
(6) Substantially all requirement.
(7) Use of computers and information technology.
(8) Illustrations.
(b) Application of requirements for qualified research.
(1) In general.
(2) Shrinking-back rule.
(3) Illustration.
(c) Excluded activities.
(1) In general.
(2) Research after commercial production.
(i) In general.
(ii) Certain additional activities related to the business component.
(iii) Activities related to production process or technique.
(iv) Clinical testing.
(3) Adaptation of existing business components.
(4) Duplication of existing business component.
(5) Surveys, studies, research relating to management functions, etc.
(6) Internal use software for taxable years beginning on or after December 31, 1985. **[Reserved]**.
(7) Activities outside the United States, Puerto Rico, and other possessions.
(i) In general.
(ii) Apportionment of in-house research expenses.
(iii) Apportionment of contract research expenses.
(8) Research in the social sciences, etc.
(9) Research funded by any grant, contract, or otherwise.
(10) Illustrations.
(d) Recordkeeping for the research credit.
(e) Effective dates.

* * * * *

Par. 3. Section 1.41–4 is amended as follows:

1. The section heading and paragraphs (a)(2)(iii), (a)(3), (a)(4), (a)(5), (a)(6), (a)(8), (b)(2), (b)(3), (c)(2)(iv), (c)(4), (c)(7)(ii), (c)(10), (d), and (e) are revised.

2. The heading of paragraph (c)(6) is revised and the text is removed and reserved.

The revisions read as follows:

§1.41–4 Qualified research for expenditures paid or incurred in taxable years ending on or after December 31, 2003.

(a) * * *

(2) * * *

(iii) Substantially all of the activities of which constitute elements of a process of experimentation that relates to a qualified purpose.

(3) *Undertaken for the purpose of discovering information*—(i) *In general*. For purposes of section 41(d) and this section, research must be undertaken for the purpose of discovering information that is technological in nature. Research is undertaken for the purpose of discovering information if it is intended to eliminate uncertainty concerning the development or improvement of a business component. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the business component, or the appropriate design of the business component.

(ii) *Application of the discovering information requirement*. A determination that research is undertaken for the purpose of discovering information that is technological in nature does not require the taxpayer be seeking to obtain information that exceeds, expands or refines the common knowledge of skilled professionals in the particular field of science or engineering in which the taxpayer is performing the research. In addition, a determination that research is undertaken for the purpose of discovering information that is technological in nature does not require that the taxpayer succeed in developing a new or improved business component.

(iii) *Patent safe harbor*. For purposes of section 41(d) and paragraph (a)(3)(i) of this section, the issuance of a patent by the Patent and Trademark Office under the provisions of 35 U.S.C. 151 (other than a patent for design issued under the provisions of 35 U.S.C. 171) is conclusive evidence that a taxpayer has discovered information that is technological in nature that is intended to eliminate uncertainty concerning the development or improvement of a business component. However, the issuance of such a patent is not a precondition for credit availability.

(4) *Technological in nature*. For purposes of section 41(d) and this section, information is technological in nature if the process of experimentation used to discover such information fundamentally relies on principles of the physical or biological sciences, engineering, or computer science. A taxpayer may employ existing technologies and may rely on existing principles of the physical or biological sciences, engineering, or computer science to satisfy this requirement.

(5) *Process of experimentation*—(i) *In general*. For purposes of section 41(d) and this section, a process of experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities. A process of experimentation must fundamentally rely on the principles of the physical or biological sciences, engineering, or computer science and involves the identification of uncertainty concerning the development or improvement of a business component, the identification of one or more alternatives intended to eliminate that uncertainty, and the identification and the conduct of a process of evaluating the alternatives (through, for example, modeling, simulation, or a systematic trial and error methodology). A process of experimentation must be an evaluative process and generally should be capable of evaluating more than one alternative. A taxpayer may undertake a process of experimentation if there is no uncertainty concerning the taxpayer's capability or method of achieving the desired result so long as the appropriate design of the desired result is uncertain as of the beginning of the taxpayer's research activities. Uncertainty concerning the development or improvement of the business component (*e.g.*, its appropriate design) does not establish that all activities undertaken to achieve that new or improved business component constitute a process of experimentation.

(ii) *Qualified purpose*. For purposes of section 41(d) and this section, a process of experimentation is undertaken for a qualified purpose if it relates to a new or improved function, performance, reliability or quality of the business component. Research will not be treated as conducted for a qualified purpose if it relates to style, taste, cosmetic, or seasonal design factors.

(6) *Substantially all requirement*. In order for activities to constitute qualified research under section 41(d)(1), substantially all of the activities must constitute elements of a process of experimentation that relates to a qualified purpose. The substantially all requirement of section 41(d)(1)(C) and paragraph (a)(2)(iii) of this section is satisfied only if 80 percent or more of a taxpayer's research activities, measured on a cost or other consistently applied reasonable basis (and without regard to §1.41–2(d)(2)), constitute elements of a process of experimentation for a purpose described in section 41(d)(3). Accordingly, if 80 percent (or more) of a taxpayer's research activities with respect to a business component constitute elements of a process of experimentation for a purpose described in section 41(d)(3), the substantially all requirement is satisfied even if the remaining 20 percent (or less) of a taxpayer's research activities with respect to the business component do not constitute elements of a process of experimentation for a purpose described in section 41(d)(3), so long as these remaining research activities satisfy the requirements of section 41(d)(1)(A) and are not otherwise excluded under section 41(d)(4). The substantially all requirement is applied separately to each business component.

* * * * *

(8) *Illustrations*. The following examples illustrate the application of paragraph (a)(5) of this section:

Example 1. (i) *Facts*. X is engaged in the business of developing and manufacturing widgets. X wants to change the color of its blue widget to green. X obtains from various suppliers several different shades of green paint. X paints several sample widgets, and surveys X's customers to determine which shade of green X's customers prefer.

(ii) *Conclusion*. X's activities to change the color of its blue widget to green are not qualified research under section 41(d)(1) and paragraph (a)(5) of this section because substantially all of X's activities are not undertaken for a qualified purpose. All of X's research activities are related to style, taste, cosmetic, or seasonal design factors.

Example 2. (i) *Facts*. The facts are the same as in *Example 1*, except that X chooses one of the green paints. X obtains samples of the green paint from a supplier and determines that X must modify its painting process to accommodate the green paint because the green paint has different characteristics from other paints X has used. X obtains detailed data on the green paint from X's paint supplier. X also consults with the manufacturer of X's paint spraying machines. The manufacturer informs X that X must acquire a new nozzle that operates with the green paint X wants to use. X tests the nozzles to ensure that they work as specified by the manufacturer of the paint spraying machines.

(ii) *Conclusion*. X's activities to modify its painting process are a separate business component under section 41(d)(2)(A). X's activities to modify its painting process to change the color of its blue widget to green are not qualified research under section 41(d)(1) and paragraph (a)(5) of this section. X did not conduct a process of evaluating alternatives in order to eliminate uncertainty regarding the modification of its painting process. Rather, the manufacturer of the paint machines eliminated X's uncertainty regarding the modification of its painting process. X's activities to test the nozzles to determine if the nozzles work as specified by the manufacturer of the paint spraying machines are in the nature of routine or ordinary testing or inspection for quality control.

Example 3. (i) *Facts*. X is engaged in the business of manufacturing food products and currently manufactures a large-shred version of a product. X seeks to modify its current production line to permit it to manufacture both a large-shred version and a fine-shred version of one of its food products. A smaller, thinner shredding blade capable of producing a fine-shred version of the food product, however, is not commercially available. Thus, X must develop a new shredding blade that can be fitted onto its current production line. X is uncertain concerning the design of the new shredding blade, because the material used in its existing blade breaks when ma-

chined into smaller, thinner blades. X engages in a systematic trial and error process of analyzing various blade designs and materials to determine whether the new shredding blade must be constructed of a different material from that of its existing shredding blade and, if so, what material will best meet X's functional requirements.

(ii) *Conclusion*. X's activities to modify its current production line by developing the new shredding blade meet the requirements of qualified research as set forth in paragraph (a)(2) of this section. Substantially all of X's activities constitute elements of a process of experimentation because X evaluated alternatives to achieve a result where the method of achieving that result, and the appropriate design of that result, were uncertain as of the beginning of the taxpayer's research activities. X identified uncertainties related to the development of a business component, and identified alternatives intended to eliminate these uncertainties. Furthermore, X's process of evaluating identified alternatives was technological in nature, and was undertaken to eliminate the uncertainties.

Example 4. (i) *Facts*. X is in the business of designing, developing and manufacturing automobiles. In response to government-mandated fuel economy requirements, X seeks to update its current model vehicle and undertakes to improve aerodynamics by lowering the hood of its current model vehicle. X determines, however, that lowering the hood changes the air flow under the hood, which changes the rate at which air enters the engine through the air intake system, and which reduces the functionality of the cooling system. X's engineers are uncertain how to design a lower hood to obtain the increased fuel economy, while maintaining the necessary air flow under the hood. X designs, models, simulates, tests, refines, and re-tests several alternative designs for the hood and associated proposed modifications to both the air intake system and cooling system. This process enables X to eliminate the uncertainties related to the integrated design of the hood, air intake system, and cooling system, and such activities constitute eighty-five percent of X's total activities to update its current model vehicle. X then engages in additional activities that do not involve a process of evaluating alternatives in order to eliminate uncertainties. The additional activities constitute only fifteen percent of X's total activities to update its current model vehicle.

(ii) *Conclusion*. In general, if eighty percent or more of a taxpayer's research activities measured on a cost or other consistently applied reasonable basis constitute elements of a process of experimentation for a qualified purpose under section 41(d)(3)(A) and paragraph (a)(5)(ii) of this section, then the substantially all requirement of section 41(d)(1)(C) and paragraph (a)(2)(iii) of this section is satisfied. Substantially all of X's activities constitute elements of a process of experimentation because X evaluated alternatives to achieve a result where the method of achieving that result, and the appropriate design of that result, were uncertain as of the beginning of X's research activities. X identified uncertainties related to the improvement of a business component and identified alternatives intended to eliminate these uncertainties. Furthermore, X's process of evaluating the identified alternatives was technological in nature and was undertaken to eliminate the uncertainties. Because substantially all (in this example, eighty-five percent) of X's activities to update its current model vehicle constitute elements of a process of experimentation for a qualified purpose described in section 41(d)(3)(A), all of X's activities to update its current model vehicle meet the requirements of qualified research as set forth in paragraph (a)(2) of this section, provided that X's remaining activities (in this example, fifteen percent of X's total activities) satisfy the requirements of section 41(d)(1)(A) and are not otherwise excluded under section 41(d)(4).

(b)* * *

(2) *Shrinking-back rule*. The requirements of section 41(d) and paragraph (a) of this section are to be applied first at the level of the discrete business component, that is, the product, process, computer software, technique, formula, or invention to be held for sale, lease, or license, or used by the taxpayer in a trade or business of the taxpayer. If these requirements are not met at that level, then they apply at the most significant subset of elements of the product, process, computer software, technique, formula, or invention to be held for sale, lease, or license. This shrinking back of the product is to continue until either a subset of elements of the product that satisfies the requirements is reached, or the most basic element of the product is reached and such element fails to satisfy the test. This shrinking-back rule is applied only if a taxpayer does not satisfy the requirements of section 41(d)(1) and paragraph (a)(2) of this section with respect to the overall business component. The shrinking-back rule is not itself applied as a reason to exclude research activities from credit eligibility.

(3) *Illustration*. The following example illustrates the application of this paragraph (b):

Example. X, a motorcycle engine builder, develops a new carburetor for use in a motorcycle engine. X also modifies an existing engine design for use with the new carburetor. Under the shrinking-back rule, the requirements of section 41(d)(1) and paragraph (a) of this section are applied first to the engine. If the modifications to the engine when viewed as a whole, including the development of the new carburetor, do not satisfy the requirements of section 41(d)(1) and paragraph (a) of this section, those requirements are applied to the next most significant subset of elements of the business component. Assuming that the next most significant subset of elements of the engine is the carburetor, the research activities in developing the new carburetor may constitute qualified research within the meaning of section 41(d)(1) and paragraph (a) of this section.

(c) * * *

(2) * * *

(iv) *Clinical testing*. Clinical testing of a pharmaceutical product prior to its commercial production in the United States is not treated as occurring after the beginning of commercial production even if the product is commercially available in other countries. Additional clinical testing of a pharmaceutical product after a product has been approved for a specific therapeutic use by the Food and Drug Administration and is ready for commercial production and sale is not treated as occurring after the beginning of commercial production if such clinical testing is undertaken to establish new functional uses, characteristics, indications, combinations, dosages, or delivery forms for the product. A functional use, characteristic, indication, combination, dosage, or delivery form shall be considered new only if such functional use, characteristic, indication, combination, dosage, or delivery form must be approved by the Food and Drug Administration.

* * * * *

(4) *Duplication of existing business component*. Activities relating to reproducing an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information about the business component are not qualified research. This exclusion does not apply merely because the taxpayer examines an existing business component in the course of developing its own business component.

* * * * *

(6) *Internal use software for taxable years beginning on or after December 31, 1985.* **[Reserved]**.

(7) * * *

(ii) *Apportionment of in-house research expenses*. In-house research expenses paid or incurred for qualified services performed both in the United States, the Commonwealth of Puerto Rico and other possessions of the United States and outside the United States, the Commonwealth of Puerto Rico and other possessions of the United States must be apportioned between the services performed in the United States, the Commonwealth of Puerto Rico and other possessions of the United States and the services performed outside the United States, the Commonwealth of

Puerto Rico and other possessions of the United States. Only those in-house research expenses apportioned to the services performed within the United States, the Commonwealth of Puerto Rico and other possessions of the United States are eligible to be treated as qualified research expenses, unless the in-house research expenses are wages and the 80 percent rule of §1.41–2(d)(2) applies.

* * * * *

(10) *Illustrations*. The following examples illustrate provisions contained in paragraphs (c)(1) through (9) (excepting paragraphs (c)(6) of this section) of this section. No inference should be drawn from these examples concerning the application of section 41(d)(1) and paragraph (a) of this section to these facts. The examples are as follows:

Example 1. (i) *Facts*. X, a tire manufacturer, develops a new material to use in its tires. X conducts research to determine the changes that will be necessary for X to modify its existing manufacturing processes to manufacture the new tire. X determines that the new tire material retains heat for a longer period of time than the materials X currently uses for tires, and, as a result, the new tire material adheres to the manufacturing equipment during tread cooling. X evaluates several alternatives for processing the treads at cooler temperatures to address this problem, including a new type of belt for its manufacturing equipment to be used in tread cooling. Such a belt is not commercially available. Because X is uncertain of the belt design, X develops and conducts sophisticated engineering tests on several alternative designs for a new type of belt to be used in tread cooling until X successfully achieves a design that meets X's requirements. X then manufactures a set of belts for its production equipment, installs the belts, and tests the belts to make sure they were manufactured correctly.

(ii) *Conclusion*. X's research with respect to the design of the new belts to be used in its manufacturing of the new tire may be qualified research under section 41(d)(1) and paragraph (a) of this section. However, X's expenses to implement the new belts, including the costs to manufacture, install, and test the belts were incurred after the belts met the taxpayer's functional and economic requirements and are excluded as research after commercial production under section 41(d)(4)(A) and paragraph (c)(2) of this section.

Example 2. (i) *Facts*. For several years, X has manufactured and sold a particular kind of widget. X initiates a new research project to develop a new or improved widget.

(ii) *Conclusion*. X's activities to develop a new or improved widget are not excluded from the definition of qualified research under section 41(d)(4)(A) and paragraph (c)(2) of this section. X's activities relating to the development of a new or improved widget constitute a new research project to develop a new business component. X's research activities relating to the development of the new or improved widget, a new business component, are not considered to be activities conducted after the beginning of commercial production under section 41(d)(4)(A) and paragraph (c)(2) of this section.

Example 3. (i) *Facts*. X, a computer software development firm, owns all substantial rights in a general ledger accounting software core program that X markets and licenses to customers. X incurs expenditures in adapting the core software program to the requirements of C, one of X's customers.

(ii) *Conclusion*. Because X's activities represent activities to adapt an existing software program to a particular customer's requirement or need, X's activities are excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section.

Example 4. (i) *Facts*. The facts are the same as in *Example 3*, except that C pays X to adapt the core software program to C's requirements.

(ii) *Conclusion*. Because X's activities are excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section, C's payments to X are not for qualified research and are not considered to be contract research expenses under section 41(b)(3)(A).

Example 5. (i) *Facts*. The facts are the same as in *Example 3*, except that C's own employees adapt the core software program to C's requirements.

(ii) *Conclusion*. Because C's employees' activities to adapt the core software program to C's requirements are excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section, the wages C paid to its employees do not constitute in-house research expenses under section 41(b)(2)(A).

Example 6. (i) *Facts*. X manufacturers and sells rail cars. Because rail cars have numerous specifications related to performance, reliability and quality, rail car designs are subject to extensive, complex testing in the scientific or laboratory sense. B orders passenger rail cars from X. B's rail car requirements differ from those of X's other existing customers only in that B wants fewer seats in its passenger cars and a higher quality seating material and carpet that are commercially available. X manufactures rail cars meeting B's requirements.

(ii) *Conclusion*. X's activities to manufacture rail cars for B are excluded from the definition of qualified research. The rail car sold to B was not a new business component, but merely an adaptation of an existing business component that did not require a process of experimentation. Thus, X's activities to manufacture rail cars for B are excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section because X's activities represent activities to adapt an existing business component to a particular customer's requirement or need.

Example 7. (i) *Facts*. X, a manufacturer, undertakes to create a manufacturing process for a new valve design. X determines that it requires a specialized type of robotic equipment to use in the manufacturing process for its new valves. Such robotic equipment is not commercially available, and X, therefore, purchases the existing robotic equipment for the purpose of modifying it to meet its needs. X's engineers identify uncertainty that is technological in nature concerning how to modify the existing robotic equipment to meet its needs. X's engineers develop several alternative designs, and conduct experiments using modeling and simulation in modifying the robotic equipment and conduct extensive scientific and laboratory testing of design alternatives. As a result of this process, X's engineers develop a design for the robotic equipment that meets X's needs. X constructs and installs the modified robotic equipment on its manufacturing process.

(ii) *Conclusion*. X's research activities to determine how to modify X's robotic equipment for its manufacturing process are not excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section, provided that X's research activities satisfy the requirements of section 41(d)(1).

Example 8. (i) *Facts*. An existing gasoline additive is manufactured by Y using three ingredients, A, B, and C. X seeks to develop and manufacture its own gasoline additive that appears and functions in a manner similar to Y's additive. To develop its own additive, X first inspects the composition of Y's additive, and uses knowledge gained from the inspection to reproduce A and B in the laboratory. Any differences between ingredients A and B that are used in Y's additive and those reproduced by X are insignificant and are not material to the viability, effectiveness, or cost of A and B. X desires to use with A and B an ingredient that has a materially lower cost than ingredient C. Accordingly, X engages in a process of experimentation to develop, analyze and test potential alternative formulations of the additive.

(ii) *Conclusion*. X's activities in analyzing and reproducing ingredients A and B involve duplication of existing business components and are excluded from the definition of qualified research under section 41(d)(4)(C) and paragraph (c)(4) of this section. X's experimentation activities to develop potential alternative formulations of the additive do not involve duplication of an existing business component and are not excluded from the definition of qualified research under section 41(d)(4)(C) and paragraph (c)(4) of this section.

Example 9. (i) *Facts*. X, a manufacturing corporation, undertakes to restructure its manufacturing organization. X organizes a team to design an organizational structure that will improve X's business operations. The team includes X's employees as well as outside management consultants. The team studies current operations, interviews X's employees, and studies the structure of other manufacturing facilities to determine appropriate modifications to X's current business operations. The team develops a recommendation of proposed modifications which it presents to X's management. X's management approves the team's recommendation and begins to implement the proposed modifications.

(ii) *Conclusion*. X's activities in developing and implementing the new management structure are excluded from the definition of qualified research under section 41(d)(4)(D) and paragraph (c)(5) of this section. Qualified research does not include activities relating to management functions or techniques including management organization plans and management-based changes in production processes.

Example 10. (i) *Facts*. X, an insurance company, develops a new life insurance product. In the course of developing the product, X engages in research with respect to the effect of pricing and tax consequences on demand for the product, the expected volatility of

interest rates, and the expected mortality rates (based on published data and prior insurance claims).

(ii) *Conclusion*. X's activities related to the new product represent research in the social sciences (including economics and business management) and are thus excluded from the definition of qualified research under section 41(d)(4)(G) and paragraph (c)(8) of this section.

(d) *Recordkeeping for the research credit*. A taxpayer claiming a credit under section 41 must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit. For the rules governing record retention, see §1.6001–1. To facilitate compliance and administration, the IRS and taxpayers may agree to guidelines for the keeping of specific records for purposes of substantiating research credits.

(e) *Effective dates*. This section is applicable for taxable years ending on or after December 31, 2003.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 4. The authority citation for part 602 continues to read in part as follows:

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

Par. 5. In §602.101, paragraph (b) is amended by removing the entry from the table for §1.41–4(d).

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

Approved December 18, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 31, 2003, 8:45 a.m., and published in the issue of the Federal Register for January 2, 2004, 69 F.R. 22)

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2004. See Rev. Rul. 2004-9, page 428.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of February 2004. See Rev. Rul. 2004-9, page 428.

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted applicable federal long-term rate is set forth for the month of February 2004. See Rev. Rul. 2004-9, page 428.

Section 409.—Qualifications for Tax Credit Employee Stock Ownership Plans

26 CFR 1.409(p)–1T: Prohibited allocation of securities in an S corporation.
(Also, §§ 1361, 4975, 4979A, 6011, 6111, and 6112; §§ 54.4975–11, 1.6011–4, 301.6111–2, and 301.6112–1.)

Employee stock ownership plans; S corporations; listed transactions. A finding of synthetic equity owned by a disqualified person in a nonallocation year of an ESOP, as those terms are defined in section 409(p) of the Code and regulations section 1.409(p)–1T, takes place in three distinct situations. In addition, the transactions described in this ruling, as well as substantially similar transactions, are designated as "listed transactions."

Rev. Rul. 2004–4

ISSUES

In the three situations described below, (1) are the individuals disqualified persons within the meaning of § 409(p)(4) of the Internal Revenue Code (the Code), (2) does the related employee stock ownership plan (ESOP) have a nonallocation year within the meaning of § 409(p)(3), and (3) are any disqualified persons treated as owning synthetic equity within the meaning of § 409(p)(5)?

FACTS

Situation 1

Before 2003, Individuals A and B own, either directly or indirectly, in whole or in part, a domestic professional services corporation. In addition, before 2003, individuals C, D, and E each owns, either directly or indirectly, in whole or in part, his or her own domestic professional services corporation. A, B, C, D, and E (Taxpayers) are employees of their respective domestic professional services corporations (Service Recipient Corporations).

In 2003, a new corporation (S Corp) is formed, and elects to be treated as a subchapter S corporation. S Corp forms a subsidiary corporation for each Taxpayer (QSubs A through E), and files a qualified subchapter S subsidiary (QSub) election for each subsidiary. S Corp contributes cash in exchange for 100 percent of the issued and outstanding stock of each QSub. Each Taxpayer is designated as an officer and investment manager for Taxpayer's respective QSub. In addition, each QSub grants its respective Taxpayer a nonqualified stock option to acquire substantially all or a majority of the shares of the QSub.

At the same time that S Corp is formed, it establishes a plan (ESOP) which is designed to be an employee stock ownership plan (within the meaning of § 4975(e)(7)) and which holds 100 percent of the stock of S Corp. All the employees of S Corp and the QSubs participate in the ESOP, with the exception of Taxpayers A through E.

Taxpayers A through E and their support staff terminate their existing employment relationship with their respective Service Recipient Corporations and become employees of the respective QSub. The customers of Taxpayers A through E stop doing business with the Service Recipient Corporations and begin doing business with the respective QSub of Taxpayers A through E.

Taxpayers A through E receive salary payments from their respective QSub, in an amount substantially less than the income to S Corp generated by the business activities of that Taxpayer after deduction for expenses. S Corp treats the subsidiaries as valid QSubs, and treats the income generated by each QSub each year, and earnings thereon, as earned by S Corp. The payments to the Taxpayers for current salary are deducted by S Corp as an ordinary and necessary business expense. However, since S Corp is wholly owned by an ESOP holding S corporation stock, S Corp's net earnings are not taxed currently.

Amounts of income to S Corp generated by the business activities of each Taxpayer (net of expenses) but not paid to Taxpayers within 2½ months after the end of the year accumulate in each Taxpayer's respective QSub, for example, in a brokerage account in each subsidiary, over which the respective Taxpayer has investment control as the investment manager of the subsidiary. A through E can access the amounts accumulated in their respective QSub by exercising their option to purchase shares in the QSub. If each Taxpayer's option to purchase shares of QSub stock were synthetic equity of S Corp (determined in accordance with § 1.409(p)–1T(f)(4)(ii)), then each Taxpayer would own at least 10 percent of the sum of the outstanding shares of S Corp plus the synthetic equity shares of S Corp.

Situation 2

The facts are the same as in *Situation 1*, except that instead of 5 individuals, there are 11 individuals (Taxpayers A through K) each of whom is an employee of a Service Recipient Corporation owned either directly or indirectly, in whole or in part, by that Taxpayer. As in *Situation 1*, amounts of income to S Corp generated by the business activities of each Taxpayer (net of expenses) but not paid to the Taxpayer accumulate in each Taxpayer's respective QSub, and each Taxpayer has the right to acquire stock in that Taxpayer's QSub under the same terms as described in *Situation 1*. If each Taxpayer's option to purchase shares of QSub stock were synthetic equity of S Corp, then each Taxpayer would own less than 10 percent of the sum of the outstanding shares of S Corp plus the synthetic equity shares of S Corp.

Situation 3

Before 2003, Corporation M is an S corporation with 200 employees, wholly owned by an ESOP that was established after March 14, 2001, in which substantially all of its employees participate. Before 2003, Individual A (Taxpayer) operated a professional services corporation as a separate business. In 2003, Corporation M forms a QSub for A by contributing cash in exchange for 100 percent of the issued and outstanding stock of the QSub. As in *Situation 1*, A and A's support staff terminate their existing employment relationship with A's Service Recipient Corporation and become employees of the QSub; A's customers become customers of the QSub; amounts of income to S Corp generated by the business activities of A (net of expenses) but not paid to A accumulate in A's QSub; and A has the right to acquire stock in the QSub under the same terms as described in *Situation 1*. A does not participate in the Corporation M ESOP. If A's option to purchase shares of the QSub were synthetic equity of S Corp, then A would own less than 10 percent of the total of the outstanding shares of S Corp plus the synthetic equity shares of S Corp.

LAW

Section 4975(e)(7) provides that an ESOP is a defined contribution plan that is designed to invest primarily in qualifying employer securities and that is either a stock bonus plan which is qualified, or a stock bonus plan and money purchase pension plan both of which are qualified, under § 401(a). A plan is not treated as an ESOP under the Code unless it meets the following requirements, to the extent applicable: § 409(h) (relating to participants' right to receive employer securities; put options); § 409(o) (relating to participants' distribution rights and payment requirements); § 409(n) (relating to securities received in transactions to which § 1042 applies); § 409(p) (relating to prohibited allocations of securities in an S corporation); § 664(g) (relating to qualified gratuitous transfers of qualified employer securities); and § 409(e) (relating to participants' voting rights if the employer has a registration-type class of securities). As authorized by § 4975(e)(7), additional requirements are imposed under § 54.4975–11 of the Excise Tax Regulations.

Section 1361(b)(1)(B) provides that an S corporation may not have as a shareholder a person that is not an estate, a trust described in § 1361(c)(2), an organization described in § 1361(c)(6), or an individual. In 1996, § 1361(c)(6) was amended to permit a qualified plan under § 401(a) to be a shareholder in an S corporation. Section 1316(a) of the Small Business Job Protection Act of 1996 (SBJPA) (110 Stat. 1755) (1996).

Section 1361(b)(3)(A) provides that, for purposes of title 26 of the U.S. Code, a corporation that is a qualified Subchapter S subsidiary will not be treated as a separate corporation and all assets, liabilities, and items of income, deduction and credit of the corporation are treated as assets, liabilities, and such items (as the case may be) of the S corporation.

Section 511(a)(1) imposes a tax on the unrelated business taxable income (as defined in § 512(a)) of organizations described in § 511(a)(2), which include plans that qualify under § 401(a). Section 512(e)(1) provides that if an organization described in § 1361(c)(6) holds stock in an S corporation, the interest is treated as an interest in an unrelated trade or business and, notwithstanding the organization's general tax-exempt status, all items of income, loss, or deduction taken into account under § 1366(a) and any gain or loss on the disposition of the stock in the S corporation are taken into account in computing the unrelated business taxable income of the organization. In 1997, § 512(e) was amended to provide that § 512(e) does not apply to employer securities (within the meaning of § 409(l)) held by an ESOP described in § 4975(e)(7). Section 1523 of the Taxpayer Relief Act of 1997 (TRA '97) (111 Stat. 788) (1997). Accordingly, S corporation income allocable to stock held by an ESOP is not subject to regular income or unrelated business income tax.

Congress became aware that the tax exemption for earnings on S corporation stock held by an ESOP may lead to inappropriate tax deferral or avoidance in some cases. In order to address these concerns, Congress enacted § 409(p) as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (115 Stat. 38) (2001). Section 409(p) is effective for plan years beginning after December 31, 2004. However, pursuant to section 656(d)(2) of EGTRRA, § 409(p) of the Code is effective for plan years ending after March 14, 2001, for an ESOP that is established after that date, or if the employer securities held by the plan consist of stock in an S corporation that did not have an S election in effect on that date. Notice 2002–2, Q&A–15, 2002–1 C.B. 285, provides that an S corporation does not have an election in effect on March 14, 2001, unless a valid election was actually filed on or before that date and is effective with respect to such corporation on or before that date. Temporary and proposed

regulations under § 409(p) were issued on July 21, 2003 (T.D. 9081, 2003–35 I.R.B. 420; REG–129709–03, 2003–35 I.R.B. 506, September 2, 2003), effective generally for plan years ending after October 20, 2003.

Section 409(p) is intended to limit the tax benefits of ESOPs maintained by S corporations unless the ESOP provides meaningful benefits to rank-and-file employees. As explained in the legislative history:

> The Committee continues to believe that S corporations should be able to encourage employee ownership through an ESOP. The Committee does not believe, however, that ESOPs should be used by S corporation owners to obtain inappropriate tax deferral or avoidance.
>
> Specifically, the Committee believes that the tax deferral opportunities provided by an S corporation ESOP should be limited to those situations in which there is broad-based employee coverage under the ESOP and the ESOP benefits rank-and-file employees as well as highly compensated employees and historical owners.

H. R. Rep. No. 107–51, part 1, at 100 (2001).

Sections 409(p) and 4979A apply if a nonallocation year occurs in an employee stock ownership plan, as defined in § 4975(e)(7), that holds shares of stock of an S corporation that are employer securities as defined in § 409(l). Section 409(p)(1) requires that an ESOP holding employer securities consisting of stock in an S corporation must provide that no portion of the assets of the plan attributable to (or allocable in lieu of) such employer securities may, during a nonallocation year, accrue (or be allocated directly or indirectly under any plan of the employer meeting the requirements of § 401(a)) for the benefit of any disqualified person, as defined in § 409(p).

Under § 409(p)(3), (4), and (5), a "nonallocation year" means a plan year of an ESOP during which, at any time, the ESOP holds any employer securities that are shares of an S corporation and either: 1) disqualified persons own at least 50 percent of the number of outstanding shares of stock in the S corporation (including deemed-owned ESOP shares), or 2) disqualified persons own at least 50 percent of the aggregate number of outstanding shares of stock (including deemed-owned ESOP shares) and synthetic equity in the S corporation. For these purposes, the rules of § 318(a) apply to determine ownership of shares in the S corporation (including deemed-owned ESOP shares) and synthetic equity. However, § 318(a)(4) (relating to options to acquire stock) is disregarded and, in applying § 318(a)(1), the members of an individual's family include members of the individual's family specified in § 409(p)(4)(D). In addition, an individual is treated as owning deemed-owned ESOP shares of that individual notwithstanding the employee trust exception in § 318(a)(2)(B)(i).

As indicated by the legislative history above, § 409(p) is intended to limit the tax benefits of ESOPs maintained by S corporations unless the ESOP provides broad based coverage for, and meaningful benefits to, rank-and-file employees. See H.R. Rep. No. 107–51, part 1, at 100 (2001). Accordingly, Congress added § 409(p)(7), recognizing that the structure of § 409(p) was not expected to be sufficient in all cases to ensure broad-based coverage for, and meaningful benefits to, rank-and-file employees. Section 409(p)(7)(A) thus authorizes the Secretary to prescribe such regulations as may be necessary to carry out the purposes of § 409(p). Section 409(p)(7)(B) provides that the Secretary may, by regulation or other guidance of general applicability, provide that a nonallocation year occurs in any case in which the principal purpose of the ownership structure of an S corporation constitutes an avoidance or evasion of § 409(p). The legislative history to § 409(p) includes the following with respect to exercise of this authority:

> For example, this might apply if more than 10 independent businesses are combined in an S corporation owned by an ESOP in order to take advantage of the income tax treatment of S corporations owned by an ESOP.

H. R. Conf. Rep. No. 107–84, at 277 (2001).

Pursuant to § 409(p)(7)(B), § 1.409(p)–1T(c)(3) of the Temporary Income Tax Regulations provides that the Commissioner, in revenue rulings, notices and other guidance published in the Internal Revenue Bulletin, may provide that a nonallocation year occurs in any case in which the principal purpose of the ownership structure of an S corporation constitutes an avoidance or evasion of § 409(p). For any year that is a nonallocation year, taking into account the legislative history cited above, § 1.409(p)–1T(c)(3) also provides that this exercise of authority includes the authority to treat any person as a disqualified person.

Under § 409(p)(4), a disqualified person is any person for whom: 1) the number of such person's deemed-owned ESOP shares is at least 10 percent of the number of deemed-owned ESOP shares of the S corporation; 2) the aggregate number of such person's deemed-owned ESOP shares and synthetic equity shares is at least 10 percent of the aggregate number of deemed-owned ESOP and synthetic equity shares of the S corporation; 3) the aggregate number of deemed-owned ESOP shares of such person and of the members of such person's family is at least 20 percent of the number of deemed-owned ESOP shares of the S corporation; or 4) the aggregate number of deemed-owned ESOP shares and synthetic equity shares of such person and of the members of such person's family is at least 20 percent of the aggregate number of deemed-owned ESOP and synthetic equity shares of the S corporation.

Section 409(p)(4)(C) defines "deemed-owned ESOP shares" to mean, with respect to any person: 1) any shares of stock in the S corporation constituting employer securities that are allocated to such person's account under the ESOP; and 2) such person's share of the stock in the S corporation that is held by the ESOP but is not allocated to the account of any participant or beneficiary (with such person's share to be determined in the same proportion as the most recent stock allocation under the ESOP).

Section 1.409(p)–1T(f)(1), interpreting § 409(p)(5), provides that the determination of whether someone is a disqualified person and whether a plan year is a nonallocation year is made without regard to "synthetic equity" attributable to that person and is also made separately taking into account synthetic equity. For purposes of § 409(p) and § 1.409(p)–1T, synthetic equity is treated as owned by a person in the same manner as stock is treated as owned by a person, directly or under the rules of § 318(a)(2) and (3).

Section 409(p)(6)(C) defines "synthetic equity" to include any stock op-

tion, warrant, restricted stock, deferred issuance stock right, stock appreciation right payable in stock, or similar interest or right that gives the holder the right to acquire or receive stock of the S corporation in the future. Synthetic equity also includes a right to a future payment (payable in cash or any other form other than stock of the S corporation) from an S corporation that is based on the value of the stock of the S corporation or appreciation in such value, such as a stock appreciation right with respect to stock of an S corporation that is payable in cash or a phantom stock unit with respect to stock of an S corporation that is payable in cash.

Section 1.409(p)–1T(f)(2)(iv) provides a rule treating nonqualified deferred compensation as synthetic equity. Specifically, that section of the temporary regulations provides that synthetic equity also includes any remuneration for services rendered to the S corporation, or a related entity, to which § 404(a)(5) applies (including remuneration for which a deduction would be permitted under § 404(a)(5) if separate accounts were maintained), any right to receive property (to which § 83 applies) in a future year for the performance of services to an S corporation, or related entity, and any transfer of property (to which § 83 applies) in connection with the performance of services to an S corporation, or a related entity, to the extent that the property is not substantially vested within the meaning of § 1.83–3(i) of the Income Tax Regulations by the end of the plan year in which transferred. Section 1.409(p)–1T(f)(2)(iv) also provides that synthetic equity includes any other remuneration for services rendered to the S corporation, or a related entity, under a plan, method or arrangement, deferring the receipt of compensation to a date that is after the 15th day of the 3d calendar month after the end of entity's taxable year in which the related services are rendered, other than a plan that is an eligible retirement plan within the meaning of § 402(c)(7)(B).

Pursuant to the authority in § 409(p)(7), § 1.409(p)–1T(f)(2)(iii)(A) provides that synthetic equity also includes a right to acquire stock or other similar interests in a related entity if such interests in the related entity are the only significant asset of the S corporation and the S corporation is the only significant owner of the related entity. Whether an asset is the only significant asset of the S corporation or the S corporation is the only significant owner of the related entity depends on the relevant facts and circumstances. Section 1.409(p)–1T(f)(2)(iii)(A)(4) provides that a related entity means any entity in which the S corporation holds an interest and which is a partnership, a trust, an eligible entity that is disregarded as an entity that is separate from its owner under § 301.7701–3 of the Procedure and Administration Regulations or a Qualified Subchapter S Subsidiary under § 1361(b)(3).

Pursuant to the authority in § 409(p)(7), § 1.409(p)–1T(f)(2)(iii)(C) provides that the Commissioner may, if necessary to carry out the purposes of § 409(p), through revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin, provide that synthetic equity includes a right to acquire stock or other similar interests in a related entity in cases in which such interests in the related entity are not the only significant asset of the S corporation or the S corporation is not the only significant owner of the related entity.

Section 1.409(p)–1T(f)(4)(ii) provides that, in the case of synthetic equity that is determined by reference to shares of stock (or other similar interests) in a related entity, the person who is entitled to the synthetic equity is treated as owning shares of stock in the S corporation with the same aggregate value as the number of shares of stock (or similar interests) of the related entity (with such value determined without regard to any lapse restriction as defined at § 1.83–3(i)).

Section 4979A imposes a 50 percent excise tax in certain cases, including an allocation of employer securities that is prohibited by § 409(p), the ownership of any synthetic equity by a disqualified person during a nonallocation year, and the occurrence of the first nonallocation year of an ESOP, as described in § 4979A(e)(2)(C). Section 4979(A)(c)(1)(A) provides for this excise tax to be paid by the employer sponsoring the ESOP.

ANALYSIS

In each situation described above, the ownership structure of the S corporation is designed to allow one or more Taxpayers, each operating a business for that Taxpayer's own benefit, to take advantage of the tax-exempt status of the S corporation that results from the ownership of its outstanding stock by the ESOP. The ownership structure thereby avoids current taxation of the profits of each Taxpayer's separate business, while each Taxpayer retains the right to at least 50 percent of the business through the right to acquire shares in the QSub. Because the profits of each business are being segregated and accumulated in each Taxpayer's QSub, the ESOP is owner of the business only in form, not in substance, to the extent that the Taxpayer has a right to the profits by exercising the Taxpayer's option to acquire the shares of the QSub. Thus, the ESOP is not providing benefits to rank-and-file employees that reflect its ownership share in the S corporation.

In *Situation 1*, each Taxpayer is using options on QSub stock to retain ownership of his or her separate business, with the profits of that business being segregated from the profits of the businesses of the other QSubs. In this way, the structure is designed to divert the profits of each business away from the ESOP. If each QSub were an S corporation directly owned by an ESOP, each Taxpayer's right to acquire shares of that corporation would be synthetic equity pursuant to § 409(p)(6)(C). Accordingly, the structure described in *Situation 1* is similar to other forms of synthetic equity, such as the right to acquire stock in a related entity that is the only significant asset of an S Corporation (owned by an ESOP). Further, the economic effect is similar to nonqualified deferred compensation for services rendered to the QSub which is declared to be synthetic equity in § 1.409(p)–1T(f)(2)(iv).

Consequently, the options granted to each Taxpayer in *Situation 1* to acquire shares in the QSub for that Taxpayer's business should be treated as synthetic equity in S Corp. Accordingly, pursuant to the authority in § 1.409(p)–1T(f)(2)(iii)(C), the Commissioner in this revenue ruling provides that the options are synthetic equity. Because these options are synthetic equity in *Situation 1*, each Taxpayer is a 10 percent owner of the number of deemed-owned shares of S Corp, Taxpayers A through E are thus disqualified persons, and, because disqualified persons A through E own an aggregate of at least 50 percent of the

shares, 2003 is a nonallocation year for the ESOP.

A group of individuals with the same right to acquire the accumulated profits of their businesses as described in *Situation 1* should not avoid the application of § 409(p) merely because each individual's right to acquire the accumulated profits of that individual's business does not have a value equal to at least 10 percent of the value of S Corp because more than 10 separate businesses are combined (as described in *Situation 2*). In fact, Congress anticipated the combining of more than 10 businesses as a means of avoiding the application of § 409(p) and gave this ownership structure as an example of the type of situation where exercise of the authority granted in § 409(p)(7)(B) would be appropriate.

Further, an individual with the same right to acquire the accumulated profits of that individual's business, similar to the rights described in *Situation 1*, should not avoid the application of § 409(p) merely because the business is combined, as in *Situation 3*, with the business of an S corporation owned by an ESOP that otherwise fulfills Congressional intent by providing broad-based coverage and benefits to rank-and-file employees. The rank-and-file employees in *Situation 3* are not sharing in the profits of the Taxpayer's separate business through the ESOP's ownership share to the extent that the profits of that business are being accumulated for the benefit of that Taxpayer. With respect to that Taxpayer's separate business, the ownership structure of the S corporation is designed to avoid or evade the application of § 409(p).

In all three situations, the accumulation of profits for the benefit of a specific individual is comparable to the operation of an S corporation owned by an ESOP. Moreover, as in *Situation 1*, if any one of these businesses were the only business activity of S Corp, the option held by the taxpayers would be synthetic equity which would result in a nonallocation year and each taxpayer being a disqualified person if those shares of synthetic equity were at least 50 percent of the shares of stock of S Corp plus the total synthetic equity shares.

Accordingly, pursuant to the authority of § 409(p)(7)(B) and § 1.409(p)–1T(c)(3), the Commissioner provides in this revenue ruling that a nonallocation year occurs and the individual is a disqualified person in any case in which (i) shares of an S corporation are employer securities held by an ESOP, (ii) the profits of the S corporation generated by the business activities of a specific individual are accumulated and held for the benefit of that individual in a QSub or similar entity (such as a limited liability company), (iii) these profits are not paid to the individual as compensation within 2½ months after the end of the year in which earned, and (iv) the individual has rights to acquire shares of stock (or similar interests) of the QSub or similar entity representing 50 percent or more of the fair market value of the stock of such QSub or similar entity. In addition, pursuant to the authority in § 1.409(p)–1T(f)(2)(iii)(C), the Commissioner in this revenue ruling provides that such individual's right to acquire shares of stock (or similar interests) of the QSub or similar entity is synthetic equity. For purposes of this paragraph, the rights of the individual are determined after taking into account the attribution rules of § 409(p).

As a result, in *Situations 2 and 3*, the Taxpayer's right to acquire the shares of the QSub is synthetic equity, each individual Taxpayer (A through K in *Situation 2*, and A in *Situation 3*) is a disqualified person, and a nonallocation year occurs. The respective Taxpayers in *Situations 2 and 3* are disqualified persons regardless of whether, at any time, a particular Taxpayer owns synthetic equity shares of S Corp equal to at least 10 percent of the sum of the outstanding shares of S Corp plus the synthetic equity shares of S Corp.

The same conclusions would apply with respect to *Situations 1, 2, and 3* even if the support staff of the Taxpayers were to continue to be employed by their respective Service Recipient Corporations, the Service Recipient Corporations were to continue to provide substantially the same services for their customers, any of the Taxpayers or their support staff were to be employees of S Corp (instead of employees of a QSub), or any of the Taxpayers were to participate in the ESOP.

Treasury and the Service intend to reflect the guidance in this revenue ruling in regulations under § 409(p), effective for plan years ending after October 20, 2003. It is expected that the regulations would apply to similar transactions that have the effect of reserving profits from an individual's business activities to provide similar tax benefits to the individual, either with the use of a QSub or through the use of another method.

In appropriate cases, the Service may challenge other tax benefits claimed by any taxpayer involved in this type of business structure. For example, in the appropriate case, the Service may take the position for income tax purposes that, even though the Taxpayer purported to transfer his or her business (including the employment of his or her support staff) to the QSub, the Taxpayer never relinquished ownership of his or her business and, therefore, the Taxpayer should still be taxed on the profits. The Service might also take the position that the subsidiary is not a QSub. Alternatively, if the support staff of the Taxpayers were to continue to be employed by their respective Service Recipient Corporations, and the Service Recipient Corporations were to continue to provide substantially the same services for their customers, the Service might assert that each Taxpayer continues to be employed by their respective Service Recipient Corporation, with the related tax consequences.

HOLDINGS

With respect to *Situation 1*, for purposes of §§ 409(p) and 4979A, (1) A through E are disqualified persons with respect to the ESOP, (2) the ESOP has a nonallocation year, and (3) the options to acquire stock in QSubs A through E are synthetic equity to which the § 4979A excise tax applies.

With respect to *Situation 2*, for purposes of §§ 409(p) and 4979A, (1) A through K are disqualified persons with respect to the ESOP, (2) the ESOP has a nonallocation year, and (3) A through K are each treated as owning synthetic equity in the form of each individual's option to acquire shares of the corresponding QSub.

With respect to *Situation 3*, for purposes of §§ 409(p) and 4979A, (1) A is a disqualified person with respect to the ESOP, (2) the ESOP has a nonallocation year, and (3) A is treated as owning synthetic equity in the form of A's option to acquire shares of the corresponding QSub.

EFFECTIVE DATE AND TRANSITION RULE

This revenue ruling applies for plan years ending after October 20, 2003, but

this revenue ruling (including the listing in the Listed Transactions section below) is not effective before March 15, 2004 if (i) all interests in a QSub held by individuals who would be disqualified persons under this revenue ruling are distributed to those individuals as compensation on or before March 15, 2004, and (ii) no such individual has been a participant in the ESOP at any time after October 20, 2003, and before March 15, 2004. In addition, for purposes of the excise tax under § 4979A, an individual's interest in a QSub that constitutes synthetic equity under this revenue ruling will be disregarded to the extent such interest is distributed to the individual as compensation on or before March 15, 2004.

LISTED TRANSACTIONS

Arrangements that are the same as, or substantially similar to, the following transaction are identified as "listed transactions" for purposes of §§ 1.6011–4(b)(2), 301.6111–2(b)(2) and 301.6112–1(b)(2) effective January 23, 2004, the date this document was released to the public: Any transaction in which (i) at least 50 percent of the outstanding shares of an S corporation are employer securities held by an ESOP, (ii) the profits of the S corporation generated by the business activities of a specific individual are accumulated and held for the benefit of that individual in a QSub or similar entity (such as a limited liability company), (iii) these profits are not paid to the individual as compensation within 2½ months after the end of the year in which earned, and (iv) the individual has rights to acquire shares of stock (or similar interests) of the QSub or similar entity representing 50 percent or more of the fair market value of the stock of such QSub or similar entity. For purposes of the preceding sentence, the rights of an individual are determined after taking into account the attribution rules of § 409(p). These arrangements are identified as "listed transactions" with respect to the S corporation and each individual who is a disqualified person under this revenue ruling.

Independent of their classification as "listed transactions," transactions that are the same as, or substantially similar to, the transactions described in the preceding paragraph may already be subject to the disclosure requirements of § 6011 (§ 1.6011–4), the tax shelter registration requirements of § 6111 (§§ 301.6111–1T, 301.6111–2), or the list maintenance requirements of § 6112 (§ 301.6112–1).

Persons required to register these tax shelters under § 6111 who have failed to do so may be subject to the penalty under § 6707(a). Persons required to maintain lists of investors under § 6112 who have failed to do so (or who fail to provide such lists when requested by the IRS) may be subject to the penalty under § 6708(a). In addition, the IRS may impose penalties on parties involved in this transaction or substantially similar transactions, including the accuracy-related penalty under § 6662.

The Service and the Treasury recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the type of transaction described in this revenue ruling. These taxpayers should consult with a tax advisor to ensure that their transactions are disclosed properly and to take appropriate corrective action.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Robert Gertner of the Employee Plans, Tax Exempt and Government Entities Division and John Ricotta of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information, Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 (a toll-free call) between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday or contact Mr. Gertner at (202) 283–9888 (not a toll-free call).

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2004. See Rev. Rul. 2004-9, page 428.

Section 446.—General Rule for Methods of Accounting

26 CFR 1.446–1: General rule for methods of accounting.

T.D. 9105

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Changes in Computing Depreciation

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations relating to a change in computing depreciation or amortization as well as a change from a nondepreciable or nonamortizable asset to a depreciable or amortizable asset (or vice versa). Specifically, these regulations provide guidance to any taxpayer that makes a change in depreciation or amortization on whether such change is a change in method of accounting under section 446(e) of the Internal Revenue Code and on the application of section 1016(a)(2) in determining whether the change is a change in method of accounting. The text of these temporary regulations also serves as the text of the proposed regulations (REG–126459–03) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

DATES: *Effective Dates*: These regulations are effective January 2, 2004.

Applicability Dates: For dates of applicability, see §§1.167(e)–1T(e), 1.446(e)–1T(e)(4), and 1.1016–3T(j).

FOR FURTHER INFORMATION CONTACT: Sara Logan or Douglas Kim, (202) 622–3110 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1 to provide regulations under sections 167, 446(e), and 1016(a)(2) of the Internal Revenue Code (Code).

These regulations provide the changes in depreciation or amortization that are, and are not, a change in method of accounting under §1.446–1(e). Additionally, these regulations amend §1.167(e)–1 to provide that certain changes in depreciation method for property for which depreciation is determined only under section 167 are made without the consent of the Commissioner of Internal Revenue, and amend §1.1016–3 to provide that section 1016(a)(2) does not permanently affect a taxpayer's lifetime income for purposes of determining whether a change in depreciation or amortization is a change in method of accounting.

Explanation of Provisions

Background

Section 446 provides in general that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes the taxpayer's income in keeping the taxpayer's books. Section 446(e) provides that, except as otherwise expressly provided in chapter 1 of the Code, a taxpayer who changes the method of accounting on the basis of which the taxpayer regularly computes the taxpayer's income in keeping the taxpayer's books shall, before computing the taxpayer's taxable income under the new method, secure the consent of the Secretary.

Section 1.446–1(e)(2)(ii)(*a*) provides in pertinent part that a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. However, §1.446–1(e)(2)(ii)(*b*) provides in pertinent part that a change in method of accounting does not include an adjustment in the useful life of a depreciable asset. Although such adjustment may involve the question of the proper time for the taking of a deduction, such item is traditionally corrected by adjustments in the current and future years.

Section 1.167(e)–1(a) provides that in general, any change in the method of computing the depreciation allowances with respect to a particular account (other than a change in method permitted or required by reason of the operation of former section 167(j)(2) and §1.167(j)–3(c)) is a change in method of accounting, and such a change will be permitted only with the consent of the Commissioner, except that certain changes to the straight line method of depreciation will be permitted without consent as provided in former section 167(e)(1), (2), and (3). Any request for a change in method of depreciation shall be made in accordance with section 446 and the regulations under section 446.

In 1996, the IRS issued Rev. Proc. 96–31, 1996–1 C.B. 714, providing that a change from not claiming the depreciation or amortization allowable to claiming the depreciation or amortization allowable is a change in method of accounting for which the consent of the Commissioner of Internal Revenue is required.

In *Kurzet v. Commissioner*, 222 F.2d 830, 842–845 (10th Cir. 2000), the taxpayer sought to change the classification of property under section 168 from nonresidential real property to 15-year property thereby resulting in a change in recovery period from 31.5 years to 15 years. The Tenth Circuit held that a change in recovery period under section 168 is a change in method of accounting under section 446(e). In reaching its holding, the Tenth Circuit considered the taxpayer's argument that a change in recovery period is analogous to a change in useful life, but concluded that the Commissioner's interpretation of §1.446–1(e)(2)(ii) in Rev. Proc. 96–31 as requiring a taxpayer to obtain permission for a change in recovery period is not plainly erroneous or inconsistent with §1.446–1(e)(2)(ii).

In *Brookshire Brothers Holding, Inc. & Subsidiaries v. Commissioner*, 320 F.3d 507 (5th Cir. 2003), *aff'g*. T.C. Memo. 2001–150, *reh'g en banc denied*, 65 Fed. Appx. 511 (5th Cir. 2003), the Fifth Circuit held that a change in classification of property under section 168 is not a change in method of accounting under section 446(e) because the change is the functional equivalent of a change in useful life thereby resulting in the change falling under the useful life exception in §1.446–1(e)(2)(ii)(*b*). The Eighth Circuit in *O'Shaughnessy v. Commissioner*, 332 F.3d 1125 (8th Cir. 2003), *rev'g in part* 2002–1 U.S.T.C. (CCH) ¶50,235 (D. Minn. 2001), adopted the analysis in *Brookshire* and held that a change in classification of property under section 168 falls within the useful life exception and, thus, does not constitute a change in method of accounting under section 446(e).

Further, in *Green Forest Manufacturing Inc. v. Commissioner*, T.C. Memo. 2003–75, the Tax Court extended its reasoning in *Brookshire*. The court held that a change in computing depreciation from the general depreciation system in section 168(a) to the alternative depreciation system in section 168(g) is a change in classification that falls within the useful life exception and, therefore, is not a change in method of accounting.

As a result of these decisions, there is inconsistent treatment of taxpayers with respect to whether a change in computing depreciation under section 168 is a change in method of accounting under section 446(e). These regulations clarify the changes in depreciation or amortization (depreciation) that are (and are not) changes in method of accounting under section 446(e).

Scope

The regulations provide the changes in depreciation for property for which depreciation is determined under section 167, 168, 197, 1400I, 1400L(b), or 1400L(c), or former section 168, of the Code that are (and are not) changes in method of accounting under section 446(e). The regulations also clarify that the rules in §1.167(e)–1 with respect to a change in the depreciation method made without the consent of the Commissioner apply only to property for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L, or former section 168).

Changes in Depreciation that are Changes in Method of Accounting

In general, the regulations provide that a change in the depreciation method, period of recovery, or convention of a depreciable or amortizable asset is a change in method of accounting. This change may be the result of, for example, a change in the classification of property under section 168(e) or a change in computing depreciation from the general depreciation system

under section 168(a) to the alternative depreciation system of section 168(g). Further, a change to or from claiming the additional first year depreciation deduction provided by section 168(k) or 1400L(b) is a change in method of accounting under certain circumstances.

The regulations clarify that the useful life exception, which has been moved from §1.446–1(e)(2)(ii)(*b*) to §1.446–1T(e)(2)(ii)(*d*), applies only to property for which the depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L, or former section 168). However, a change to or from a useful life (or recovery period or amortization period) that is specifically assigned by the Code, the regulations under the Code, or other guidance published in the Internal Revenue Bulletin is a change in method of accounting.

The regulations also provide that a change in salvage value to zero for a depreciable or amortizable asset for which the salvage value is expressly treated as zero by the Code, the regulations under the Code, or other guidance published in the Internal Revenue Bulletin, is treated as a change in method of accounting. Any other change in salvage value is not treated as a change in method of accounting.

Further, the regulations provide that a change in the accounting for depreciable or amortizable assets from single asset accounting to multiple asset accounting (pooling), or vice versa, or from one type of multiple asset accounting (pooling) to a different type of multiple asset accounting (pooling) is a change in method of accounting. Also, for depreciable or amortizable assets that are mass assets accounted for in multiple asset accounts or pools, a change in the method of identifying which assets have been disposed is a change in method of accounting (for example, from specific identification to a first-in, first-out method).

Finally, the regulations provide that a change in the treatment of an asset from nondepreciable or nonamortizable (nondepreciable) to depreciable or amortizable (depreciable), or vice versa, is a change in method of accounting. For example, a change in the treatment of an asset that was used entirely in the taxpayer's trade or business and was never held for sale from being treated as inventory to being treated as depreciable property is a change in method of accounting.

Exceptions

The regulations provide that a change in computing depreciation allowances in the taxable year in which the use of property changes in the hands of the same taxpayer is not a change in method of accounting.

The regulations also provide that the making of a late depreciation election or the revocation of a timely valid depreciation election generally is not a change in method of accounting. This rule also applies to the making of a late election or the revocation of a timely valid election under section 13261(g)(2) or (3) of the Revenue Reconciliation Act of 1993 (107 Stat. 312, 540) (relating to amortizable section 197 intangibles). To make a late depreciation election or to revoke a timely valid depreciation election, a taxpayer must submit a request for a private letter ruling. Elections made under section 168(b)(2)(C), 168(b)(3)(D), or 168(g)(7) are irrevocable.

Finally, the regulations provide that any change in the placed-in-service date of a depreciable or amortizable asset is not treated as a change in method of accounting.

Item Being Changed

The regulations clarify that for purposes of changes in depreciation, the item being changed is the depreciation treatment of each individual depreciable or amortizable asset. However, the item is the depreciation treatment of each vintage account with respect to depreciable assets for which depreciation is determined under §1.167(a)–11 (CLADR property). Further, a change in computing depreciation under section 167 (other than a change under section 168, section 1400I, section 1400L, or former section 168) is permitted only with respect to all assets in a particular account (as defined in §1.167(a)–7) or vintage account.

Special Rules

The regulations also provide rules for the following: (1) a change from a declining balance method under section 168(b)(1) or (2) to the straight line method; (2) changes in certain depreciation methods under section 167 (other than under section 168, section 1400I, section 1400L, or former section 168); and (3) section 481 adjustments.

With respect to a change from the 200-percent or 150-percent declining balance method under section 168(b)(1) or (2) to the straight line method, the regulations provide that this change may be made without the consent of the Commissioner in the first taxable year in which the depreciation allowance under the straight line method is greater than the depreciation allowance under the declining balance method.

With respect to changes in depreciation methods under section 167 (other than under section 168, section 1400I, section 1400L, or former section 168), the regulations provide cross-references to regulations under section 167 that allow certain depreciation method changes to be made without the consent of the Commissioner.

With respect to section 481 adjustments, the regulations also clarify that except as otherwise expressly provided by the Code, the regulations under the Code, or other guidance published in the Internal Revenue Bulletin, a change from one permissible method of computing depreciation to another permissible method of computing depreciation for a depreciable or amortizable asset is implemented on either a cut-off method (as described in section 2.06 of Rev. Proc. 97–27, 1997–1 C.B. 680, and in section 2.06 of Rev. Proc. 2002–9, 2002–1 C.B. 327) or a modified cut-off method (under which the adjusted depreciable basis of the asset as of the beginning of the year of change is recovered using the new permissible method of accounting). Because no items are duplicated or omitted from income when the cut-off method or the modified cut-off method is used to effect the change in method of accounting, no section 481 adjustment is required or permitted. However, a change from an impermissible method of computing depreciation to a permissible method of computing depreciation results in a negative or positive section 481 adjustment because the adjusted depreciable basis of the asset as of the beginning of the year of change is changed as a result of the change in computing depreciation. Similarly, a change in the treatment of an asset from nondepreciable to depreciable (or vice versa) or

a change from expensing to depreciating an asset (or vice versa) will also result in a negative or positive section 481 adjustment.

Application of the Allowed or Allowable Rule to Changes in Method of Accounting

Section 1016(a)(2) provides that the basis of property is adjusted in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount allowed as deductions in computing taxable income and resulting in a reduction for any taxable year of the taxpayer's taxes, but not less than the amount allowable.

Concurrently with the issuance of these regulations, the IRS and Treasury Department will issue a revenue procedure that will allow a taxpayer to change the taxpayer's method of determining depreciation for a depreciable or amortizable asset after its disposition if the taxpayer did not take into account any depreciation allowance, or did take into account some depreciation but less than the depreciation allowable, for the asset in computing taxable income in the year of disposition or in prior taxable years. Because the taxpayer is permitted to claim the allowable depreciation not taken into account for this asset, the taxpayer's lifetime income is not permanently affected by the "allowed or allowable" rule under section 1016(a)(2). Accordingly, the regulations provide that section 1016(a)(2) does not permanently affect a taxpayer's lifetime income for purposes of determining whether a change in depreciation is a change in method of accounting under section 446(e) and the regulations under section 446(e).

The revenue procedure also will revise the depreciation changes included in Rev. Proc. 2002–9, 2002–1 C.B. 327, the automatic change in method of accounting revenue procedure, to conform with these regulations and will waive the application of Rev. Rul. 90–38, 1990–1 C.B. 57, for changes in depreciation made under Rev. Proc. 97–27, 1997–1 C.B. 680, or Rev. Proc. 2002–9.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the Special Analyses section of the preamble to the cross-reference notice of proposed rulemaking published in the **Federal Register**. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Sara Logan, Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.167(e)–1 is amended by:

1. Revising paragraph (a).
2. Adding new paragraph (e).

The addition and revision read as follows:

§1.167(e)–1 Change in method.

(a) *In general*. [Reserved]. For further guidance, see §1.167(e)–1T(a).

* * * * *

(e) *Effective date*. [Reserved]. For further guidance, see the first two sentences of §1.167(e)–1T(e).

Par. 3. Section 1.167(e)–1T is added to read as follows:

§1.167(e)–1T Change in method (temporary).

(a) *In general*. (1) Any change in the method of computing the depreciation allowances with respect to a particular account (other than a change in method permitted or required by reason of the operation of former section 167(j)(2) and §1.167(j)–3(c)) is a change in method of accounting, and such a change will be permitted only with the consent of the Commissioner, except that certain changes to the straight line method of depreciation will be permitted without consent as provided in former section 167(e)(1), (2), and (3). Except as provided in paragraphs (c) and (d) of this section, a change in method of computing depreciation will be permitted only with respect to all the assets contained in a particular account as defined in §1.167(a)–7. Any change in the percentage of the current straight line rate under the declining balance method, for example, from 200 percent of the straight line rate to any other percent of the straight line rate, or any change in the interest factor used in connection with a compound interest or sinking fund method, will constitute a change in method of depreciation. Any request for a change in method of depreciation shall be made in accordance with section 446(e) and the regulations under section 446(e). For rules covering the use of depreciation methods by acquiring corporations in the case of certain corporate acquisitions, see section 381(c)(6) and the regulations under section 381(c)(6).

(2) Paragraphs (b), (c), and (d) of this section apply to property for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L, or under section 168 prior to its amendment by the Tax Reform Act of 1986 (100 Stat. 2121)) of the Internal Revenue Code.

(b) through (d) [Reserved]. For further guidance, see §1.167(e)–1(b) through (d).

(e) *Effective date*. This section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see §1.167(e)–1 in effect prior to December 30, 2003 (§1.167(e)–1 as contained in 26 CFR part 1 edition revised as of April 1, 2003). The applicability of this section expires on or before December 29, 2006.

Par. 4. Section 1.446–1 is amended by:

1. Revising paragraphs (e)(2)(ii)(*a*), (e)(2)(ii)(*b*), and (e)(2)(iii).
2. Adding new paragraphs (e)(2)(ii)(*d*) and (e)(4).

The additions and revisions read as follows:

§1.446–1 General rule for methods of accounting.

* * * * *

(e) * * *

(2) * * *

(ii) (*a*) [Reserved]. For further guidance, see §1.446–1T(e)(2)(ii)(*a*).

(*b*) [Reserved]. For further guidance, see §1.446–1T(e)(2)(ii)(*b*).

* * * * *

(*d*) *Changes involving depreciable or amortizable assets*. [Reserved]. For further guidance, see §1.446–1T(e)(2)(ii)(*d*).

(iii) *Examples*. [Reserved]. For further guidance, see §1.446–1T(e)(2)(iii).

* * * * *

(4) *Effective date*. [Reserved]. For further guidance, see §1.446(e)–1T(e)(4)(i) and (ii).

Par. 5. Section 1.446–1T is added to read as follows:

§1.446–1T General rule for methods of accounting (temporary).

(a) through (e)(2)(i) [Reserved]. For further guidance, see §1.446–1(a) through (e)(2)(i).

(e)(2)(ii)(*a*) A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. Changes in method of accounting include a change from the cash receipts and disbursement method to an accrual method, or vice versa, a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations under sections 471 and 472), a change from the cash or accrual method to a long-term contract method, or vice versa (see §1.460–4), certain changes in computing depreciation or amortization (see paragraph (e)(2)(ii)(*d*) of this section), a change involving the adoption, use or discontinuance of any other specialized method of computing taxable income, such as the crop method, and a change where the Internal Revenue Code and regulations under the Code specifically require that the consent of the Commissioner must be obtained before adopting such a change.

(*b*) A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion, or investment credit). Also, a change in method of accounting does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, corrections of items that are deducted as interest or salary, but that are in fact payments of dividends, and of items that are deducted as business expenses, but which are in fact personal expenses, are not changes in method of accounting. In addition, a change in the method of accounting does not include an adjustment with respect to the addition to a reserve for bad debts. Although such adjustment may involve the question of the proper time for the taking of a deduction, such items are traditionally corrected by adjustment in the current and future years. For the treatment of the adjustment of the addition to a bad debt reserve (for example, for banks under section 585 of the Internal Revenue Code), see the regulations under section 166 of the Internal Revenue Code. A change in the method of accounting also does not include a change in treatment resulting from a change in underlying facts. For further guidance on changes involving depreciable or amortizable assets, see paragraph (e)(2)(ii)(*d*) of this section and §1.1016–3T(h).

(*c*) [Reserved]. For further guidance, see §1.446–1(e)(2)(ii)(*c*).

(*d*) *Changes involving depreciable or amortizable assets*—(*1*) *Scope*. This paragraph (e)(2)(ii)(*d*) applies to property subject to section 167, 168, 197, 1400I, 1400L(b), or 1400L(c), or to section 168 prior to its amendment by the Tax Reform Act of 1986 (100 Stat. 2121) (former section 168).

(*2*) *Changes in depreciation or amortization that are a change in method of accounting*. Except as provided in paragraph (e)(2)(ii)(*d*)(*3*) of this section, a change in the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable, or vice versa, is a change in method of accounting. Additionally, a correction to require depreciation or amortization in lieu of a deduction for the cost of depreciable or amortizable assets that had been consistently treated as an expense in the year of purchase, or vice versa, is a change in method of accounting. Further, except as provided in paragraph (e)(2)(ii)(*d*)(*3*) of this section, the following changes in computing depreciation or amortization are a change in method of accounting:

(*i*) A change in the depreciation or amortization method, period of recovery, or convention of a depreciable or amortizable asset.

(*ii*) A change from not claiming to claiming the additional first year depreciation deduction provided by section 168(k) or 1400L(b) for, and the resulting change to the amount otherwise allowable as a depreciation deduction for the remaining adjusted depreciable basis (or similar basis) of, qualified property, 50-percent bonus depreciation property, or qualified New York Liberty Zone property, provided the taxpayer did not make the election out of the additional first year depreciation deduction (or did not make a deemed election out of the additional first year depreciation deduction; for further guidance, see Rev. Proc. 2002–33, 2002–1 C.B. 963, Rev. Proc. 2003–50, 2003–29 I.R.B. 119, and §601.601(d)(2)(ii)(*b*) of this chapter) for the class of property in which the qualified property, the 50-percent bonus depreciation property, or the qualified New York Liberty Zone property is included.

(*iii*) A change from claiming the 30-percent additional first year depreciation deduction to claiming the 50-percent additional first year depreciation deduction for 50-percent bonus depreciation property (provided the property is not included in any class of property for which the taxpayer elected the 30-percent, instead of the 50-percent, additional first year depreciation deduction) or a change from claiming the 50-percent additional first year depreciation deduction to claiming the 30-percent additional first year depre-

ciation deduction for qualified property (including property that is included in a class of property for which the taxpayer elected the 30-percent, instead of the 50-percent, additional first year depreciation deduction) or qualified New York Liberty Zone property, and the resulting change to the amount otherwise allowable as a depreciation deduction for the property's remaining adjusted depreciable basis (or similar basis). This paragraph (e)(2)(ii)(*d*)(*2*)(*iii*) does not apply if a taxpayer is making a late election or revoking a timely valid election under section 168(k) or 1400L(b) (see paragraph (e)(2)(ii)(*d*)(*3*)(*iii*) of this section).

(*iv*) A change from claiming to not claiming the additional first year depreciation deduction for an asset that is not qualified property, 50-percent bonus depreciation property, or qualified New York Liberty Zone property, and the resulting change to the amount otherwise allowable as a depreciation deduction for the property's depreciable basis.

(*v*) A change in salvage value to zero for a depreciable or amortizable asset for which the salvage value is expressly treated as zero by the Internal Revenue Code (for example, section 168(b)(4)), the regulations under the Code (for example, §1.197–2(f)(1)(ii)), or other guidance published in the Internal Revenue Bulletin.

(*vi*) A change in the accounting for depreciable or amortizable assets from a single asset account to a multiple asset account (pooling), or vice versa, or from one type of multiple asset account (pooling) to a different type of multiple asset account (pooling).

(*vii*) For depreciable or amortizable assets that are mass assets accounted for in multiple asset accounts or pools, a change in the method of identifying which assets have been disposed. For purposes of this paragraph (e)(2)(ii)(*d*)(*2*)(*vii*), the term *mass assets* means a mass or group of individual items of depreciable or amortizable assets that are not necessarily homogeneous, each of which is minor in value relative to the total value of the mass or group, numerous in quantity, usually accounted for only on a total dollar or quantity basis, with respect to which separate identification is impracticable, and placed in service in the same taxable year.

(*viii*) Any other change in depreciation or amortization as the Secretary may designate by publication in the **Federal Register** or in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(*3*) *Changes in depreciation or amortization that are not a change in method of accounting*—(*i*) *Useful life*. An adjustment in the useful life of a depreciable or amortizable asset for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L, or former section 168) is not a change in method of accounting. This adjustment in useful life is corrected by adjustments in the taxable year in which the conditions known to exist at the end of that taxable year changed thereby resulting in a redetermination of the useful life under §1.167(a)–1(b) (or if the period of limitation for assessment under section 6501(a) has expired for that taxable year, in the first succeeding taxable year open under the period of limitation for assessment), and in subsequent taxable years. In other situations, the adjustment in useful life may be corrected by adjustments in the earliest taxable year open under the period of limitation for assessment under section 6501(a) or the earliest taxable year under examination by the Internal Revenue Service (IRS) but in no event earlier than the placed-in-service year of the asset, and in subsequent taxable years. However, if a taxpayer initiates the correction in useful life, in lieu of filing amended federal tax returns (for example, because the conditions known to exist at the end of a prior taxable year changed thereby resulting in a redetermination of the useful life under §1.167(a)–1(b)), the taxpayer may correct the adjustment in useful life by adjustments in the current and subsequent taxable years. This paragraph (e)(2)(ii)(*d*)(*3*)(*i*) does not apply if a taxpayer is changing to or from a useful life (or recovery period or amortization period) that is specifically assigned by the Internal Revenue Code (for example, section 167(f)(1), section 168(c), section 197), the regulations under the Code, or other guidance published in the Internal Revenue Bulletin and, therefore, such change is a change in method of accounting (unless paragraph (e)(2)(ii)(*d*)(*3*)(*v*) of this section applies).

(*ii*) *Change in use*. A change in computing depreciation or amortization allowances in the taxable year in which the use of an asset changes in the hands of the same taxpayer is not a change in method of accounting.

(*iii*) *Elections*. Generally, the making of a late depreciation or amortization election or the revocation of a timely valid depreciation or amortization election is not a change in method of accounting, except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Code, or other guidance published in the Internal Revenue Bulletin. This paragraph (e)(2)(ii)(*d*)(*3*)(*iii*) also applies to making a late election or revoking a timely valid election made under section 13261(g)(2) or (3) of the Revenue Reconciliation Act of 1993 (107 Stat. 312, 540) (relating to amortizable section 197 intangibles). A taxpayer may request consent to make a late election or revoke a timely valid election by submitting a request for a private letter ruling.

(*iv*) *Salvage value*. Except as provided under paragraph (e)(2)(ii)(*d*)(*2*)(*v*) of this section, a change in salvage value of a depreciable or amortizable asset is not treated as a change in method of accounting.

(*v*) *Placed-in-service date*. Any change in the placed-in-service date of a depreciable or amortizable asset is not treated as a change in method of accounting. The change in placed-in-service date may be corrected by adjustments in the earliest taxable year open under the period of limitation for assessment under section 6501(a) or the earliest taxable year under examination by the IRS but in no event earlier than the placed-in-service year of the asset, and in subsequent taxable years. However, if a taxpayer initiates the change in placed-in-service date, in lieu of filing amended federal tax returns, the taxpayer may correct the placed-in-service date by adjustments in the current and subsequent taxable years.

(*vi*) Any other change in depreciation or amortization as the Secretary may designate by publication in the **Federal Register** or in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(*4*) *Item being changed*. For purposes of a change in depreciation or amortization to which this paragraph (e)(2)(ii)(*d*) applies, the item being changed generally is the depreciation treatment of each individual depreciable or amortizable asset. However, the item is the depreciation treatment of each vintage account with respect to a depreciable asset for which depreciation is

determined under §1.167(a)–11 (CLADR property). Further, a change in computing depreciation or amortization under section 167 (other than under section 168, section 1400I, section 1400L, or former section 168) is permitted only with respect to all assets in a particular account (as defined in §1.167(a)–7) or vintage account.

(*5*) *Special rules*. For purposes of a change in depreciation or amortization to which this paragraph (e)(2)(ii)(*d*) applies—

(*i*) *Declining balance method to the straight line method for MACRS property*. For tangible, depreciable property subject to section 168 (MACRS property) that is depreciated using the 200-percent or 150-percent declining balance method of depreciation under section 168(b)(1) or (2), a taxpayer may change without the consent of the Commissioner from the declining balance method of depreciation to the straight line method of depreciation in the first taxable year in which the use of the straight line method with respect to the adjusted depreciable basis of the MACRS property as of the beginning of that year will yield a depreciation allowance that is greater than the depreciation allowance yielded by the use of the declining balance method. When the change is made, the adjusted depreciable basis of the MACRS property as of the beginning of the taxable year is recovered through annual depreciation allowances over the remaining recovery period (for further guidance, see section 6.06 of Rev. Proc. 87–57, 1987–2 C.B. 687, and §601.601(d)(2)(ii)(*b*) of this chapter).

(*ii*) *Depreciation method changes for section 167 property*. For a depreciable or amortizable asset for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L, or former section 168), see §1.167(e)–1T(b), (c), and (d) for the changes in depreciation method that are permitted to be made without the consent of the Commissioner. For CLADR property, see §1.167(a)–11(c)(1)(iii) for the changes in depreciation method for CLADR property that are permitted to be made without the consent of the Commissioner. Further, see §1.167(a)–11(b)(4)(iii)(*c*) for how to correct an incorrect classification or characterization of CLADR property.

(*iii*) *Section 481 adjustment*. Except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Code, or other guidance published in the Internal Revenue Bulletin, no section 481 adjustment is required or permitted for a change from one permissible method of computing depreciation or amortization to another permissible method of computing depreciation or amortization for an asset because this change is implemented by either a cut-off method (for further guidance, see section 2.06 of Rev. Proc. 97–27, 1997–1 C.B. 680, section 2.06 of Rev. Proc. 2002–9, 2002–1 C.B. 327, and §601.601(d)(2)(ii)(*b*) of this chapter) or a modified cut-off method (under which the adjusted depreciable basis of the asset as of the beginning of the year of change is recovered using the new permissible method of accounting), as appropriate. However, a change from an impermissible method of computing depreciation or amortization to a permissible method of computing depreciation or amortization for an asset results in a section 481 adjustment. Similarly, a change in the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable (or vice versa) or a change in the treatment of an asset from expensing to depreciating (or vice versa) results in a section 481 adjustment.

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

Example 1. Although the sale of merchandise is an income producing factor, and therefore inventories are required, a taxpayer in the retail jewelry business reports his income on the cash receipts and disbursements method of accounting. A change from the cash receipts and disbursements method of accounting to the accrual method of accounting is a change in the overall plan of accounting and thus is a change in method of accounting.

Example 2. A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis except for real estate taxes which have been reported on the cash receipts and disbursements method of accounting. A change in the treatment of real estate taxes from the cash receipts and disbursements method to the accrual method is a change in method of accounting because such change is a change in the treatment of a material item within his overall accounting practice.

Example 3. A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis. Vacation pay has been deducted in the year in which paid because the taxpayer did not have a completely vested vacation pay plan, and, therefore, the liability for payment did not accrue until that year. Subsequently, the taxpayer adopts a completely vested vacation pay plan that changes its year for accruing the deduction from the year in which payment is made to the year in which the liability to make the payment now arises. The change for the year of deduction of the vacation pay plan is not a change in method of accounting but results, instead, because the underlying facts (that is, the type of vacation pay plan) have changed.

Example 4. From 1968 through 1970, a taxpayer has fairly allocated indirect overhead costs to the value of inventories on a fixed percentage of direct costs. If the ratio of indirect overhead costs to direct costs increases in 1971, a change in the underlying facts has occurred. Accordingly, an increase in the percentage in 1971 to fairly reflect the increase in the relative level of indirect overhead costs is not a change in method of accounting but is a change in treatment resulting from a change in the underlying facts.

Example 5. A taxpayer values inventories at cost. A change in the basis for valuation of inventories from cost to the lower of cost or market is a change in an overall practice of valuing items in inventory. The change, therefore, is a change in method of accounting for inventories.

Example 6. A taxpayer in the manufacturing business has for many taxable years valued its inventories at cost. However, cost has been improperly computed since no overhead costs have been included in valuing the inventories at cost. The failure to allocate an appropriate portion of overhead to the value of inventories is contrary to the requirement of the Internal Revenue Code and the regulations under the Code. A change requiring appropriate allocation of overhead is a change in method of accounting because it involves a change in the treatment of a material item used in the overall practice of identifying or valuing items in inventory.

Example 7. A taxpayer has for many taxable years valued certain inventories by a method which provides for deducting 20 percent of the cost of the inventory items in determining the final inventory valuation. The 20 percent adjustment is taken as a "reserve for price changes." Although this method is not a proper method of valuing inventories under the Internal Revenue Code or the regulations under the Code, it involves the treatment of a material item used in the overall practice of valuing inventory. A change in such practice or procedure is a change of method of accounting for inventories.

Example 8. A taxpayer has always used a base stock system of accounting for inventories. Under this system a constant price is applied to an assumed constant normal quantity of goods in stock. The base stock system is an overall plan of accounting for inventories which is not recognized as a proper method of accounting for inventories under the regulations. A change in this practice is, nevertheless, a change of method of accounting for inventories.

Example 9. In 2000, A1, a calendar year taxpayer engaged in the trade or business of manufacturing knitted goods, purchased and placed in service a building and its components at a total cost of $10,000,000 for use in its manufacturing operations. A1 classified the $10,000,000 as nonresidential real property under section 168(e). A1 did not make any elections under section 168 on its 2000 Federal tax return. As a result, on its 2000, 2001, and 2002

federal tax returns, A1 depreciated the $10,000,000 under the general depreciation system of section 168(a), using the straight line method of depreciation, a 39-year recovery period, and the mid-month convention. In 2003, A1 completes a cost segregation study on the building and its components and identifies items that cost a total of $1,500,000 as section 1245 property. As a result, the $1,500,000 should have been classified in 2000 as 5-year property under section 168(e) and depreciated on A1's 2000, 2001, and 2002 Federal tax returns under the general depreciation system, using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. Pursuant to paragraph (e)(2)(ii)(*d*)(*2*)(*i*) of this section, A1's change to this depreciation method, recovery period, and convention is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(*d*)(*3*)(*i*) of this section does not apply because the assets are depreciated under section 168.

Example 10. In 1996, B, a calendar year taxpayer, purchased and placed in service new equipment at a total cost of $1,000,000 for use in its plant located outside the United States. The equipment is 15-year property under section 168(e) with a class life of 20 years. The equipment is required to be depreciated under the alternative depreciation system of section 168(g). However, B incorrectly depreciated the equipment under the general depreciation system of section 168(a), using the 150-percent declining balance method, a 15-year recovery period, and the half-year convention. In 2003, the IRS examines B's 2000 Federal income tax return and changes the depreciation of the equipment to the alternative depreciation system, using the straight line method of depreciation, a 20-year recovery period, and the half-year convention. Pursuant to paragraph (e)(2)(ii)(*d*)(*2*)(*i*) of this section, this change in depreciation method and recovery period made by the IRS is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(*d*)(*3*)(*i*) of this section does not apply because the assets are depreciated under section 168.

Example 11. In May 2001, C, a calendar year taxpayer, purchased and placed in service equipment for use in its trade or business. C never held this equipment for sale. However, C incorrectly treated the equipment as inventory on its 2001 and 2002 Federal tax returns. In 2003, C realizes that the equipment should have been treated as a depreciable asset. Pursuant to paragraph (e)(2)(ii)(*d*)(*2*) of this section, C's change in the treatment of the equipment from inventory to a depreciable asset is a change in method of accounting. This method change results in a section 481 adjustment.

Example 12. Since 2001, D, a calendar year taxpayer, has used the distribution fee period method to amortize distributor commissions and, under that method, established pools to account for the distributor commissions (for further guidance, see Rev. Proc. 2000–38, 2000–2 C.B. 310, and §601.601(d)(2)(ii)(*b*) of this chapter). A change in the accounting of distributor commissions under the distribution fee period method from pooling to single asset accounting is a change in method of accounting pursuant to paragraph (e)(2)(ii)(*d*)(*2*)(*vi*) of this section. This method change results in no section 481 adjustment because the change is from one permissible method to another permissible method.

Example 13. Since 2000, E, a calendar year taxpayer, has accounted for items of MACRS property that are mass assets in pools. Each pool includes only the mass assets that are placed in service by E in the same taxable year. E is able to identify the cost basis of each asset in each pool. None of the pools are general asset accounts under section 168(i)(4) and the regulations under section 168(i)(4). E identified any dispositions of these mass assets by specific identification. Because of changes in E's recordkeeping in 2003, it is impracticable for E to continue to identify disposed mass assets using specific identification. As a result, E wants to change to a first-in, first-out method under which the mass assets disposed of in a taxable year are deemed to be from the pool with the earliest placed-in-service year in existence as of the beginning of the taxable year of each disposition. Pursuant to paragraph (e)(2)(ii)(*d*)(*2*)(*vii*) of this section, this change is a change in method of accounting. This method change results in no section 481 adjustment because the change is from one permissible method to another permissible method.

Example 14. In August 2001, F, a calendar taxpayer, purchased and placed in service a copier for use in its trade or business. F incorrectly classified the copier as 7-year property under section 168(e). F made no elections under section 168 on its 2001 Federal tax return. As a result, on its 2001 and 2002 Federal tax returns, F depreciated the copier under the general depreciation system of section 168(a), using the 200-percent declining balance method of depreciation, a 7-year recovery period, and the half-year convention. In 2003, F realizes that the copier is 5-year property and should have been depreciated on its 2001 and 2002 Federal tax returns under the general depreciation system using a 5-year recovery period rather than a 7-year recovery period. Pursuant to paragraph (e)(2)(ii)(*d*)(*2*)(*i*) of this section, F's change in recovery period from 7 to 5 years is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(*d*)(*3*)(*i*) of this section does not apply because the copier is depreciated under section 168.

Example 15. In 1998, G, a calendar year taxpayer, purchased and placed in service an intangible asset that is not an amortizable section 197 intangible and that is not described in section 167(f). G amortized the cost of the intangible asset under section 167(a) using the straight line method of depreciation and a useful life of 13 years. In 2003, because of changing conditions, G changes the remaining useful life of the intangible asset to 2 years. Pursuant to paragraph (e)(2)(ii)(*d*)(*3*)(*i*) of this section, G's change in useful life is not a change in method of accounting because the intangible asset is depreciated under section 167 and G is not changing to or from a useful life that is specifically assigned by the Internal Revenue Code, the regulations under the Code, or other guidance published in the Internal Revenue Bulletin.

Example 16. In July 2001, H, a calendar year taxpayer, purchased and placed in service "off-the-shelf" computer software and a new computer. The cost of the new computer and computer software are separately stated. H incorrectly included the cost of this software as part of the cost of the computer, which is 5-year property under section 168(e). On its 2001 Federal tax return, H elected to depreciate its 5-year property placed in service in 2001 under the alternative depreciation system of section 168(g). The class life for a computer is 5 years. As a result, because H included the cost of the computer software as part of the cost of the computer hardware, H depreciated the cost of the software under the alternative depreciation system, using the straight line method of depreciation, a 5-year recovery period, and the half-year convention. In 2003, H realizes that the cost of the software should have been amortized under section 167(f)(1), using the straight line method of depreciation, a 36-month useful life, and a monthly convention. H's change from 5-years to 36-months is a change in method of accounting because H is changing to a useful life that is specifically assigned by section 167(f)(1). The change in convention from the half-year to the monthly convention also is a change in method of accounting. Both changes result in a section 481 adjustment.

Example 17. On September 15, 2001, I2, a calendar year taxpayer, purchased and placed in service new equipment at a total cost of $500,000 for use in its business. The equipment is 5-year property under section 168(e) with a class life of 9 years and is qualified property under section 168(k). I2 did not place in service any other depreciable property in 2001. Section 168(g)(1)(A) through (D) do not apply to the equipment. I2 intended to elect the alternative depreciation system under section 168(g) for 5-year property placed in service in 2001. However, I2 did not make the election. Instead, I2 deducted on its 2001 Federal tax return the 30-percent additional first year depreciation attributable to the equipment and, on its 2001 and 2002 Federal tax returns, depreciated the remaining adjusted depreciable basis of the equipment under the general depreciation system under 168(a), using the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. In 2003, I2 realizes its failure to make the alternative depreciation system election in 2001 and files a Form 3115 to change its method of depreciating the remaining adjusted depreciable basis of the 2001 equipment to the alternative depreciation system. Because this equipment is not required to be depreciated under the alternative depreciation system, I2 is attempting to make an election under section 168(g)(7). However, this election must be made in the taxable year in which the equipment is placed in service (2001) and, consequently, I2 is attempting to make a late election under section 168(g)(7). Accordingly, I2's change to the alternative depreciation system is not a change in accounting method pursuant to paragraph (e)(2)(ii)(*d*)(*3*)(*iii*) of this section. Instead, I2 must submit a request for a private letter ruling under §301.9100–3 of this chapter, requesting an extension of time to make the alternative depreciation system election on its 2001 Federal tax return.

(3) [Reserved]. For further guidance, see §1.446–1(e)(3).

(4) *Effective date*—(i) *In general*. Except as provided in paragraphs (e)(3)(iii) and (e)(4)(ii) of this section, paragraph (e) of this section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see

§1.446–1(e) in effect prior to December 30, 2003 (§1.446–1(e) as contained in 26 CFR part 1 edition revised as of April 1, 2003).

(ii) *Changes involving depreciable or amortizable assets*. With respect to paragraph (e)(2)(ii)(*d*) of this section, paragraph (e)(2)(iii) *Examples 9* through *17* of this section, the addition of the language "certain changes in computing depreciation or amortization (see paragraph (e)(2)(ii)(*d*) of this section)" to the last sentence of paragraph (e)(2)(ii)(*a*) of this section, and the removal of all language regarding useful life and the sentence "On the other hand, a correction to require depreciation in lieu of a deduction for the cost of a class of depreciable assets which had been consistently treated as an expense in the year of purchase involves the question of the proper timing of an item, and is to be treated as a change in method of accounting" from paragraph (e)(2)(ii)(*b*) of this section—

(A) For any change in depreciation or amortization that is a change in method of accounting, this section applies to such a change in method of accounting made for taxable years ending on or after December 30, 2003; and

(B) For any change in depreciation or amortization that is not a change in method of accounting, this section applies to such a change made for taxable years ending on or after December 30, 2003.

(iii) The applicability of paragraph (e) of this section expires on or before December 29, 2006.

Par. 6. Section 1.1016–3 is amended by:

1. Redesignating paragraph (h) as paragraph (i).

2. Adding new paragraphs (h) and (j).

The additions read as follows:

§1.1016–3 Exhaustion, wear and tear, obsolescence, amortization, and depletion for periods since February 28, 1913.

* * * * *

(h) *Application to a change in method of accounting*. [Reserved]. For further guidance, see §1.1016–3T(h).

* * * * *

(j) *Effective date*. [Reserved]. For further guidance, see §1.1016–3T(j)(1) and (2).

Par. 7. Section 1.1016–3T is added to read as follows:

§1.1016–3T Exhaustion, wear and tear, obsolescence, amortization, and depletion for periods since February 28, 1913 (temporary).

(a) through (g) [Reserved]. For further guidance, see §1.1016–3(a) through (g).

(h) *Application to a change in method of accounting*. For purposes of determining whether a change in depreciation or amortization for property subject to section 167, 168, 197, 1400I, 1400L(b), or 1400L(c), or to section 168 prior to its amendment by the Tax Reform Act of 1986 (100 Stat. 2121) (former section 168) is a change in method of accounting under section 446(e) and the regulations under section 446(e), section 1016(a)(2) does not permanently affect a taxpayer's lifetime income.

(i) [Reserved]. For further guidance, see §1.1016–3(i).

(j) *Effective date*—(1) *In general*. Except as provided in paragraph (j)(2) of this section, this section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see §1.1016–3 in effect prior to December 30, 2003 (§1.1016–3 as contained in 26 CFR part 1 edition revised as of April 1, 2003).

(2) *Depreciation or amortization changes*. Paragraph (h) of this section applies to a change in depreciation or amortization for property subject to section 167, 168, 197, 1400I, 1400L(b), or 1400L(c), or former section 168 for taxable years ending on or after December 30, 2003.

(3) The applicability of this section expires on or before December 29, 2006.

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

Approved December 18, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on December 30, 2003, 8:45 a.m., and published in the issue of the Federal Register for January 2, 2004, 69 F.R. 5)

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2004. See Rev. Rul. 2004-9, page 428.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2004. See Rev. Rul. 2004-9, page 428.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of February 2004. See Rev. Rul. 2004-9, page 428.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2004. See Rev. Rul. 2004-9, page 428.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of February 2004. See Rev. Rul. 2004-9, page 428.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2004. See Rev. Rul. 2004-9, page 428.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2004. See Rev. Rul. 2004-9, page 428.

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 642, 1274, 1288, and other sections of the Code, tables set forth the rates for February 2004.

Rev. Rul. 2004–9

This revenue ruling provides various prescribed rates for federal income tax purposes for February 2004 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 2004–9 TABLE 1

Applicable Federal Rates (AFR) for February 2004

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	1.62%	1.61%	1.61%	1.60%
110% AFR	1.78%	1.77%	1.77%	1.76%
120% AFR	1.94%	1.93%	1.93%	1.92%
130% AFR	2.10%	2.09%	2.08%	2.08%
Mid-Term				
AFR	3.44%	3.41%	3.40%	3.39%
110% AFR	3.79%	3.75%	3.73%	3.72%
120% AFR	4.13%	4.09%	4.07%	4.06%
130% AFR	4.48%	4.43%	4.41%	4.39%
150% AFR	5.19%	5.12%	5.09%	5.07%
175% AFR	6.06%	5.97%	5.93%	5.90%
Long-Term				
AFR	4.94%	4.88%	4.85%	4.83%
110% AFR	5.44%	5.37%	5.33%	5.31%
120% AFR	5.95%	5.86%	5.82%	5.79%
130% AFR	6.44%	6.34%	6.29%	6.26%

REV. RUL. 2004–9 TABLE 2

Adjusted AFR for February 2004

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	1.41%	1.41%	1.41%	1.41%
Mid-term adjusted AFR	2.64%	2.62%	2.61%	2.61%
Long-term adjusted AFR	4.31%	4.26%	4.24%	4.22%

REV. RUL. 2004–9 TABLE 3	
Rates Under Section 382 for February 2004	
Adjusted federal long-term rate for the current month	4.31%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	4.58%

REV. RUL. 2004–9 TABLE 4	
Appropriate Percentages Under Section 42(b)(2) for February 2004	
Appropriate percentage for the 70% present value low-income housing credit	7.97%
Appropriate percentage for the 30% present value low-income housing credit	3.42%

REV. RUL. 2004–9 TABLE 5	
Rate Under Section 7520 for February 2004	
Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	4.2%

Section 1288.—Treatment of Original Issue Discounts on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2004. See Rev. Rul. 2004-9, page 428.

Section 1361.—S Corporation Defined

26 CFR 1.1361–4: Effect on QSub election.

Whether an Employee Stock Ownership Plan may be a shareholder in an S corporation. See Rev. Rul. 2004-4, page 414.

Section 4975.—Tax on Prohibited Transactions

26 CFR 54.4975–11: "ESOP" requirements.

Whether, under each of the three situations described therein, the Employee Stock Ownership Plan of an S corporation has a nonallocation year within the meaning of section 409(p)(3) of the Internal Revenue Code. See Rev. Rul. 2004-4, page 414.

Section 4979A.—Tax on Certain Prohibited Allocations of Qualified Securities

Whether transactions involving an S corporation ESOP and the ownership by a disqualified person of synthetic equity in a nonallocation year of the ESOP give rise to the excise tax described in section 4979A. See Rev. Rul. 2004-4, page 414.

Section 6011.—General Requirement of Return, Statement or List

26 CFR 1.6011–4: Requirement of statement disclosing participation in certain transactions by taxpayers.

Whether transactions involving an S corporation ESOP and the ownership by a disqualified person of synthetic equity in a nonallocation year of the ESOP is a listed transaction. See Rev. Rul. 2004-4, page 414.

26 CFR 1.6011–4: Requirement of statement disclosing participation in certain transactions by taxpayers.

T.D. 9108

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 301

Confidential Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: These final regulations modify and clarify the rules relating to confidential transactions under the Income Tax Regulations, and make minor conforming changes to the list maintenance rules under the Procedure and Administration Regulations. These regulations affect taxpayers participating in reportable transactions and persons responsible for maintaining and furnishing lists of investors in reportable transactions.

DATES: *Effective Date:* These regulations are effective December 29, 2003.

Applicability Date: For dates of applicability, see §1.6011–4(h) and §301.6112–1.

FOR FURTHER INFORMATION CONTACT: Tara P. Volungis or Charlotte Chyr, 202–622–3070 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these regulations have been previously reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control numbers 1545–1685 and 1545–1686.

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

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

Background

This document amends 26 CFR parts 1 and 301 by modifying and clarifying the rules relating to the disclosure of reportable transactions by certain taxpayers on their Federal income tax returns under section 6011 and by making conforming changes to the rules under section 6112.

On October 17, 2002, the IRS issued temporary and proposed regulations modifying the rules under sections 6011, 6111, and 6112 (T.D. 9017, 2002–2 C.B. 815; REG–103735–00, REG–154117–02, REG–154116–02, REG–154115–02, REG–154429–02, REG–154423–02, REG–154426–02, REG–110311–98, 2002–2 C.B. 832; T.D. 9018, 2002–2 C.B 823; REG–103736–00, 2002–2 C.B. 834) (the October 2002 regulations). The October 2002 regulations were published in the **Federal Register** (67 FR 64799, 67 FR 64840; 67 FR 64807, 67 FR 64842) on October 22, 2002. On December 11, 2002, and on January 7, 2003, the IRS and Treasury Department held a public hearing on these regulations. On February 28, 2003, the IRS issued final regulations under sections 6011, 6111, and 6112 (T.D. 9046, 2003–1 C.B. 614) (the February 2003 regulations). The February 2003 regulations were published in the **Federal Register** (68 FR 10161) on March 4, 2003.

Since finalizing the disclosure regulations, the IRS and Treasury Department have received numerous comments concerning the confidentiality filter. The IRS and Treasury Department received requests to exclude certain transactions from the scope of the confidentiality filter, and requests to modify the language of the regulation itself. After reviewing these comments, the IRS and Treasury Department have decided to narrow the confidentiality filter under §1.6011–4(b)(3).

Explanation of Provisions

Section 1.6011–4(b)(3) provides that certain transactions are identified as confidential transactions. Confidential transactions are reportable transactions that are subject to the disclosure rules under §1.6011–4 and the list maintenance rules under §301.6112–1. Currently, a confidential transaction is a transaction that is offered under conditions of confidentiality. The confidentiality filter generally provides a presumption of non-confidentiality if the taxpayer receives written authorization to disclose the tax treatment and tax structure of the transaction.

The IRS and Treasury Department have concluded that the confidentiality filter should be limited to situations in which an advisor is paid a large fee and imposes a limitation on disclosure that protects the confidentiality of the advisor's tax strategies. The IRS and Treasury Department believe that the confidentiality filter should not apply to transactions in which confidentiality is imposed by a party to the transaction acting in such capacity. Accordingly, the confidentiality filter has been narrowed to reflect this policy. Further, the exceptions and presumption language have been removed because the IRS and Treasury Department have concluded that they no longer are necessary under this narrower rule. Conforming changes have been made to the rules under §301.6112–1.

The IRS and Treasury Department also have made minor clarifying changes under §1.6011–4. The regulations clarify that a return includes amended returns for purposes of determining when a disclosure must be made. The IRS and Treasury Department will continue to accept comments and will make other changes as appropriate.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has been determined pursuant to 5 U.S.C. 553(b)(B) that notice and public procedure are unnecessary and contrary to the public interest. These final regulations substantially reduce taxpayer compliance burdens by limiting the scope of transactions subject to the disclosure requirements of §1.6011–4. For the same reason, pursuant to 5 U.S.C. 553(d)(1) and (3) a delayed effective date for these final regulations is not required. Because no notice of proposed rulemaking is required, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply. However, the IRS and Treasury Department welcome comments on whether these final regulations impose additional costs and compliance burdens on small businesses. Any such comments should provide specific information concerning those costs and burdens. In addition, the IRS and Treasury Department will consider holding a public hearing concerning these regulations if there is sufficient interest from affected parties. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these regulations are Tara P. Volungis and Charlotte Chyr, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.6011–4 is amended as follows:

1. Paragraph (b)(3) is revised.

2. Paragraph (e)(1) is amended by removing the second sentence and replacing it with two new sentences in its place.

3. Paragraphs (e)(2)(i) and (h) are revised.

The revisions and additions read as follows:

§1.6011–4 Requirement of statement disclosing participation in certain transactions by taxpayers.

* * * * *

(b) * * * * *

(3) *Confidential transactions*—(i) *In general*. A confidential transaction is a transaction that is offered to a taxpayer under conditions of confidentiality and for which the taxpayer has paid an advisor a minimum fee.

(ii) *Conditions of confidentiality*. A transaction is considered to be offered to a taxpayer under conditions of confidentiality if the advisor who is paid the minimum fee places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that advisor's tax strategies. A transaction is treated as confidential even if the conditions of confidentiality are not legally binding on the taxpayer. A claim that a transaction is proprietary or exclusive is not treated as a limitation on disclosure if the advisor confirms to the taxpayer that there is no limitation on disclosure of the tax treatment or tax structure of the transaction.

(iii) *Minimum fee*. For purposes of this paragraph (b)(3), the minimum fee is:

(A) $250,000 for a transaction if the taxpayer is a corporation.

(B) $50,000 for all other transactions unless the taxpayer is a partnership or trust, all of the owners or beneficiaries of which are corporations (looking through any partners or beneficiaries that are themselves partnerships or trusts), in which case the minimum fee is $250,000.

(iv) *Determination of minimum fee*. For purposes of this paragraph (b)(3), a minimum fee includes all fees for a tax strategy or for services for advice (whether or not tax advice) or for the implementation of a transaction. These fees include consideration in whatever form paid, whether in cash or in kind, for services to analyze the transaction (whether or not related to the tax consequences of the transaction), for services to implement the transaction, for services to document the transaction, and for services to prepare tax returns to the extent that the fees exceed the fees customary for return preparation. For purposes of this paragraph (b)(3), a taxpayer also is treated as paying fees to an advisor if the taxpayer knows or should know that the amount it pays will be paid indirectly to the advisor, such as through a referral fee or fee-sharing arrangement. A fee does not include amounts paid to a person, including an advisor, in that person's capacity as a party to the transaction. For example, a fee does not include reasonable charges for the use of capital or the sale or use of property.

(v) *Related parties*. For purposes of this paragraph (b)(3), persons who bear a relationship to each other as described in section 267(b) or 707(b) will be treated as the same person.

* * * * *

(e) * * *

(1) * * * In addition, the disclosure statement for a reportable transaction must be attached to each amended return that reflects a taxpayer's participation in a reportable transaction. A copy of the disclosure statement must be sent to OTSA at the same time that any disclosure statement is first filed by the taxpayer. * * *

(2) * * *

(i) *Listed transactions*. If a transaction becomes a listed transaction after the filing of a taxpayer's tax return (including an amended return) reflecting either tax consequences or a tax strategy described in the published guidance listing the transaction (or a tax benefit derived from tax consequences or a tax strategy described in the published guidance listing the transaction) and before the end of the period of limitations for the final return (whether or not already filed) reflecting the tax consequences, tax strategy, or tax benefit, then a disclosure statement must be filed as an attachment to the taxpayer's tax return next filed after the date the transaction is listed regardless of whether the taxpayer participated in the transaction in that year.

* * * * *

(h) *Effective dates*. This section applies to Federal income tax returns filed after February 28, 2000. However, paragraphs (b)(3), (e)(1), and (e)(2)(i) of this section apply to transactions entered into on or after December 29, 2003. All the rules in this section may be relied upon for transactions entered into on or after January 1, 2003, and before December 29, 2003. Otherwise, the rules that apply with respect to transactions entered into before December 29, 2003, are contained in §1.6011–4 in effect prior to December 29, 2003, (see 26 CFR part 1 revised as of April 1, 2003).

PART 301—PROCEDURE AND ADMINISTRATION

Par. 3. The authority citation for part 301 continues to read in part as follows:

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

Par. 4. In §301.6112–1, paragraph (c)(3)(iii) is amended by revising the first sentence, removing the words "for advice or implementation" from the third sentence, and adding two sentences after the third sentence, to read as follows:

§301.6112–1 Requirement to prepare, maintain, and furnish lists with respect to potentially abusive tax shelters.

* * * * *

(c) * * *

(3) * * *

(iii) * * * In determining whether the minimum fee threshold is satisfied, all fees for a tax strategy or for services for advice (whether or not tax advice) or for the implementation of a transaction that is a potentially abusive tax shelter are taken into account. * * * A fee does not include amounts paid to a person, including an advisor, in that person's capacity as a party to the transaction. For example, a fee does not include reasonable charges for the use of capital or the sale or use of property. * * *

* * * * *

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

Approved December 18, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 29, 2003, 8:45 a.m., and published in the issue of the Federal Register for December 30, 2003, 68 F.R. 75128)

Section 6111.—Registration of Tax Shelters

26 CFR 301.6111–2: Confidential corporate tax shelters.

Whether transactions involving an S corporation ESOP and the ownership by a disqualified person of synthetic equity in a nonallocation year of the ESOP

is a listed transaction. See Rev. Rul. 2004-4, page 414.

Section 6112.—Organizers and Sellers of Potentially Abusive Tax Shelters Must Keep Lists of Investors

26 CFR 301.6112–1: Requirement to prepare, maintain and furnish lists with respect to potentially abusive tax shelters.

Whether a list must be maintained identifying each person who was sold an interest in transactions involving an S corporation ESOP and the ownership by a disqualified person of synthetic equity in a nonallocation year of the ESOP. See Rev. Rul. 2004-4, page 414.

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2004. See Rev. Rul. 2004-9, page 428.

Section 7872.—Treatment of Loans With Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2004. See Rev. Rul. 2004-9, page 428.

Part III. Administrative, Procedural, and Miscellaneous

Electronic Delivery of Form 1099 and Form 5498 Payee Statements

Notice 2004–10

I. Purpose and Scope

This notice provides guidance to sponsors or administrators of retirement plans or qualified tuition programs (QTPs), employers of simplified employee pensions (SEPs), or trustees, custodians, or issuers of traditional Individual Retirement Arrangements (IRAs), Roth IRAs, Coverdell education savings accounts (CESAs), or Archer Medical Savings Accounts (Archer MSAs) regarding the electronic delivery of payee statements to recipients. Specifically, this notice provides that a furnisher of a Form 1099 or a Form 5498 relating to the reporting of contributions and distributions of pensions, SEPs, traditional IRAs, Roth IRAs, QTPs, CESAs, and Archer MSAs may deliver electronically the payee statements required to be furnished to recipients for 2003 and subsequent years.

II. Background

Section 220(h) of the Internal Revenue Code provides that the Secretary may require the trustee of an Archer MSA to make such reports regarding the account to the Secretary and to the account holder with respect to contributions, distributions, and such other matters as the Secretary determines appropriate. The required reports must be filed at the time and in the manner and furnished to the individuals at the time and in the manner prescribed by the Secretary.

Section 408(i) provides that the trustee of an IRA and the issuer of an endowment contract described in § 408(b) or an individual retirement annuity must make such reports regarding the account, contract, or annuity to the Secretary and to the individuals for whom the account, contract, or annuity is, or is to be, maintained with respect to contributions (and the years to which they relate), distributions aggregating $10 or more in any calendar year, and such other matters as the Secretary may require. These reports must be filed at the time and in the manner the Secretary prescribes and must be furnished to individuals not later than January 31 of the calendar year following the calendar year to which the reports relate and in the manner prescribed by the Secretary.

Section 408(l) provides that an employer who makes contributions on behalf of employees to a SEP must provide reports with respect to such contributions as the Secretary may require. The required reports must be filed at the time and in the manner and furnished to employees at the time and in the manner prescribed by the Secretary.

Section 529(d) provides that each officer or employee having control of a § 529 QTP must make such reports regarding the program to the Secretary and to designated beneficiaries with respect to contributions, distributions, or such other matters as the Secretary may require. The required reports must be filed at the time and in the manner and furnished to the individuals at the time and in the manner prescribed by the Secretary.

Section 530(h) provides that the trustee of a CESA must make reports regarding the account to the Secretary and to the beneficiary of the account with respect to contributions, distributions, or such other matters as the Secretary may require. The required reports must be filed at the time and in the manner and furnished to the individuals at the time and in the manner prescribed by the Secretary.

Section 6047(d)(1) provides for the Secretary by forms or regulations to require the plan sponsor or administrator from which designated distributions may be made and the issuer of a contract under which designated distributions may be made to make returns and reports regarding the plan or contract to the Secretary and to participants and beneficiaries of the plan or contract and such other persons as the Secretary may by regulations prescribe. Section 6047(d)(2) provides that the reports must be in the form, be made at such time, and contain such information as the Secretary may prescribe by forms or regulations. Under § 3405(e)(1), a designated distribution generally includes any distribution or payment from or under a § 401 qualified plan, a § 403(b) tax-sheltered annuity, a § 457 governmental plan, an IRA, and a commercial annuity.

Section 401 of the Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107–147, 116 Stat. 21, 40 (2002), provides that any person required to furnish a statement under any section of subpart B of part III of subchapter A of chapter 61 of the Internal Revenue Code for any taxable year ending after the date of the enactment of the Act, may electronically furnish such statement (without regard to any first class mailing requirement) to any recipient who has consented to the electronic provision of the statement in a manner similar to the one permitted under the regulations issued under § 6051 of the Internal Revenue Code or in such other manner as provided by the Secretary. In accordance with this provision, part H of the 2003 General Instructions for Forms 1099, 1098, 5498, and W–2G, under the heading "Electronic recipient statements," provides that if a furnisher is required by sections 6041 through 6050T to furnish a written statement of an information return to a recipient, then the furnisher may provide the payee statement electronically instead of on paper if the requirements specified in the instructions are satisfied.

The Secretary also has the authority to permit the electronic furnishing of Forms 1099 and 5498 payee statements relating to pensions, SEPs, traditional IRAs, Roth IRAs, QTPs, CESAs, and Archer MSAs. However, the 2003 General Instructions for Forms 1099, 1098, 5498, and W–2G do not provide that payee statements for reporting contributions and distributions of pensions, traditional IRAs, Roth IRAs, and Archer MSAs may be furnished electronically.

III. Permitted Electronic Delivery of Payee Statements

This notice provides that, until further guidance is published, notwithstanding part H of the 2003 General Instructions for Forms 1099, 1098, 5498, and W–2G, a sponsor or administrator of a retirement plan or a QTP, an employer of a SEP, or a trustee, custodian, or issuer of an IRA, a Roth IRA, a CESA, or an Archer MSA may furnish the required Form 1099 or Form 5498 payee statements electroni-

cally to recipients if the furnisher satisfies the consent, format, posting, and notification requirements described in part H of the 2003 General Instructions for Forms 1099, 1098, 5498, and W–2G and furnishes such payee statements by their respective due dates.

This notice hereby modifies part H of the 2003 General Instructions for Forms 1099, 1098, 5498, and W–2G by permitting the electronic delivery of the Form 1099–R, Form 1099–MSA, Form 1099–Q, Form 5498, Form 5498–ESA, and Form 5498–MSA payee statements by their respective due dates.

IV. Effective Date

This notice is applicable with respect to Form 1099–R, Form 1099–MSA, Form 1099–Q, Form 5498, Form 5498–ESA, and Form 5498–MSA payee statements required to be furnished to recipients for 2003 and subsequent years.

V. Effect on Other Documents

The document entitled 2003 General Instructions for Forms 1099, 1098, 5498, and W–2G is hereby modified.

Drafting Information

The principal author of this notice is Pamela R. Kinard of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in its development. For further information regarding this notice, contact Pamela R. Kinard at (202) 622–6060 (not a toll-free number).

Recordkeeping Agreement Pilot Program Involving Credit for Increasing Research Activities

Notice 2004–11

SECTION 1. PURPOSE

This notice announces a pilot program that will permit the Internal Revenue Service (Service) and large and mid-size business taxpayers to enter into research credit recordkeeping agreements (RCRAs). If a taxpayer complies with the terms of a RCRA, then the Service will deem the taxpayer to have satisfied the recordkeeping requirements of section 6001 of the Internal Revenue Code (Code) for purposes of the credit for increasing research activities under section 41 (research credit). A RCRA does not relieve the taxpayer of its section 6001 recordkeeping obligations for purposes of any other provision of the Code.

The purposes of the pilot program are to develop and evaluate a procedure:

1. To resolve issues concerning the type and amount of documents that a taxpayer must maintain, retain, and produce to satisfy the recordkeeping requirements of section 6001 for the research credit; and

2. To reduce the costs, burdens, and delays frequently encountered by taxpayers and the Service in examinations involving the research credit.

SECTION 2. DESCRIPTION OF THE PILOT PROGRAM

The Large and Mid-Size Business Operating Division (LMSB) will administer the pilot program. The pilot program is available to LMSB taxpayers who have claimed the research credit on a timely filed original Form 1120, *"U.S. Corporation Income Tax Return,"* series return if the return is currently under examination. LMSB anticipates that it may select five to ten applicants for participation in the pilot program.

LMSB intends to establish a team to work with selected applicants to resolve the type and amount of documents that each of these taxpayers must maintain, retain, and produce with respect to the taxable years covered by the RCRA to satisfy the recordkeeping requirements of section 6001 for the research credit. Pilot program participants may be asked to evaluate the pilot program. The Service will evaluate the program and it may be extended, with modifications, on a permanent basis.

SECTION 3. DESCRIPTION OF A RCRA

The Service and a taxpayer will enter into a RCRA through a letter of understanding signed by the Industry Director. The letter of understanding will specify the type and amount of documents that the taxpayer must maintain, retain, and produce to be deemed to satisfy the recordkeeping requirements of section 6001 for the research credit.

A RCRA may cover up to three consecutive taxable years ending after the date of the RCRA's issuance. A RCRA will not cover the following businesses or taxpayers:

1. Any trade or business (or major portion of any trade or business) acquired by the taxpayer after the RCRA was issued;

2. Any corporation that joined the taxpayer's controlled group of corporations after the RCRA was issued, see I.R.C. § 41(f)(1)(A); and

3. Any trade or business (whether or not incorporated) that was not under common control with the taxpayer on the date the RCRA was issued, see I.R.C. § 41(f)(1)(B).

SECTION 4. REQUEST TO PARTICIPATE IN THE RCRA PILOT PROGRAM

.01 *Content of request*.

A taxpayer must submit a written request to participate in the pilot program to the Team Manager assigned to the examination. Taxpayers should submit the request on or before May 10, 2004. The request to participate in the RCRA pilot program must contain the following information:

1. The names, addresses, telephone numbers, and taxpayer identification numbers of all members of the taxpayer's controlled group of corporations and trades or businesses under common control with the taxpayer;

2. The name, title, address, and telephone number of a contact person and a properly executed Form 2848, *"Power of Attorney and Declaration of Representative,"* if the information contact is an authorized representative of the taxpayer;

3. The location of the person responsible for the taxpayer's tax matters;

4. The location of the taxpayer's research credit records;

5. A discussion of the taxpayer's suitability for the pilot program and any unique benefits that may result from a RCRA with the taxpayer;

6. A statement that the taxpayer agrees that interviews and the inspection of the taxpayer's books and records under the RCRA procedures (*see* Section 6): (1) do

not constitute an examination or an inspection of books of account for purposes of section 7605(b) or any administrative provisions adopted by the Service, and (2) will not preclude or impede a later examination of a return or inspection of records under section 7602 or any administrative provisions adopted by the Service for any taxable year.

7. A statement that the Service need not comply with any applicable procedural restrictions (including providing notice under section 7605(b)) before beginning an examination or inspection under RCRA procedures (*see* Section 6); and

8. A statement that the taxpayer is willing to participate in the pilot program and to evaluate the pilot program.

.02 *Signature*.

The taxpayer or the taxpayer's authorized representative must sign the request to participate in the RCRA pilot program. The request must include a copy of Form 2848 if the request is signed by an authorized representative.

.03 *No user fee*.

The Service will not charge a user fee for a RCRA request during the pilot program.

SECTION 5. RECOMMENDATION AND SELECTION PROCESS FOR PARTICIPATION IN THE RCRA PILOT PROGRAM

.01 *Team Manager's role*.

Team Managers will forward a copy of the taxpayer's written request to participate in the pilot program to:

1. The Industry Director for the LMSB industry group with jurisdiction over the taxpayer;

2. The Director, Pre-filing and Technical Guidance, for LMSB; and

3. The Director, Field Specialists, for LMSB.

.02 *Recommendation process*.

The Team Manager will recommend whether LMSB should accept the taxpayer to participate in the pilot program. The Team Manager will consider the following factors:

1. The taxpayer's cooperation with the Service in the past;

2. The resources needed for the Service to evaluate the taxpayer's records and recordkeeping systems; and

3. The potential benefits of a RCRA.

.03 *Selection process*.

The selection of a taxpayer for the pilot program is subject to the approval of the Industry Director and the concurrence of the Director, Pre-filing and Technical Guidance. In addition to the factors set forth in Section 5.02, the following factors will be considered in selecting taxpayers to participate in the pilot program:

1. The potential to provide a cross-section of industries; and

2. The probability of the parties completing a RCRA within a reasonable period of time.

.04 *Communication with the taxpayer*.

The Industry Director or Director, Field Operations, will contact the taxpayer within 14 days after receipt of the request to discuss the taxpayer's suitability for the pilot program. LMSB will notify the taxpayer in writing whether the taxpayer has been selected to participate in the pilot program. If LMSB does not select the taxpayer, the taxpayer has no right to appeal the decision.

SECTION 6. TERMS OF A RCRA

The LMSB team and the taxpayer will negotiate the terms of the RCRA. The LMSB team and the taxpayer will take into account the taxpayer's current recordkeeping systems, records created during research activities, and records used to track costs associated with research activities. A RCRA may require a taxpayer to create and retain records that it does not currently create and retain. The Service will enter into a RCRA only if it determines that the records to be maintained, retained, and produced under the RCRA satisfy the requirements of section 6001 for the research credit.

SECTION 7. APPROVAL OF A RCRA

The terms of the RCRA negotiated by the LMSB team and the taxpayer are subject to the approval of the Industry Director and the concurrence of the Director, Pre-filing and Technical Guidance, and the Director, Field Specialists. If the Industry Director approves the negotiated RCRA, the Industry Director will sign a letter of understanding evidencing the terms of the RCRA.

SECTION 8. EFFECT OF A RCRA

The taxpayer must maintain, retain, and produce records in accordance with the terms and conditions in the RCRA. The taxpayer's compliance with the RCRA establishes only that the taxpayer has satisfied the recordkeeping requirements of section 6001 for the research credit and does not establish that any amounts will be treated as qualified research expenses for purposes of section 41(b).

With respect to the taxable years covered by the RCRA, a RCRA does not limit the Service's ability to request non-recorded information during examinations through interviews and other information gathering methods. In addition, the Service during examinations may request non-recorded information, through interviews and other information gathering methods, as well as recorded information not identified in the RCRA, to verify the information contained in documents required under the RCRA if the Service has reason to question the information's accuracy or reliability.

A taxpayer may terminate the RCRA at any time. The Industry Director may terminate the RCRA if the Service determines that the taxpayer has not complied with the terms of the RCRA. The taxpayer may not appeal an Industry Director's decision to terminate a RCRA.

SECTION 9. EFFECTIVE DATE

The pilot program is effective on February 9, 2004.

SECTION 10. COMMENTS

The Service invites interested persons to comment on the pilot program. Interested persons should send comments to:

Internal Revenue Service
Attn: Large and Mid-Size Business
Division LM:Q
Mint Building, 3rd Floor, M–3–148
1111 Constitution Avenue, NW
Washington, D.C. 20224

SECTION 11. PAPERWORK REDUCTION ACT

The collection of information contained in this notice has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork

Reduction Act (44 U.S.C. 3507) under control number 1545–1859.

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

The collection of information in this notice is in Section 4. This information is required to submit a request to participate in the RCRA Pilot Program. This information will be used to enable the Service to determine whether the applicant is suitable for participation in the RCRA Pilot Program. The collection of information is voluntary to obtain a benefit. The likely respondents are businesses or other for profit institutions.

The estimated total annual reporting burden is 1,170 hours.

The estimated annual burden per respondent varies from 5 hours to 126 hours, depending on individual circumstances, with an estimated average of 18 hours. The estimated number of respondents is 65.

The estimated annual frequency of responses is on occasion.

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

SECTION 12. CONTACT INFORMATION

The principal author of this notice is Michael Hara of the Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division. Mr. Hara may be contacted at (202) 622–4910 (not a toll-free number).

For information regarding the RCRA Pilot Program, contact Hugh Whitledge, Engineer Technical Advisor, of the LMSB Pre-filing and Technical Guidance Office at (972) 308–7115 (not a toll-free number). Taxpayers interested in participating in the pilot program, or with questions about the pilot program, may also contact the Team Manager assigned to the examination of the taxpayer before submitting a request to participate in the pilot program.

Part IV. Items of General Interest

Notice of Proposed Rulemaking; Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations and Notice of Public Hearing

Changes in Computing Depreciation

REG–126459–03

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking; Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: In this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9105) under sections 446(e) and 1016(a)(2) of the Internal Revenue Code relating to a change in computing depreciation or amortization as well as a change from a nondepreciable or nonamortizable asset to a depreciable or amortizable asset (or vice versa). The text of those temporary regulations also serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by April 1, 2004. Outlines of topics to be discussed at the public hearing scheduled for April 7, 2004, at 10 a.m. must be received by March 17, 2004.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG–126459–03), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Alternatively, 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–126459–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the IRS Internet site at: *http://www.irs.gov/regs*.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Sara Logan or Douglas Kim, (202) 622–3110; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Sonya Cruse, (202) 622–4693 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Temporary regulations (T.D. 9105) in this issue of the Bulletin amend 26 CFR part 1 relating to sections 167, 446, and 1016 of the Internal Revenue Code (Code). The temporary regulations provide guidance under section 446(e) on whether a change in computing depreciation or amortization as well as a change from a nondepreciable or nonamortizable asset to a depreciable or amortizable asset (or vice versa) is a change in method of accounting that requires the consent of the Commissioner.

The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations and these proposed regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. 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 Public Hearing

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

A public hearing has been scheduled for April 7, 2004, beginning at 10:00 a.m. in the Auditorium, 7th Floor, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by March 17, 2004. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Sara Logan, Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 reads as follows:

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

Par. 2. Section 1.167(e)–1 is amended by revising paragraphs (a) and (e) to read as follows:

§1.167(e)–1 Change in method.

(a) [The text of the proposed amendment to §1.167(e)–1(a) is the same as the text of §1.167(e)–1T(a) published elsewhere in this issue of the Bulletin].

* * * * *

(e) *Effective date*. This section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see §1.167(e)–1 in effect prior to December 30, 2003 (§1.167(e)–1 as contained in 26 CFR part 1 edition revised as of April 1, 2003).

Par. 3. Section 1.446–1 is amended by revising paragraphs (e)(2)(ii)(*a*), (e)(2)(ii)(*b*), (e)(2)(ii)(*d*), (e)(2)(iii), and (e)(4) to read as follows:

§1.446–1 General rule for methods of accounting.

* * * * *

(e) * * *

(2) * * *

(ii)(*a*) and (*b*) [The text of the proposed amendment to §1.446–1(e)(2)(ii)(*a*) and (*b*) is the same as the text of §1.446–1T(e)(2)(ii)(*a*) and (*b*) published elsewhere in this issue of the Bulletin].

* * * * *

(*d*) [The text of this paragraph (e)(2)(ii)(*d*) is the same as the text of §1.446–1T(e)(2)(ii)(*d*) published elsewhere in this issue of the Bulletin].

(iii) [The text of the proposed amendment to §1.446–1(e)(2)(iii) is the same as the text of §1.446–1T(e)(2)(iii) published elsewhere in this issue of the Bulletin].

* * * * *

(4) *Effective date*—(i) *In general*. Except as provided in paragraphs (e)(3)(iii) and (e)(4)(ii) of this section, paragraph (e) of this section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see §1.446–1(e) in effect prior to December 30, 2003 (§1.446–1(e) as contained in 26 CFR part 1 edition revised as of April 1, 2003).

(ii) *Changes involving depreciable or amortizable assets*. With respect to paragraph (e)(2)(ii)(*d*) of this section, paragraph (e)(2)(iii) *Examples 9* through *17* of this section, the addition of the language "certain changes in computing depreciation or amortization (see paragraph (e)(2)(ii)(*d*) of this section)" to the last sentence of paragraph (e)(2)(ii)(*a*) of this section, and the removal of all language regarding useful life and the sentence "On the other hand, a correction to require depreciation in lieu of a deduction for the cost of a class of depreciable assets which had been consistently treated as an expense in the year of purchase involves the question of the proper timing of an item, and is to be treated as a change in method of accounting" from paragraph (e)(2)(ii)(*b*) of this section—

(A) For any change in depreciation or amortization that is a change in method of accounting, this section applies to such a change in method of accounting made for taxable years ending on or after December 30, 2003; and

(B) For any change in depreciation or amortization that is not a change in method of accounting, this section applies to such a change made for taxable years ending on or after December 30, 2003.

Par. 4. Section 1.1016–3 is amended by revising paragraphs (h) and (j) to read as follows:

§1.1016–3 Exhaustion, wear and tear, obsolescence, amortization, and depletion for periods since February 28, 1913.

* * * * *

(h) [The text of the proposed amendment to §1.1016–3(h) is the same as the text of §1.1016–3T(h) published elsewhere in this issue of the Bulletin].

* * * * *

(j) *Effective date*—(1) *In general*. Except as provided in paragraph (j)(2) of this section, this section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see §1.1016–3 in effect prior to December 30, 2003 (§1.1016–3 as contained in 26 CFR part 1 edition revised as of April 1, 2003).

(2) *Depreciation or amortization changes*. Paragraph (h) of this section applies to a change in depreciation or amortization for property subject to section 167, 168, 197, 1400I, 1400L(b), or 1400L(c), or former section 168 for taxable years ending on or after December 30, 2003.

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

(Filed by the Office of the Federal Register on December 30, 2003, 8:45 a.m., and published in the issue of the Federal Register for January 2, 2004, 69 F.R. 42)

Announcement of Disciplinary Actions Involving Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries — Suspensions, Censures, Disbarments, and Resignations

Announcement 2004-6

Under Title 31, Code of Federal Regulations, Part 10, attorneys, certified public accountants, enrolled agents, and enrolled actuaries may not accept assistance from, or assist, any person who is under disbarment or suspension from practice before the Internal Revenue Service if the assistance relates to a matter constituting practice before the Internal Revenue Service and may not knowingly aid or abet another person to practice before the Internal Revenue Service during a period of suspension, disbarment, or ineligibility of such other person.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify persons to whom these restrictions apply, the Director, Office of Professional Responsibility will announce in the Internal Revenue Bulletin their names, their city and state, their professional designation, the effective date of disciplinary action, and the period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks.

Disbarments From Practice Before the Internal Revenue Service After Notice and an Opportunity for a Proceeding

Under Title 31, Code of Federal Regulations, Part 10, after notice and an opportunity for a proceeding before an administrative law judge, the following individuals have been disbarred from practice before the Internal Revenue Service:

Name	Address	Designation	Effective Date
Baxley II, Milton	Gainesville, FL	CPA	October 24, 2003

Consent Suspensions From Practice Before the Internal Revenue Service

Under Title 31, Code of Federal Regulations, Part 10, an attorney, certified public accountant, enrolled agent, or enrolled actuary, in order to avoid institution or conclusion of a proceeding for his or her disbarment or suspension from practice before the Internal Revenue Service, may offer his or her consent to suspension from such practice. The Director, Office of Professional Responsibility, in his discretion, may suspend an attorney, certified public accountant, enrolled agent or enrolled actuary in accordance with the consent offered.

The following individuals have been placed under consent suspension from practice before the Internal Revenue Service:

Name	Address	Designation	Date of Suspension
Nietupski, John E.	Springfield, MA	Enrolled Agent	Indefinite from October 15, 2005
Roberts, Dennis C.	Oklahoma City, OK	Attorney	Indefinite from October 27, 2003

Name	Address	Designation	Date of Suspension
Waldo-Grant, Barbara A.	Grand Rapids, MI	Enrolled Agent	Indefinite from November 1, 2003
Naylor, Dale C.	El Cajon, CA	Enrolled Agent	Indefinite from November 12, 2003
Schlude, Richard M.	Wilkes Barre, PA	Enrolled Agent	Indefinite from November 19, 2003
Stern, Samuel L.	Robbinsdale, MN	Attorney	Indefinite from November 19, 2003
Robles, Michael	Dallas, TX	CPA	Indefinite from December 1, 2003
Young Jr., Donald A.	Redondo Beach, CA	Enrolled Agent	December 1, 2003 to August 31, 2004
Hitchcock, William C.	Irvine, CA	Enrolled Agent	Indefinite from December 30, 2003
Willms, Bryant E.	Lee Summit, MO	Enrolled Agent	January 1, 2004 to December 31, 2004

Expedited Suspensions From Practice Before the Internal Revenue Service

Under Title 31, Code of Federal Regulations, Part 10, the Director, Office of Professional Responsibility, is authorized to immediately suspend from practice before the Internal Revenue Service any practitioner who, within five years from the date the expedited proceeding is instituted (1) has had a license to practice as an attorney, certified public accountant, or actuary suspended or revoked for cause or (2) has been convicted of certain crimes.

The following individuals have been placed under suspension from practice before the Internal Revenue Service by virtue of the expedited proceeding provisions:

Name	Address	Designation	Date of Suspension
Greene, Marvin	Chicago, IL	CPA	Indefinite from October 21, 2003
Bolusky, Eric B.	Perkins, OK	Attorney	Indefinite from October 21, 2003
Crutchfield Jr., Ernest	Latty, OH	Enrolled Agent	Indefinite from October 21, 2003

Name	Address	Designation	Date of Suspension
Covey, Charles	Gladstone, MO	CPA	Indefinite from October 23, 2003
Prosperi, Arnold P.	Jupiter Island, FL	Attorney	Indefinite from November 24, 2003
Lucas, Christopher	Overland Park, KS	Attorney	Indefinite from November 24, 2003
Ramsey, Henry A.	Burnet, TX	CPA	Indefinite from December 15, 2003

Resignations of Enrolled Agents

Under Title 31, Code of Federal Regulations, Part 10, an enrolled agent, in order to avoid the institution or conclusion of a proceeding for his or her disbarment or suspension from practice before the Internal Revenue Service, may offer his or her resignation as an enrolled agent. The Director, Office of Professional Responsibility, in his discretion, may accept the offered resignation.

The Director, Office of Professional Responsibility, has accepted offers of resignation as an enrolled agent from the following individuals:

Name	Address	Date of Resignation
Pettyplace, Edward F.	Sacramento, CA	January 30, 2004

Correction of User Fee in Appendix A of Rev. Proc. 2004–1

Announcement 2004–8

Section (3)(b)(ii) of Appendix A of Rev. Proc. 2004–1, 2004–1 I.R.B. 1, 62 (January 5, 2004) incorrectly provides that the user fee is $1,500 for a letter ruling request involving an extension of time to file Form 3115, *"Application for Change in Accounting Method,"* under § 301.9100–3. The correct user fee is $1,200, not $1,500.

For further information regarding this announcement, contact George Bowden at (202) 622–3400 (not a toll-free call).

Credit for Increasing Research Activities

Announcement 2004–9

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: This document invites comments from the public regarding certain rules and standards relating to internal-use software under section 41(d)(4)(E) of the Internal Revenue Code (REG–153656–03). All materials submitted will be available for public inspection and copying. This document also addresses the effective date for final rules relating to internal-use software.

DATES: Comments are requested on or before March 2, 2004.

ADDRESSES: Send written comments to: Internal Revenue Service, Attn: CC:PA:LPD:PR [REG–153656–03], room 5203, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, taxpayers may submit comments in writing, by hand delivery to CC:PA:LPD:PR [REG–153656–03], Courier's Desk, Internal Revenue Service, 1111 Constitution Ave., NW, Washington, DC, or electronically, via the IRS Internet site at: *www.irs.gov/regs*.

FOR FURTHER INFORMATION CONTACT: Nicole R. Cimino at (202) 622–3120 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Introduction

On December 31, 2003, the Treasury Department and the IRS issued final regulations (T.D. 9104, 2004–6 I.R.B. 406) for the credit for increasing research activities under section 41 (research credit).

T.D. 9104 provides rules relating to the definition of *qualified research* under section 41(d) but does not finalize rules relating to internal-use software under section 41(d)(4)(E). This advance notice of proposed rulemaking (ANPRM) invites comments from the public regarding the proposed regulations issued in 2001 relating to internal-use software under section 41(d)(4)(E). Although the Treasury Department and the IRS welcome comments on all aspects of those proposed regulations, the Treasury Department and the IRS specifically request comments concerning the definition of internal-use software. In addition, the Treasury Department and the IRS request comments on whether final rules relating to internal-use software should have retroactive effect.

Background

Section 41(d)(4)(E) provides that, except to the extent provided by regulations, research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer (internal-use software) is excluded from the definition of qualified research under section 41(d). (Software that is developed for use in an activity which constitutes qualified research and software that is developed for use in a production process with respect to which the general credit eligibility requirements are satisfied are not excluded as internal-use software under the provisions of section 41(d)(4)(E).) The statutory exclusion for internal-use software and the regulatory exceptions to this exclusion have been the subject of a series of proposed and final regulations.

Legislative History

The legislative history to the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2085) (1986 Act), states that "the costs of developing software are not eligible for the credit where the software is used internally, for example, in general and administrative functions (such as payroll, bookkeeping, or personnel management) or in providing noncomputer services (such as accounting, consulting, or banking services) except to the extent permitted by Treasury regulations." See H.R. Conf. Rep. No. 841, at II–73 (1986 legislative history). The 1986 legislative history further states that Congress intended that regulations would make the costs of new or improved internal-use software eligible for the credit only if the research satisfies, in addition to the general requirements for credit eligibility, an additional, three-part high threshold of innovation test (*i.e.*, that the software was innovative, that the software development involved significant economic risk, and that the software was not commercially available for use by the taxpayer).

Congress has extended the research credit a number of times since the 1986 Act but has not made any changes to the statutory definition of qualified research or to the statutory exclusion for internal-use software in section 41(d)(4)(E). When Congress extended the research credit in the Tax Relief Extension Act of 1999, Public Law 106–170 (113 Stat. 1860) (1999 Act), however, the legislative history stated the following with respect to internal-use software:

> The conferees further note the rapid pace of technological advance, especially in service-related industries, and urge the Secretary to consider carefully the comments he has and may receive in promulgating regulations in connection with what constitutes "internal use" with regard to software expenditures. The conferees also wish to observe that software research, that otherwise satisfies the requirements of section 41, which is undertaken to support the provision of a service, should not be deemed "internal use" solely because the business component involves the provision of a service.

H.R. Conf. Rep. No. 106–478, at 132 (1999).

1997 Proposed Regulations

On January 2, 1997, the Treasury Department and the IRS published proposed regulations (REG–209494–90, 1997–1 C.B. 723 [62 FR 81]) in the **Federal Register** under section 41 relating to internal-use software (1997 proposed regulations). In relevant part, the 1997 proposed regulations stated:

> Research with respect to computer software that is developed by (or for the benefit of) the taxpayer primarily for the taxpayer's internal use is eligible for the research credit only if the software satisfies the requirements of paragraph (e)(2) of this section. Generally, research with respect to computer software is not eligible for the research credit where software is used internally, for example, in general and administrative functions (such as payroll, bookkeeping, or personnel management) or in providing noncomputer services (such as accounting, consulting, or banking services).

Prop. §1.41–4(e)(1) (1997).

The 1997 proposed regulations contained an exception to the internal-use software rules for certain software developed by the taxpayer as a part of a new or improved package of computer software and hardware developed together as a single product. Such software would not be subject to the high threshold of innovation requirements for internal-use software under the 1997 proposed regulations. The 1997 proposed regulations, however, did not contain a specific definition of internal-use software. Instead, the 1997 proposed regulations provided that the determination of whether software was internal-use software would depend on the facts and circumstances of each case:

> All relevant facts and circumstances are to be considered in determining if computer software is developed primarily for the taxpayer's internal use. If computer software is developed primarily for the taxpayer's internal use, the requirements of this paragraph (e) apply even though the taxpayer intends to, or subsequently does, sell, lease, or license the computer software.

Prop. §1.41–4(e)(4) (1997).

2001 Final Regulations (T.D. 8930)

On January 3, 2001, the Treasury Department and the IRS published in the **Federal Register** final regulations (T.D. 8930, 2001–1 C.B. 433 [66 FR 280]) relating, in relevant part, to the definition of internal-use software for purposes of section 41(d)(4)(E). With respect to the general definition of internal-use software, T.D. 8930 provided:

> Software is developed primarily for the taxpayer's internal use if the software is to be used internally, for example, in general administrative functions of the taxpayer (such as payroll, bookkeeping,

or personnel management) or in providing noncomputer services (such as accounting, consulting, or banking services). If computer software is developed primarily for the taxpayer's internal use, the requirements of this paragraph (c)(6) apply even though the taxpayer intends to, or subsequently does, sell, lease, or license the computer software.

§1.41–4(c)(6)(iv). T.D. 8930, therefore, did not provide a specific definition of internal-use software but instead identified two general categories of software as examples of internal-use software: software "used internally" and software used "in providing noncomputer services." T.D. 8930 eliminated the general facts and circumstances standard contained in the 1997 proposed regulations.

The preamble to T.D. 8930 addressed the requests made by some commentators that the definition of internal-use software exclude software used to deliver a service to customers and software that includes an interface with customers or the public. The preamble stated that after careful analysis of the legislative history, the Treasury Department and the IRS had concluded that such broad exclusions would be inconsistent with the statutory mandate, because the exclusion would extend to some software that Congress clearly intended to treat as internal-use software. The preamble, however, continued by highlighting changes that had been made in T.D. 8930 to take into account the commentators' concerns as well as the legislative history to the 1999 Act.

First, T.D. 8930 provided that the high threshold of innovation test applicable to internal-use software does not apply to software used to provide computer services (defined in T.D. 8930 generally as a service offered by a taxpayer to customers who conduct business with the taxpayer primarily for the use of the taxpayer's computer or software technology). In contrast, software used to provide a noncomputer service (defined in T.D. 8930 generally as a service other than a computer service, even if such other service is enabled, supported, or facilitated by computer or software technology) would be subject to the high threshold of innovation test under T.D. 8930.

Second, T.D. 8930 contained a new exception to the high threshold of innovation test for internal-use software for software used to provide a noncomputer service if the software, among other things, contained features or improvements not yet offered by a taxpayer's competitors. In describing this exception, the preamble to T.D. 8930 stated:

> This exercise of regulatory authority [to create the exception for certain software used to provide non-computer services] is based on a determination that the development of software containing features or improvements that are not available from a taxpayer's competitors and that provide a demonstrable competitive advantage is more likely to increase the innovative qualities and efficiency of the U.S. economy (by generating knowledge that can be used by other service providers) than is the development of software used to provide noncomputer services containing features or improvements that are already offered by others. IRS and Treasury believe that drawing such a line is an appropriate way to administer the credit with a view to identifying and facilitating the credit availability for software with the greatest potential for benefiting the U.S. economy, an important rationale for the research credit.

In response to taxpayer concerns, on January 31, 2001, the Treasury Department and the IRS published Notice 2001–19, 2001–1 C.B. 784, announcing that the Treasury Department and the IRS would review T.D. 8930 and reconsider comments previously submitted in connection with the finalization of T.D. 8930.

2001 Proposed Regulations

On December 26, 2001, the Treasury Department and the IRS published in the **Federal Register** a notice of proposed rulemaking (REG–112991–01, 2002–1 C.B. 404 [66 FR 66362]) reflecting their review of T.D. 8930 (2001 proposed regulations). The 2001 proposed regulations revised the definition of internal-use software as compared to the definitions contained in the 1997 proposed regulations and T.D. 8930. The definition in the 2001 proposed regulations was based on a presumption that turns on whether the software is developed to be commercially sold, leased, licensed, or otherwise marketed for separately stated consideration:

> *Unless computer software is developed to be commercially sold, leased, licensed, or otherwise marketed, for separately stated consideration to unrelated third parties*, computer software is presumed developed by (or for the benefit of) the taxpayer primarily for the taxpayer's internal use. For example, the computer software may serve general and administrative functions of the taxpayer, or may be used in providing a noncomputer service. General and administrative functions include, but are not limited to, functions such as payroll, bookkeeping, financial management, financial reporting, personnel management, sales and marketing, fixed asset accounting, inventory management and cost accounting. Computer software that is developed to be commercially sold, leased, licensed, or otherwise marketed, for separately stated consideration to unrelated third parties is not developed primarily for the taxpayer's internal use. The requirements of this paragraph (c)(6) apply to computer software that is developed primarily for the taxpayer's internal use even though the taxpayer subsequently sells, leases, licenses, or otherwise markets the computer software for separately stated consideration to unrelated third parties.

Prop. §1.41–4(c)(6)(iv) (2001) (emphasis added).

As explained in the preamble to the 2001 proposed regulations, this "separately stated consideration" standard reflected the Treasury Department and the IRS' determination that software that is sold, leased, licensed, or otherwise marketed, for separately stated consideration to unrelated third parties is software that is intended to be used primarily by the customers of the taxpayer, whereas software that does not satisfy this requirement is software that is intended to be used primarily by the taxpayer for its internal use or in connection with a noncomputer service provided by the taxpayer. The 2001 proposed regulations modified the hardware-software exception and continued to provide that software used to provide computer services was not required to satisfy the additional qualification requirements imposed on internal-use software. The new proposed regulations, however, eliminated the special rule in T.D. 8930 for

certain software used to provide noncomputer services. The preamble to the 2001 proposed regulations explained that "[d]ue to other revisions contained in these proposed regulations, Treasury and the IRS believe that the computer software targeted by this rule generally would be credit eligible without this rule."

The preamble to the 2001 proposed regulations also addressed the continued concerns expressed by some commentators that the definition of internal-use software should not include software used to deliver a service to customers and software that includes an interface with customers or the public. In addition to repeating the Treasury Department and IRS' concern that such exclusions may conflict with Congress' intent regarding software used in the provision of noncomputer services, the preamble stated that an exclusion for software that includes an interface with customers or the public would entail substantial administrative difficulties and "may inappropriately permit certain categories of costs (*e.g.*, certain web site development costs) to constitute qualified research expenses without having to satisfy the high threshold of innovation test."

Discussion

Prior regulatory guidance generally reflects three approaches to the definition of internal-use software. First, the 1997 proposed regulations closely mirrored the language contained in the legislative history but did not provide a specific definition of internal-use. Instead, the 1997 proposed regulations used the "general and administrative functions" and "noncomputer services" language from the legislative history as examples of internal-use software and provided that the determination of whether particular software was internal-use software required an evaluation of "all relevant facts and circumstances."

T. D. 8930 then attempted to provide greater specificity regarding the definition of internal-use software. Although T.D. 8930 eliminated the facts and circumstances test in the 1997 proposed regulations, T.D. 8930 continued to provide a general definition of internal-use software that incorporated the legislative history's examples of general and administrative functions and non-computer services. Additionally, T.D. 8930 provided that software used by the taxpayer to provide "computer services" was not subject to the high threshold of innovation test applicable to internal-use software, and provided definitions of *computer services* and *noncomputer services*. The exception for computer services software, however, required a determination of the primary reason why a taxpayer's customers conduct business with the taxpayer. T.D. 8930 also applied this exception to certain software used to provide "noncomputer services" provided that the software satisfied additional requirements intended to identify software containing new features or improvements that provide a competitive advantage to the taxpayer.

Finally, the 2001 proposed regulations prescribed a bright-line, separately-stated consideration rule for determining which software is treated as internal-use software for purposes of the research credit. (The 2001 proposed regulations retained the exception for software used to provide computer services, but removed the special rule for noncomputer services. Additionally, the 2001 proposed regulations expanded upon the list of general and administrative functions contained in the legislative history and expanded the exception for integrated software-hardware products.) The purpose of this rule was to provide a clear definition of internal-use software that could be readily applied by taxpayers and more readily administered by the IRS.

Numerous comments were received in response to the 1997 proposed regulations, T.D. 8930 and Notice 2001–19, and the 2001 proposed regulations regarding the provisions relating to internal-use software. Although commentators addressed virtually all aspects of the internal-use software provisions in the various iterations of regulations, most of the comments focused on the definition of internal-use software. As previously stated, many commentators believed that the definition of internal-use software should exclude any software used to deliver a service to customers and any software that includes an interface with customers or the public. Some commentators suggested, as an alternative, that the statutory production process exception be extended to software used in connection with the provision of services.

With respect to the definition of internal-use software in the 2001 proposed regulations, commentators stated that the separately-stated consideration test was a poor indication of when computer software was developed "primarily for internal use by the taxpayer" and directly conflicted with the legislative history to the 1999 Act. In support of a narrower definition of internal-use software, these commentators pointed to technological advancements and changes to the role of computer software in business activities since the exclusion for internal-use software was enacted in 1986, including the increased development of computer software by taxpayers, the increased use of computer software in all aspects of business activity, and the role of computer software (often integrated across a business) in providing goods and services in addition to the internal operations of a business. Commentators further argued that the definition should be based on the underlying functionality of the software (*i.e.*, whether the software, in light of the facts and circumstances, is used to deliver services or goods to a taxpayer's customers). Commentators urged that a functionality rule is preferable to a bright-line rule (such as the separately-stated consideration rule in T.D. 8930) even though a bright-line rule provided a clearer rule for identifying internal-use software for purposes of the research credit.

The Treasury Department and the IRS are continuing to consider the concerns raised by commentators in response to the definition of internal-use software contained in the 2001 proposed regulations, including the concern that the separately-stated consideration test is over-inclusive. Nevertheless, the Treasury Department and the IRS are concerned that the alternatives, including expanded or modified exceptions, proposed by commentators generally would make the definition of internal-use software more complex without providing additional clarity. Several commentators suggested similar definitions that would exclude software that, for example, is "integral and essential" to the provision of services with integral defined as software that directly "enables, supports, or facilitates" a service. Some commentators suggested a definition that would exclude software that is "primarily used" by cus-

tomers, suppliers, or other third parties. Other commentators suggested a definition that would limit internal-use software to software that is developed primarily for use in general and administrative functions that enable, facilitate, or support the taxpayer's conduct of the taxpayer's trade or business, but would exclude certain customer interface software. These suggestions would introduce many terms (including *enable*, *support*, *facilitate*, *primarily*) that, due to their subjective nature, the Treasury Department and the IRS believe would be prone to controversy and could not be readily applied by taxpayers or administered by the IRS. Another commentator suggested limiting the definition of internal-use software to software used to perform a specifically enumerated list of general and administrative functions. Some commentators, however, have noted that the often highly integrated nature of software development today makes it difficult, if not impossible, to divide software development projects into separate components, and thus a list approach may not be administrable. Finally, as part of their review of these comments, the Treasury Department and the IRS also reviewed the possibility of using definitions of internal-use software contained in prior guidance.

In light of the statute, the legislative history, the history of the regulations regarding internal-use software, and the comments received, the Treasury Department and the IRS have decided not to finalize in T.D. 9104 the provisions in the 2001 proposed regulations relating to internal-use software. Instead, the Treasury Department and the IRS are issuing this ANPRM to solicit further comments regarding the definition of internal-use software as well as other provisions affecting the qualification of internal-use software for the research credit. The Treasury Department and the IRS are mindful that Congress specifically intended that computer software "developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer" be subject to additional requirements before the software could qualify for the research credit. At the same time, the Treasury Department and the IRS recognize that there have been changes in computer software, and its role in business activity, since the mid-1980s. In light of these changes, the Treasury Department and the IRS are concerned about the difficulty of effecting Congressional intent behind the exclusion for internal-use software with respect to computer software being developed today. Despite Congress' broad grant of regulatory authority in section 41(d)(4)(E), the Treasury Department and the IRS believe that this authority may not be broad enough to resolve those difficulties.

Accordingly, the Treasury Department and the IRS request comments regarding a definition of internal-use software that appropriately reflects the statute and legislative history, can be readily applied by taxpayers and readily administered by the IRS, and is flexible enough to provide continuing application into the future. In submitting comments, commentators are invited to address any of the definitions included in prior guidance as well as other definitions that have been proposed to the Treasury Department and the IRS by commentators.

In addressing these alternatives, commentators also are invited to discuss how software development efforts that encompass both internal-use software and non-internal use software should be addressed under any particular definition. The Treasury Department and the IRS are concerned that the tendency toward the integration of software across many functions of a taxpayer's business activities may make it difficult for both taxpayers and the IRS to separate internal-use software from non-internal use software (or software not subject to additional qualification requirements) under any particular definition of internal-use software. In addition, the Treasury Department and the IRS are concerned that a definition of internal-use software that relies upon the "primary" or "principal" use of that software would be difficult to apply and administer. The Treasury Department and the IRS' continuing goal is that any final rule must provide clear, objective guidance on what software is treated as internal-use software for purposes of the research credit.

Effective Dates

On December 31, 2003, the Treasury Department and the IRS issued final regulations (T.D. 9104) relating to the definition of qualified research under section 41(d). The final regulations apply to taxable years ending on or after December 31, 2003. The final regulations do not contain final rules for research with respect to computer software "which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer" for purposes of section 41(d)(4)(E) (*i.e.*, internal-use software).

The Treasury Department and the IRS have announced in prior guidance, including Notice 87–12, 1987–1 C.B. 432, and more recently in the 2001 proposed regulations, that final regulations relating to internal-use software generally will be effective for taxable years beginning after December 31, 1985. In light of the length of time that has passed since 1986, as well as the developments with respect to computer software discussed in this ANPRM, the Treasury Department and the IRS request comments on whether final regulations relating to internal-use software should have any retroactive effect.

With respect to internal-use software for taxable years beginning after December 31, 1985, and until further guidance is published in the **Federal Register**, taxpayers may continue to rely upon all of the provisions relating to internal-use software in the 2001 proposed regulations (66 FR 66362). Alternatively, taxpayers may continue to rely upon all of the provisions relating to internal-use software in T.D. 8930 (66 FR 280). For example, taxpayers relying upon the internal-use software rules of T.D. 8930 must also apply the "discovery test" as set forth in T.D. 8930.

Request for Public Comment

The Treasury Department and the IRS invite interested persons to submit comments (in the manner described in the ADDRESSES caption) on issues arising under the provisions for internal-use software. The Treasury Department and the IRS invite comments that address any of the definitions included in prior guidance as well as other definitions that have been proposed to the Treasury Department and the IRS by commentators. Specifically, the Treasury Department and the IRS invite comments that provide a definition of internal-use software that—

1. Appropriately reflects the statute and legislative history;

2. Can be readily applied by taxpayers and readily administered by the IRS; and

3. Is flexible enough to provide continuing application in the future.

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

(Filed by the Office of the Federal Register on December 31, 2003, 8:45 a.m., and published in the issue of the Federal Register for January 2, 2004, 69 F.R. 43)

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.

Numerical Finding List[1]

Bulletins 2004–1 through 2004–6

Announcements:

2004-1, 2004-1 I.R.B. *254*
2004-2, 2004-3 I.R.B. *322*
2004-3, 2004-2 I.R.B. *294*
2004-4, 2004-4 I.R.B. *357*
2004-5, 2004-4 I.R.B. *362*
2004-6, 2004-3 I.R.B. *322*
2004-7, 2004-4 I.R.B. *365*
2004-8, 2004-6 I.R.B. *441*
2004-9, 2004-6 I.R.B. *441*

Notices:

2004-1, 2004-2 I.R.B. *268*
2004-2, 2004-2 I.R.B. *269*
2004-3, 2004-5 I.R.B. *391*
2004-4, 2004-2 I.R.B. *273*
2004-6, 2004-3 I.R.B. *308*
2004-7, 2004-3 I.R.B. *310*
2004-8, 2004-4 I.R.B. *333*
2004-9, 2004-4 I.R.B. *334*
2004-10, 2004-6 I.R.B. *433*
2004-11, 2004-6 I.R.B. *434*

Proposed Regulations:

REG-116664-01, 2004-3 I.R.B. *319*
REG-122379-02, 2004-5 I.R.B. *392*
REG-139845-02, 2004-5 I.R.B. *397*
REG-126459-03, 2004-6 I.R.B. *437*
REG-156232-03, 2004-5 I.R.B. *399*

Revenue Procedures:

2004-1, 2004-1 I.R.B. *1*
2004-2, 2004-1 I.R.B. *83*
2004-3, 2004-1 I.R.B. *114*
2004-4, 2004-1 I.R.B. *125*
2004-5, 2004-1 I.R.B. *167*
2004-6, 2004-1 I.R.B. *197*
2004-7, 2004-1 I.R.B. *237*
2004-8, 2004-1 I.R.B. *240*
2004-9, 2004-2 I.R.B. *275*
2004-10, 2004-2 I.R.B. *288*
2004-11, 2004-3 I.R.B. *311*
2004-13, 2004-4 I.R.B. *335*

Revenue Rulings:

2004-1, 2004-4 I.R.B. *325*
2004-2, 2004-2 I.R.B. *265*
2004-4, 2004-6 I.R.B. *414*
2004-5, 2004-3 I.R.B. *295*
2004-6, 2004-4 I.R.B. *328*
2004-7, 2004-4 I.R.B. *327*
2004-9, 2004-6 I.R.B. *428*

Treasury Decisions:

9099, 2004-2 I.R.B. *255*
9100, 2004-3 I.R.B. *297*
9101, 2004-5 I.R.B. *376*
9102, 2004-5 I.R.B. *366*
9103, 2004-3 I.R.B. *306*
9104, 2004-6 I.R.B. *406*
9105, 2004-6 I.R.B. *419*
9106, 2004-5 I.R.B. *384*
9108, 2004-6 I.R.B. *429*

[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2003–27 through 2003–52 is in Internal Revenue Bulletin 2003–52, dated December 29, 2003.

Findings List of Current Actions on Previously Published Items[1]

Bulletins 2004–1 through 2004–6

Proposed Regulations:

REG-115037-00
Corrected by
Ann. 2004-7, 2004-4 I.R.B. *365*

REG-143321-02
Withdrawn by
REG-156232-03, 2004-5 I.R.B. *399*

REG-146893-02
Corrected by
Ann. 2004-7, 2004-4 I.R.B. *365*

Revenue Procedures:

2000-38
Modified by
Rev. Proc. 2004-11, 2004-3 I.R.B. *311*

2000-50
Modified by
Rev. Proc. 2004-11, 2004-3 I.R.B. *311*

2002-9
Modified by
Rev. Proc. 2004-11, 2004-3 I.R.B. *311*

2002-71
Superseded by
Rev. Proc. 2004-13, 2004-4 I.R.B. *335*

2003-1
Superseded by
Rev. Proc. 2004-1, 2004-1 I.R.B. *1*

2003-2
Superseded by
Rev. Proc. 2004-2, 2004-1 I.R.B. *83*

2003-3
As amplified by Rev. Proc. 2003-14, and as modified by Rev. Proc. 2003-48 superseded by
Rev. Proc. 2004-3, 2004-1 I.R.B. *114*

2003-4
Superseded by
Rev. Proc. 2004-4, 2004-1 I.R.B. *125*

2003-5
Superseded by
Rev. Proc. 2004-5, 2004-1 I.R.B. *167*

2003-6
Superseded by
Rev. Proc. 2004-6, 2004-1 I.R.B. *197*

2003-7
Superseded by
Rev. Proc. 2004-7, 2004-1 I.R.B. *237*

Revenue Procedures— Continued:

2003-8
Superseded by
Rev. Proc. 2004-8, 2004-1 I.R.B. *240*

2004-1
Corrected by
Ann. 2004-8, 2004-6 I.R.B. *441*

[1] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2003–27 through 2003–52 is in Internal Revenue Bulletin 2003–52, dated December 29, 2003.

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