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

Insurance companies; interest rate tables. Prevailing state assumed interest rates are provided for the determination of reserves under section 807 of the Code for contracts issued in 2003 and 2004. Rev. Rul. 92–19 supplemented in part.

Short sale; broker; transfer. This ruling provides guidance on whether the delivery of shares made to a broker in transferring a short sale position from one broker to another broker will (1) cause a short sale to be deemed consummated under regulations section 1.1233–1(a), and (2) cause a short-against-the-box transaction to cease to be covered by the transition rule of section 1259 of the Code.

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

Treatment of environmental remediation expenses under section 1341. This ruling holds that amounts paid or incurred in the current taxable year to remediate environmental contamination that occurred in prior taxable years do not qualify for treatment under section 1341 of the Code.

Treatment of environmental remediation expenses under section 263A. This ruling holds that amounts incurred to clean up land that a taxpayer contaminated with hazardous waste by the operation of a manufacturing plant must be included in inventory costs under section 263A of the Code. Rev. Ruls. 94–38 and 98–25 clarified. Rev. Proc. 2002–9 modified and amplified.

LIFO; price indexes; department stores. The December 2003 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, December 31, 2003.

T.D. 9110, page 504.
Final regulations under section 42 of the Code amend current regulations that affect the order in which credits are allocated from the state housing credit ceiling under section 42(h)(3)(C) and the time for meeting the 10-percent basis requirement under sections 42(h)(1)(E) and (F). These regulations also amend current regulations under section 42 to facilitate the electronic filing of income tax returns.

(Continued on the next page)
T.D. 9109, page 519.
Final regulations under sections 6662 and 6664 of the Code limit the defenses available to the imposition of the accuracy-related penalty when taxpayers fail to disclose reportable transactions or fail to disclose they have taken a position based upon a regulation being invalid. The regulations also clarify the existing regulations with respect to the facts and circumstances that the IRS will consider in determining whether a taxpayer acted with reasonable cause and in good faith in relying on an opinion or advice. The regulations provide that failure to disclose a reportable transaction strongly indicates that the taxpayer did not act in good faith.

T.D. 9111, page 518.
Final regulations under section 6103 of the Code relate to the definition of agent for certain purposes. The regulations clarify that the term agent in certain provisions of section 6103 includes contractors.
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 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."

*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 42.—Low-Income Housing Credit

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

Rev. Rul. 2004–16

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

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

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

<table>
<thead>
<tr>
<th></th>
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</table>


DRAFTING INFORMATION

The principal author of this revenue ruling is Gregory N. Doran of the Office of Associate Chief Counsel (Passthroughs 2004-8 I.R.B. 503 February 23, 2004
DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Section 42 Carryover and Stacking Rule Amendments

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that amend several existing regulations concerning the low-income housing tax credit. The regulations primarily reflect changes to the law made by the Community Renewal Tax Relief Act of 2000 and affect owners of low-income housing projects who claim the credit and the State or local housing credit agencies who administer the credit.

DATES: Effective Date: These regulations are effective January 6, 2004.

Applicability Dates: For dates of applicability of these regulations, see §§1.42–12(a)(2) and (3), and 1.42–14(i)(2).

FOR FURTHER INFORMATION CONTACT: Lauren R. Taylor (202) 622–3040 or Christopher J. Wilson (808) 539–2874 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

On July 7, 2003, the IRS published a notice of proposed rulemaking in the Federal Register (REG–131997–02, 2003–33 I.R.B. 366 [68 FR 40218]) proposing amendments to the Income Tax Regulations (26 CFR part 1) under section 42 of the Internal Revenue Code. These amendments provide guidance regarding changes to section 42 made by the Community Renewal Tax Relief Act of 2000 (Public Law 106–554) (2000 Act) and make certain changes to the regulations to help facilitate the electronic filing (E-filing) of income tax returns.

One commentator submitted written comments in response to the notice of proposed rulemaking. A public hearing was scheduled for September 23, 2003, pursuant to a notice of public hearing published simultaneously with the notice of proposed rulemaking. The IRS received one request to speak at the public hearing. This request was withdrawn before the hearing date. On September 15, 2003, the IRS published a notice (68 FR 53926) canceling the public hearing on the proposed regulations. After consideration of the comments received, the proposed regulations are adopted as revised by this Treasury decision. The revisions are discussed below.

Explanation of Provisions

Section 42 provides for a low-income housing tax credit that may be claimed as part of the general business credit under section 38. In general, the credit is allowable only if the owner of a qualified low-income building receives a housing credit allocation from a State or local housing credit agency (Agency) of the jurisdiction where the building is located.

In general, an allocation must be made not later than the close of the calendar year in which the building is placed in service. Under section 42(h)(1)(E), an allocation (carryover allocation) may be made to a “qualified building” that has not yet been placed in service, provided the building is placed in service not later than the close of the second calendar year following the calendar year of the allocation. Section 42(h)(1)(F) provides rules for multi-building projects receiving project-based carryover allocations. Following the changes made by the 2000 Act, section 42(h)(1)(E)(ii) defines a qualified building as any building that is part of a project if the taxpayer’s basis in the project (as of the close of the second calendar year following the calendar year of the allocation).

The commentator recommended revising §1.42–6(a)(2) of the proposed regulations to clarify that each building in a multi-building project receiving a project-based carryover allocation under section 42(h)(1)(F) need not separately meet the 10 percent basis requirement. The commentator states that the proposed regulations appear to require that each building in a multi-building project that receives a project-based carryover allocation must meet the 10 percent basis requirement separately. The proposed regulations do not require that each building in a multi-building project satisfy the 10 percent basis requirement separately for project-based carryover allocations made under section 42(h)(1)(F). For allocations made under section 42(h)(1)(F), the 10 percent basis requirement is only required to be met on a project basis. The final regulations clarify this issue.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a new collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. The collection of information contained in this Treasury decision has been previously 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 1545–1102. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking that preceded this Treasury decision was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Christopher J. Wilson and Lauren R. Taylor, Office of the Associate Chief
A carryover allocation may only be made with respect to a qualified building. A qualified building is any building which is part of a project if, by the date specified under paragraph (a)(2)(i) or (ii) of this section, a taxpayer’s basis in the project is more than 10 percent of the taxpayer’s reasonably expected basis in the project as of the close of the second calendar year following the calendar year the allocation is made. For purposes of meeting the 10 percent basis requirement, the determination of whether a building is part of a single-building project or multi-building project is based on whether the carryover allocation is made after June 30. A carryover allocation is treated as made before the close of the second calendar year following the calendar year the allocation is made. If a taxpayer does not meet the 10 percent basis requirement by the close of the calendar year of the allocation, the carryover allocation is treated as a valid allocation for the calendar year of allocation, but is included in the “returned credit component” for purposes of determining the State housing credit ceiling under section 42(h)(3)(C) for the calendar year following the calendar year of the allocation. See §1.42–14(d)(1).

Example 2. (i) Facts. D, an accrual-method taxpayer, received a carryover allocation from Agency, the state housing credit agency of State X, on September 12, 2003. As of that date, D has not begun construction of the low-income housing building D plans to build and D does not have basis in the land on which D plans to build the building. From September 12, 2003, to the close of March 12, 2004, D incurs some costs related to the planned building, including architects’ fees. As of the close of March 12, 2004, these costs do not exceed 10 percent of D’s reasonably expected basis in the single-building project as of the close of 2003.

(ii) Determination of whether building is qualified. Because D’s carryover-allocation basis as of the close of March 12, 2004, is not more than 10 percent of D’s reasonably expected basis in the single-building project, the building is not a qualified building for purposes of section 42(h)(1)(E)(ii) and paragraph (a) of this section. Accordingly, the carryover allocation to D must be returned to the Agency. The allocation is valid for purposes of determining the amount of credit allocated by Agency from State X’s 2003 State housing credit ceiling, but is included in the returned credit component of State X’s 2004 housing credit ceiling.

(c) Verification of basis by Agency—(1) Verification requirement. An Agency that makes a carryover allocation to a taxpayer must verify that the taxpayer has met the 10 percent basis requirement of paragraph (a)(2) of this section. (2) * * *

(3) Time of verification—(i) Allocations made after June 30. A carryover allocation made after June 30 is valid if the taxpayer meets the 10 percent basis requirement by the close of the calendar year following the allocation. If a taxpayer does not meet the 10 percent basis requirement by the close of the required date, the Agency will need to verify the basis certification provided in paragraph (c)(2) of this section to accurately complete the Form 8610, “Annual Low-Income Housing Credit Agencies Report,” and the Schedule A (Form 8610), “Carryover Allocation of Low-Income Housing Credit,” for the calendar year of the allocation.
taxpayer and try to get adequate documentation. If the Agency cannot verify before the Form 8610 is filed that the taxpayer has satisfied the 10 percent basis requirement for a carryover allocation made before July 1, the allocation is not valid and is treated as if it had not been made and the carryover allocation should not be reported on the Schedule A (Form 8610).

(ii) Allocations made after June 30. An Agency may require that the basis certification be submitted to or received by the Agency prior to the close of the date that is 6 months after the date the allocation was made or within a reasonable period of time following the close of the date that is 6 months after the date the allocation was made. The Agency will need to verify basis as provided in paragraph (c)(2) of this section. If the basis certification is not timely made, or supporting documentation is lacking, inadequate, or does not actually support the certification, the Agency should notify the taxpayer and try to get adequate documentation. If the Agency cannot verify that the taxpayer has satisfied the 10 percent basis requirement for a carryover allocation made after June 30, the allocation must be returned to the Agency. The carryover allocation is a valid component of the State housing credit ceiling for the calendar year of the allocation.

(viii) For carryover allocations made before July 1, the taxpayer’s basis in the project (land and depreciable basis) as of the close of the calendar year of the allocation and the percentage that basis bears to the reasonably expected basis in the project (land and depreciable basis) as of the close of the second calendar year following the calendar year of the allocation;

4. Recordkeeping requirements—(i) Taxpayer. When an allocation is made pursuant to section 42(h)(1)(E) or (F), the taxpayer must retain a copy of the allocation document. The Form 8609 that reflects the allocation must be filed for the first taxable year that the credit is claimed and for each taxable year thereafter throughout the compliance period, whether or not a credit is claimed for the taxable year.

Par. 3. Section 1.42–8 is amended by:

1. Revising the second sentence of paragraph (a)(6)(i), paragraph (a)(6)(ii), the sixth sentence of paragraph (a)(7) Example 1, (ii), paragraphs (a)(7) Example 1, (iv), (a)(7) Example 2 (iv) and (b)(4)(ii).

2. Removing the year “1993” each place it appears in paragraph (a)(7), Example 1 and Example 2 and adding the year “2003” in its place; removing the year “1994” each place it appears in paragraph (a)(7) and adding the year “2004” in its place.

3. Removing the second sentence of paragraph (a)(7) Example 1, (iii), the third sentence of paragraph (a)(7) Example 2 (iii) and the third sentence of paragraph (b)(4)(i).

The revisions read as follows:

§1.42–8 Election of appropriate percentage month.

(a) * * *

(6) Procedures—(i) Taxpayer. * * * The taxpayer must retain a copy of the binding agreement and the election statement.

(ii) Agency. The Agency must retain the original of the binding agreement and election statement and, to the extent required by Schedule A (Form 8610), “Carryover Allocation of Low-Income Housing Credit,” account for the binding agreement and election statement on that schedule.

Example 1. * * *

(ii) * * * Because allocations were made for the building in two separate calendar years, Agency must issue two Forms 8609, “Low-Income Housing Credit Allocation Certification,” to X. * * *

Example 2. * * *

(iv) Agency retains the original of the binding agreement, election statement, and 2003 carryover allocation document. Agency accounts for the binding agreement, election statement, and 2003 carryover allocation on the Schedule A (Form 8610) that it files for the 2003 calendar year. After the building is placed in service in 2004, and assuming other necessary requirements for issuing a Form 8609 are met (for example, taxpayer has certified all sources and uses of funds and development costs for the building under §1.42–17), the Agency will issue to X a copy of the Form 8609 reflecting the 2003 carryover allocation of $70,000 and a copy of the Form 8609 reflecting the 2004 carryover allocation of $50,000, respectively. Agency files the original of each Form 8609 with the Form 8610 that reflects the calendar year each Form 8609 is issued. Agency retains copies of the Forms 8609 that are issued to X.

(b) * * *

(4) * * *

(ii) Agency. The Agency must retain the original of the election statement and a copy of the Form 8609 that reflects the election statement. The Agency must file an additional copy of the Form 8609 with the Agency’s Form 8610 that reflects the calendar year the Form 8609 is issued.

Par. 4. Section 1.42–12 is amended by revising paragraph (a) to read as follows:

§1.42–12 Effective dates and transitional rules.

(a) Effective dates—(1) In general. Except as provided in paragraphs (a)(2) and (a)(3) of this section, the rules set forth in §§1.42–6 and 1.42–8 through 1.42–12 are applicable on May 2, 1994. However, binding agreements, election statements, and carryover allocation documents entered into before May 2, 1994, that follow the guidance set forth in Notice 89–1, 1989–1 C.B. 620 (see §601.601(d)(2)(ii)(b) of this chapter) need not be changed to conform to the rules set forth in §§1.42–6 and 1.42–8 through 1.42–12.

(2) Community Renewal Tax Relief Act of 2000—(1) In general. Section 1.42–6(a), (b)(4)(iii) Example 1 and Example 2, (c), (d)(2)(viii), and (e)(2) are applicable for housing credit dollar amounts
allocated after January 6, 2004. However, the rules in §1.42–6(a), (b)(4)(iii) Example 1 and Example 2, (c), (d)(2)(viii), and (e)(2) may be applied by Agencies and taxpayers for housing credit dollar amounts allocated after December 31, 2000, and on or before January 6, 2004. Otherwise, subject to the applicable effective dates of the corresponding statutory provisions, the rules that apply for housing credit dollar amounts allocated on or before January 6, 2004, are contained in §1.42–6 in effect on and before January 6, 2004 (see 26 CFR part 1 revised as of April 1, 2003).

(3) Electronic filing simplification changes. Sections 1.42–6(d)(4) and 1.42–8(a)(6)(i), (a)(6)(ii), (a)(7) Example 1 and Example 2, (b)(4)(i), and (b)(4)(ii) are applicable for forms filed after January 6, 2004. The rules that apply for forms filed on or before January 6, 2004, are contained in §1.42–6 and §1.42–8 in effect on and before January 6, 2004 (see 26 CFR part 1 revised as of April 1, 2003).

* * * * *

Par. 5. Section 1.42–14 is amended by:
1. Revising the section heading and paragraphs (a), (g), (i)(2), (k) and (l).
2. Removing paragraph (c) and the second to last sentence of paragraph (e).
3. Redesignating paragraph (b) as paragraph (c).
4. Adding a new paragraph (b).

The revisions and additions read as follows:


(a) State housing credit ceiling—(1) In general. The State housing credit ceiling for a State for any calendar year after 2000 is comprised of four components. The four components are—

(i) The unused State housing credit ceiling, if any, of the State for the preceding calendar year (the unused carryforward component);

(ii) The greater of—

(A) $1.75 ($1.50 for calendar year 2001) multiplied by the State population; or

(B) $2,000,000 (the population component);

(iii) The amount of State housing credit ceiling returned in the calendar year (the returned credit component); plus

(iv) The amount, if any, allocated to the State by the Secretary under section 42(h)(3)(D) from a national pool of unused credit (the national pool component).

(2) Cost of Living Adjustment—(i) General rule. For any calendar year after 2002, the $2,000,000 and $1.75 amounts in paragraph (a)(1)(ii) of this section are each increased by an amount equal to—

(A) The dollar amount; multiplied by

(B) The cost-of-living adjustment determined under section 1(f)(3) for the calendar year by substituting “calendar year 2001” for “calendar year 1992” in section 1(f)(3).

(ii) Rounding. Any increase resulting from the application of paragraph (a)(2)(i) of this section which, in the case of the $2,000,000 amount, is not a multiple of $5,000, is rounded to the next lowest multiple of $5,000, and which, in the case of the $1.75 amount, is not a multiple of 5 cents, is rounded to the next lowest multiple of 5 cents.

(b) The unused carryforward component. The unused carryforward component of the State housing credit ceiling for any calendar year is the unused State housing credit ceiling, if any, of the State for the preceding calendar year. The unused State housing credit ceiling for any calendar year is treated as credit from the various components of the State housing credit ceiling consisting of the following housing credit dollar amounts:

(a) Building not qualified within required time period. * * * Also, a building that has received a post-June 30 carryover allocation is not qualified within the required time period if the taxpayer does not meet the 10 percent basis requirement by the date that is 6 months after the date the allocation was made (as described in §1.42–6(a)(2)(ii)).

* * * * *

(g) Stacking Order. Credit is treated as allocated from the various components of the State housing credit ceiling in the following order. The first credit allocated for any calendar year is treated as credit from the unused carryforward component of the State housing credit ceiling for the calendar year. After all of the credit in the unused carryforward component has been allocated, any credit allocated is treated as allocated from the sum of the population, returned credit, and national pool components of the State housing credit ceiling.

* * * * *

(i) * * *

(2) Unused housing credit carryover. The unused housing credit carryover of a State for any calendar year is the excess, if any, of—

(i) The unused carryforward component of the State housing credit ceiling for the calendar year; over

(ii) The total housing credit dollar amount allocated for the calendar year.

* * * * *

(k) Example. (1) The operation of the rules of this section is illustrated by the following examples. Unless otherwise stated in an example, Agency A is the sole Agency authorized to make allocations of housing credit dollar amounts in State M, all of Agency A’s allocations are valid, and for calendar year 2003, Agency A has available for allocation a State housing credit ceiling consisting of the following housing credit dollar amounts:
(2) In addition, the $10 of returned credit component was returned before October 1, 2003.

Example 1—(i) Additional facts. By the close of 2003, Agency A had allocated $80 of the State M housing credit ceiling. Of the $80 allocated, $17 was allocated to projects involving qualified nonprofit organizations.

(ii) Application of stacking rules. The $80 of allocated credit is first treated as allocated from the unused carryforward component of the State housing credit ceiling. The $80 of allocated credit exceeds the $50 attributable to the unused carryforward component by $30. Because the unused carryforward component is fully utilized, no credit will be forfeited by State M to the 2004 National Pool. The remaining $30 of allocated credit will next be treated as allocated from the $120 in credit determined by aggregating the population, returned credit, and national pool components ($110 + 10 + 0 = $120). The $90 of unallocated credit remaining in State M’s 2003 State housing credit ceiling ($120 - 30 = $90) represents the unused carryforward component of State M’s 2003 State housing credit ceiling. Under paragraph (i)(3) of this section, State M does not qualify for credit from the 2004 National Pool.

(iii) Nonprofit set-aside. Agency A allocated exactly the amount of credit to projects involving qualified nonprofit organizations as necessary to meet the nonprofit set-aside requirement ($17, 10% of the $170 ceiling).

Example 2—(i) Additional facts. By the close of 2003, Agency A had allocated $40 of the State M housing credit ceiling. Of the $40 allocated, $20 was allocated to projects involving qualified nonprofit organizations.

(ii) Application of stacking rules. The $40 of allocated credit is first treated as allocated from the unused carryforward component of the State housing credit ceiling. Because the $40 of allocated credit does not exceed the $50 attributable to the unused carryforward component, the remaining components of the State housing credit ceiling are unaffected. The $10 remaining in the unused carryforward component is assigned to the Secretary for inclusion in the 2004 National Pool. The $120 in credit determined by aggregating the population, returned credit, and national pool components becomes the unused carryforward component of State M’s 2004 State housing credit ceiling. Under paragraph (ii)(3) of this section, State M does not qualify for credit from the 2004 National Pool.

(iii) Nonprofit set-aside. Agency A allocated $3 more credit to projects involving qualified nonprofit organizations than necessary to meet the nonprofit set-aside requirement. This does not reduce the application of the 10% nonprofit set-aside requirement to the State M housing credit ceiling for calendar year 2004.

<table>
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<tr>
<th>Capitalization component</th>
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<tr>
<td>B. population component</td>
<td>$110</td>
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<tr>
<td>C. returned credit component</td>
<td>$10</td>
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<tr>
<td>D. national pool component</td>
<td>$0</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>$170</strong></td>
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</table>

Example 3—(i) Additional fact. None of the applications for credit that Agency A received for 2003 are for projects involving qualified nonprofit organizations.

(ii) Nonprofit set-aside. Because at least 10% of the State housing credit ceiling must be set aside for projects involving a qualified nonprofit organization, Agency A can allocate only $153 of the $170 State housing credit ceiling for calendar year 2003 ($170 - 17 = $153). If Agency A allocates $153 of credit, the credit is treated as allocated $50 from the unused carryforward component and $103 from the sum of the population, returned credit, and national pool components. The $17 of unallocated credit that is set aside for projects involving qualified nonprofit organizations becomes the unused carryforward component of State M’s 2004 State housing credit ceiling. Under paragraph (i)(3) of this section, State M does not qualify for credit from the 2004 National Pool.

(i) Effective dates—(1) In general. Except as provided in paragraph (i)(2) of this section, the rules set forth in §1.42–14 are applicable on January 1, 1994.

(2) Community Renewal Tax Relief Act of 2000 changes. Paragraphs (a), (b), (c), (e), (ii)(2) and (k) of this section are applicable for housing credit dollar amounts allocated after January 6, 2004. However, paragraphs (a), (b), (c), (e), (ii)(2) and (k) of this section may be applied by Agencies and taxpayers for housing credit dollar amounts allocated after December 31, 2000, and on or before January 6, 2004. Otherwise, subject to the applicable effective dates of the corresponding statutory provisions, the rules that apply for housing credit dollar amounts allocated on or before January 6, 2004, are contained in this section in effect on and before January 6, 2004 (see 26 CFR part 1 revised as of April 1, 2003).

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

Pamela F. Olson, Assistant Secretary of the Treasury.

Section 162.—Trade or Business Expenses

Environmental remediation costs that are otherwise deductible under section 162 are includible in inventory costs under section 263A by a taxpayer that contaminated land with hazardous waste as part of

February 23, 2004 508 2004-8 I.R.B.
Section 263A.—Capitalization and Inclusion in Inventory Costs of Certain Expenses

26 CFR 1.263A–1: Uniform capitalization of costs.

Costs incurred to clean up land that a taxpayer contaminated with hazardous waste by the operation of a manufacturing plant must be included in inventory costs under section 263A of the Code. Rev. Rul. 1964–2 C.B. 333 (1962), nonacq., 39 T.C. 333 (1962), demonstrates that the costs of environmental remediation are capital expenditures. The ruling holds that the costs to clean up land used in the taxpayer’s manufacturing process and to treat groundwater that a taxpayer contaminated with hazardous waste from the taxpayer’s manufacturing business are capital expenditures. The ruling holds that the costs to clean up land used in the taxpayer’s manufacturing process and to treat groundwater are not capital expenditures because these costs do not prolong the useful life of the land or adapt the land to a new or different use. Therefore, costs incurred to clean up land and to treat groundwater that a taxpayer contaminated with hazardous waste from the taxpayer’s manufacturing business are deductible by the taxpayer as business expenses under § 162. Costs properly allocable to constructing groundwater treatment facilities, however, are capital expenditures under § 263.

Rev. Rul. 98–25, 1998–1 C.B. 998, holds that costs incurred to replace underground storage tanks containing waste by-products under the circumstances in the ruling are not capital expenditures under § 263, but are ordinary and necessary expenses under § 162.

ANALYSIS

The discussion in Rev. Rul. 94–38 of Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962), nonacq., 1964–2 C.B. 8, demonstrates that the revenue ruling was intended to address whether costs incurred to clean up land and to treat the groundwater are capital expenditures that must be capitalized into the basis of the land under § 263(a) or whether the costs are ordinary and necessary repair expenses under § 162. Rev. Rul. 94–38 does not address the treatment of these costs as inventory costs under § 263A. Similarly, Rev. Rul. 98–25 does not address whether amounts incurred to remediate the soil and groundwater that had been contaminated by the hazardous waste, and to establish an appropriate system for the continued monitoring of the groundwater to ensure that the remediation removes all hazardous waste. The costs incurred are not research and experimental expenditures within the meaning of § 174 or environmental management policy costs. The soil remediation and groundwater treatment restores X’s land to essentially the same physical condition that existed prior to the contamination. During and after the remediation and treatment, X continues to use the land and operate the plant in the same manner as it did prior to the cleanup except that X disposes of any hazardous waste in compliance with environmental requirements.

LAW

Section 263A(a) provides that the direct costs and indirect costs properly allocable to property that is inventory in the hands of the taxpayer shall be included in inventory costs.

Section 1.263A–1(a)(3)(ii) of the Income Tax Regulations provides, in part, that taxpayers that produce tangible personal property must capitalize (1) all direct costs of producing the property, and (2) the property’s allocable share of indirect costs.

Section 1.263A–1(e)(3)(i) provides, in part, that indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production activities. Cost recovery, production facility repair and maintenance costs, and scrap and spoilage costs, such as waste removal costs, are examples of indirect costs that must be capitalized to the extent the costs are properly allocable to produced property. See § 1.263A–1(e)(3)(ii) (I), (O) and (Q).

Section 1.263A–1(e)(4)(iv)(I) provides that costs incurred for environmental management policy generally are not allocated to production or resale activities (except to the extent that the costs of any system or procedure benefit a particular production or resale activity).

Section 1.263A–1(c)(2)(ii) provides that the amount of any cost required to be capitalized under § 263A may not be included in inventory or charged to capital account or basis before the taxable year during which the amount is incurred within the meaning of § 1.461–1(c)(1)(ii). Pursuant to § 461(h), in determining whether an accrual method taxpayer has incurred an amount for any item during the taxable year, the all events test shall not be treated as met any earlier than when economic performance occurs.

Section 1.263A–2(a)(3)(i) provides that any cost required to be capitalized by § 263A must be capitalized regardless of whether the cost was incurred before, during, or after production.

Rev. Rul. 94–38, 1994–1 C.B. 35, analyzes whether costs incurred to clean up land and to treat groundwater that a taxpayer contaminated with hazardous waste from the taxpayer’s manufacturing business are capital expenditures. The ruling holds that the costs to clean up land used in the taxpayer’s manufacturing process and to treat groundwater are not capital expenditures because these costs do not prolong the useful life of the land or adapt the land to a new or different use. Therefore, costs incurred to clean up land and to treat groundwater that a taxpayer contaminated with hazardous waste from the taxpayer’s business are deductible by the taxpayer as business expenses under § 162. Costs properly allocable to constructing groundwater treatment facilities, however, are capital expenditures under § 263.

Rev. Rul. 98–25, 1998–1 C.B. 998, holds that costs incurred to replace underground storage tanks containing waste by-products under the circumstances in the ruling are not capital expenditures under § 263, but are ordinary and necessary expenses under § 162.
The holding of Rev. Rul. 94–38 that the costs to construct a groundwater treatment facility must be capitalized under §§ 263(a) and 263A rather than deducted under § 162 demonstrates the distinction between capital expenditures and costs that are more in the nature of repairs than capital improvements. As with other types of deductible business costs, such as labor costs, taxes, rent, and supplies, once repair costs are determined to be deductible under § 162, a taxpayer with inventories must still apply the rules of § 263A to determine whether the repair costs must be included in inventory. Section 1.263A–1(e)(3). In addition, if repair costs must be capitalized under §§ 263(a) and 263A to a depreciable asset, a taxpayer with inventories must still apply the rules of §§ 263A to determine whether the depreciation expense must be included in inventory. Section 1.263A–1(e)(3)(ii)(I).

In this situation, X incurs environmental remediation costs to clean up land that was contaminated as part of the ordinary business operations of X’s manufacturing of inventory. X’s environmental remediation costs are incurred by reason of X’s production activities within the meaning of § 1.263A–1(e)(3)(ii). The costs are properly allocable to property produced by X that is in inventory in X’s hands under § 1.263A–1(e)(3)(ii). Accordingly, X must capitalize the otherwise deductible environmental remediation costs by including the costs in inventory costs in accordance with § 1.263A–1(c)(3). Similarly, costs incurred to replace underground storage tanks and depreciation cost recoveries of the groundwater treatment facility must be included in inventory costs to the extent properly allocable to inventory.

**HOLDING**

Environmental remediation costs are subject to capitalization under § 263A. Therefore, costs incurred (within the meaning of § 461(h) and § 1.263A–1(c)(2)(iii)) to clean up land that a taxpayer contaminated with hazardous waste by the operation of the taxpayer’s manufacturing plant must be included in inventory costs under § 263A.

**TRANSITION RULE**

This paragraph applies to costs that would have been properly deducted in the taxable year but for the requirement to capitalize the costs to inventory under § 263A, and for which the taxpayer’s method of accounting was to deduct the costs. The Internal Revenue Service will not challenge the treatment of environmental remediation costs to which this paragraph applies as deductible expenses rather than as costs properly capitalized to inventory under § 263A in any taxable year ending on or before February 6, 2004. Therefore, the treatment of environmental remediation costs to which this paragraph applies as amounts properly capitalized to inventory under § 263A will not be raised as an issue in any taxable year ending on or before February 6, 2004, and, if the treatment of such environmental remediation costs as deductible expenses rather than as amounts properly capitalized to inventory under § 263A has already been raised as an issue in an examination or before Appeals or the Tax Court in a taxable year ending on or before February 6, 2004, the issue will not be further pursued. The Service will not impose penalties on taxpayers or preparers for treating environmental remediation costs to which this paragraph applies as deductible expenses rather than as costs properly capitalized to inventory under § 263A in taxable years ending on or before February 6, 2004.

**CHANGE IN METHOD OF ACCOUNTING**


1. The scope limitations in section 4.02 of Rev. Proc. 2002–9 do not apply to a taxpayer that wants to make the change for its first taxable year ending after February 6, 2004; and
2. A taxpayer that files a Form 3115 in accordance with this revenue ruling to make the change in method of accounting for its first taxable year ending after February 6, 2004, may effect the change using either a § 481(a) adjustment as provided in sections 5.03 and 5.04 of Rev. Proc. 2002–9 or a cut-off method. For purposes of Line 1a of Form 3115 (revised December 2003), the designated number for the automatic accounting method change authorized by this revenue ruling is “77.” A taxpayer making the automatic change in method of accounting authorized by this revenue ruling and another automatic change in method of accounting under § 263A for the same taxable year may file one Form 3115 to make both changes, but must comply with the ordering rules of § 1.263A–7(b)(2) and must enter the automatic accounting method change numbers for both changes on Line 1a of Form 3115 (revised December 2003).

**EFFECT ON OTHER DOCUMENTS**

Rev. Rul. 98–25 and Rev. Rul. 94–38 are clarified by providing that the otherwise deductible amounts at issue in Rev. Rul. 98–25 and Rev. Rul. 94–38 are subject to capitalization to inventory under § 263A. Rev. Proc. 2002–9 is modified and amplified to include in the APPENDIX the automatic change provided in this revenue ruling.

**DRAFTING INFORMATION**

The principal author of this revenue ruling is John Moriarty of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue ruling, contact Mr. Moriarty at 202–622–4930 (not a toll-free call).

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**Section 472.—Last-in, First-out Inventories**

26 CFR 1.472–1: Last-in, first-out inventories

LIFO; price indexes; department stores. The December 2003 Bureau of
Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, December 31, 2003.

**Rev. Rul. 2004–19**

The following Department Store Inventory Price Indexes for December 2003 were issued by the Bureau of Labor Statistics. The indexes are accepted by the Internal Revenue Service, under § 1.472–1(k) of the Income Tax Regulations and Rev. Proc. 86–46, 1986–2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, December 31, 2003.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups — soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco, and contract departments.

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### BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS

(January 1941 = 100, unless otherwise noted)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Piece Goods</td>
<td>465.6</td>
<td>473.7</td>
<td>1.7</td>
</tr>
<tr>
<td>2. Domestics and Draperies</td>
<td>561.8</td>
<td>543.9</td>
<td>-3.2</td>
</tr>
<tr>
<td>3. Women’s and Children’s Shoes</td>
<td>640.1</td>
<td>629.7</td>
<td>-1.6</td>
</tr>
<tr>
<td>4. Men’s Shoes</td>
<td>888.0</td>
<td>847.8</td>
<td>-4.5</td>
</tr>
<tr>
<td>5. Infants’ Wear</td>
<td>612.4</td>
<td>586.4</td>
<td>-4.2</td>
</tr>
<tr>
<td>6. Women’s Underwear</td>
<td>536.7</td>
<td>509.6</td>
<td>-5.0</td>
</tr>
<tr>
<td>7. Women’s Hosiery</td>
<td>345.3</td>
<td>344.1</td>
<td>-0.3</td>
</tr>
<tr>
<td>8. Women’s and Girls’ Accessories</td>
<td>540.3</td>
<td>551.3</td>
<td>2.0</td>
</tr>
<tr>
<td>9. Women’s Outerwear and Girls’ Wear</td>
<td>356.4</td>
<td>362.7</td>
<td>1.8</td>
</tr>
<tr>
<td>10. Men’s Clothing</td>
<td>550.6</td>
<td>535.1</td>
<td>-2.8</td>
</tr>
<tr>
<td>11. Men’s Furnishings</td>
<td>584.7</td>
<td>583.4</td>
<td>-0.2</td>
</tr>
<tr>
<td>12. Boys’ Clothing and Furnishings</td>
<td>446.2</td>
<td>429.0</td>
<td>-3.9</td>
</tr>
<tr>
<td>13. Jewelry</td>
<td>855.4</td>
<td>848.0</td>
<td>-0.9</td>
</tr>
<tr>
<td>14. Notions</td>
<td>793.2</td>
<td>799.6</td>
<td>0.8</td>
</tr>
<tr>
<td>15. Toilet Articles and Drugs</td>
<td>967.5</td>
<td>976.5</td>
<td>0.9</td>
</tr>
<tr>
<td>16. Furniture and Bedding</td>
<td>623.8</td>
<td>612.9</td>
<td>-1.7</td>
</tr>
<tr>
<td>17. Floor Coverings</td>
<td>734.4</td>
<td>710.6</td>
<td>-3.2</td>
</tr>
<tr>
<td>18. Housewares</td>
<td>596.3</td>
<td>595.1</td>
<td>-0.2</td>
</tr>
<tr>
<td>19. Major Appliances</td>
<td>219.4</td>
<td>206.8</td>
<td>-5.7</td>
</tr>
<tr>
<td>20. Radio and Television</td>
<td>47.3</td>
<td>43.8</td>
<td>-7.4</td>
</tr>
<tr>
<td>21. Recreation and Education²</td>
<td>84.3</td>
<td>81.5</td>
<td>-3.3</td>
</tr>
<tr>
<td>22. Home Improvements²</td>
<td>125.8</td>
<td>125.4</td>
<td>-0.3</td>
</tr>
<tr>
<td>23. Automotive Accessories²</td>
<td>111.3</td>
<td>112.1</td>
<td>0.7</td>
</tr>
</tbody>
</table>

Groups 1–15: Soft Goods
Groups 16–20: Durable Goods
Groups 21–23: Misc. Goods²

Store Total³ | 503.0 | 495.1 | -1.6

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1. Absence of a minus sign before the percentage change in this column signifies a price increase.
2. Indexes on a January 1986 = 100 base.
3. The store total index covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco and contract departments.

**DRAFTING INFORMATION**

The principal author of this revenue ruling is Michael Burkom of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Burkom at (202) 622–7924 (not a toll-free call).

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**Section 807.—Rules for Certain Reserves**

Insurance companies; interest rate tables. Prevailing state assumed interest

Rev. Rul. 2004–14

For purposes of § 807(d)(4) of the Internal Revenue Code, for taxable years beginning after December 31, 2002, this ruling supplements the schedules of prevailing state assumed interest rates set forth in Rev. Rul. 92–19, 1992–1 C.B. 227. This information is to be used by insurance companies in computing their reserves for (1) life insurance and supplementary total and permanent disability benefits, (2) individual annuities and pure endowments, and (3) group annuities and pure endowments. As § 807(d)(2)(B) requires that the interest rate used to compute these reserves be the greater of (1) the applicable federal interest rate, or (2) the prevailing state assumed interest rate, the table of applicable federal interest rates in Rev. Rul. 92–19 is also supplemented.

Following are supplements to schedules A, B, C, and D to Part III of Rev. Rul. 92–19, providing prevailing state assumed interest rates for insurance products with different features issued in 2003 and 2004, and a supplement to the table in Part IV of Rev. Rul. 92–19, providing the applicable federal interest rates under § 807(d) for 2003 and 2004. This ruling does not supplement Parts I and II of Rev. Rul. 92–19.


Part III. Prevailing State Assumed Interest Rates — Products Issued in Years After 1982.*

Schedule A

STATUTORY VALUATION INTEREST RATES
BASED ON THE 1980 AMENDMENTS TO THE
NAIC STANDARD VALUATION LAW

A. Life insurance valuation:

<table>
<thead>
<tr>
<th>Guarantee Duration (years)</th>
<th>Calendar Year of Issue</th>
</tr>
</thead>
<tbody>
<tr>
<td>10 or fewer</td>
<td>5.00</td>
</tr>
<tr>
<td>More than 10 but not more than 20</td>
<td>4.75**</td>
</tr>
<tr>
<td>More than 20</td>
<td>4.50**</td>
</tr>
</tbody>
</table>

Source: Rates calculated from the monthly averages, ending June 30, 2003, of Moody’s Composite Yield on Seasoned Corporate Bonds (formerly known as Moody’s Corporate Bond Yield Average — Monthly Average Corporates).

** As the applicable federal interest rate for 2004 of 4.82 percent exceeds this prevailing state assumed interest rate, the interest rate to be used for this product under § 807 is 4.82 percent.

* The terms used in the schedules in this ruling and in Part III of Rev. Rul. 92–19 are those used in the Standard Valuation Law; the terms are defined in Rev. Rul. 92–19.
Part III, Schedule B

STATUTORY VALUATION INTEREST RATES
BASED ON THE 1980 AMENDMENTS TO THE
NAIC STANDARD VALUATION LAW

B. Single premium immediate annuities and annuity benefits involving life contingencies arising from other annuities with cash settlement options and from guaranteed interest contracts with cash settlement options:

<table>
<thead>
<tr>
<th>Calendar Year of Issue</th>
<th>Valuation Interest Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>6.00*</td>
</tr>
</tbody>
</table>

Source: Rates calculated from the monthly averages, ending June 30, 2003, of Moody’s Composite Yield on Seasoned Corporate Bonds (formerly known as Moody’s Corporate Bond Yield Average — Monthly Average Corporates). The terms used in this schedule are those used in the Standard Valuation Law as defined in Rev. Rul. 92–19.

*As this prevailing state assumed interest exceeds the applicable federal interest rate for 2003 of 5.27 percent, the valuation interest rate of 6.00 percent is to be used for this product under § 807.

Part III, Schedule C21–2003

STATUTORY VALUATION INTEREST RATES
BASED ON NAIC STANDARD VALUATION LAW
FOR 2003 CALENDAR YEAR BUSINESS
GOVERNED BY THE 1980 AMENDMENTS

C. Valuation interest rates for other annuities and guaranteed interest contracts that are valued on an issue year basis:

<table>
<thead>
<tr>
<th>Cash Settlement Options?</th>
<th>Future Interest Guarantee?</th>
<th>Guarantee Duration (years)</th>
<th>Valuation Interest Rate For Plan Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>Yes</td>
<td>5 or fewer</td>
<td>A  6.00  B 5.25*  C 4.75*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>More than 5, but not more than 10</td>
<td>A  5.75  B 5.25*  C 4.75*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>More than 10, but not more than 20</td>
<td>A  5.50  B 4.75*  C 4.75*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>More than 20</td>
<td>A  4.75*  B 4.25*  C 4.25*</td>
</tr>
<tr>
<td>Yes</td>
<td>No</td>
<td>5 or fewer</td>
<td>A  6.25  B 5.50  C 5.00*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>More than 5, but not more than 10</td>
<td>A  6.00  B 5.50  C 5.00*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>More than 10, but not more than 20</td>
<td>A  5.50  B 5.00*  C 4.75*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>More than 20</td>
<td>A  4.75*  B 4.50*  C 4.50*</td>
</tr>
<tr>
<td>Cash Settlement Options?</td>
<td>Future Interest Guarantee?</td>
<td>Guarantee Duration (years)</td>
<td>Valuation Interest Rate For Plan Type</td>
</tr>
<tr>
<td>-------------------------</td>
<td>---------------------------</td>
<td>-----------------------------</td>
<td>--------------------------------------</td>
</tr>
<tr>
<td>Yes</td>
<td>Yes</td>
<td>5 or fewer</td>
<td>A: 6.50, B: 6.25, C: 5.00*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>More than 5, but not more than 10</td>
<td>A: 6.25, B: 6.25, C: 5.00*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>More than 10, but not more than 20</td>
<td>A: 6.00, B: 5.75, C: 5.25*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>More than 20</td>
<td>A: 5.25*, B: 5.25*, C: 4.50*</td>
</tr>
<tr>
<td>Yes</td>
<td>No</td>
<td>5 or fewer</td>
<td>A: 6.75, B: 6.25, C: 5.25*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>More than 5, but not more than 10</td>
<td>A: 6.50, B: 6.25, C: 5.25*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>More than 10, but not more than 20</td>
<td>A: 6.25, B: 6.00, C: 5.00*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>More than 20</td>
<td>A: 5.50, B: 5.50, C: 4.75*</td>
</tr>
</tbody>
</table>

Source: Rates calculated from the monthly averages, ending June 30, 2003, of Moody’s Composite Yield on Seasoned Corporate Bonds (formerly known as Moody’s Corporate Bond Yield Average — Monthly Average Corporates).

*As the applicable federal interest rate for 2003 of 5.27 percent exceeds this prevailing state assumed interest rate, the interest rate to be used for this product under § 807 is 5.27 percent.
EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 92–19 is supplemented by the addition to Part III of that ruling of prevailing state assumed interest rates under § 807 for certain insurance products issued in 2003 and 2004 and is further supplemented by an addition to the table in Part IV of Rev. Rul. 92–19 listing applicable federal interest rates. Parts I and II of Rev. Rul. 92–19 are not affected by this ruling.

DRAFTING INFORMATION

The principal author of this revenue ruling is Ann H. Logan of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact her at (202) 622–3970 (not a toll-free call).

Section 1233.—Gains and Losses From Short Sales

(Also § 1259; 26 CFR 1.1233–1.)

Short sale; broker; transfer. This ruling provides guidance on whether the delivery of shares made to a broker in transferring a short sale position from one broker to another broker will (1) cause a short sale to be deemed consummated under regulations section 1.1233–1(a), and (2) cause a short-against-the-box transaction to cease to be covered by the transition rule of section 1259 of the Code.

Rev. Rul. 2004–15

ISSUES

(1) If a taxpayer is obligated to transfer stock to a broker as a result of a short sale and borrows stock from another broker to satisfy the obligation to the first broker by having the second broker transfer the borrowed stock to the first broker, does the transfer close the short sale for purposes of § 1.1233–1(a)(4) of the Income Tax Regulations?

(2) If a taxpayer held appreciated stock, entered into a short sale prior to June 9, 1997, of identical stock borrowed from a broker, identified the short sale and the stock as offsetting positions in accordance with the transition rule in § 1001(d)(2) of the Taxpayer Relief Act of 1997, 1997–4 (Vol. 1) C.B. 1, 121, and continues to hold the appreciated stock, does a transfer of stock borrowed from another broker to satisfy the obligation to the first broker cause the transition rule to cease to apply?

FACTS

In January 1997, Taxpayer TP owned 100 shares of XYZ stock. In May 1997, at a time when the value of the XYZ stock exceeded TP’s basis in the stock, TP effected a short sale (the Short Sale) of 100 shares of XYZ stock. To do this, TP borrowed 100 shares of XYZ stock from Broker A and instructed Broker A to sell those borrowed shares on TP’s behalf. Thus, as a result of the Short Sale, TP incurred an obligation to transfer 100 shares of XYZ stock to Broker A. Before September 4, 1997, in its books and records, TP clearly identified the Short Sale and the XYZ stock (which TP still owned) as offsetting positions under § 1001(d)(2) of the Taxpayer Relief Act of 1997.

In January 2004, TP decides to replace its obligation to Broker A with a substantially identical obligation to Broker B. To do so, TP arranges for Broker B to deliver 100 shares of XYZ stock to Broker A in satisfaction of TP’s obligation to Broker A, and TP thus incurs an obligation to transfer 100 shares of XYZ stock to Broker B. After Broker B’s transfer of 100 shares of XYZ stock to Broker A, TP continues to have the obligation to deliver 100 shares of XYZ stock, but the obligation is owed to Broker B rather than to Broker A.

TP continues to hold the XYZ stock, and TP has not satisfied its obligation to Broker B.

LAW AND ANALYSIS

(1) Section 1233

Section 1.1233–1(a)(1) provides, “For income tax purposes, a short sale is not deemed to be consummated until delivery of property to close the short sale.” Pursuant to § 1.1233–1(a)(4), if the short sale is made through a broker and the broker borrows property to make a delivery, the short sale is not deemed to be consummated until the obligation of the seller created by the short sale is finally discharged by delivery of property to the broker to replace the property borrowed by the broker.

In general, a short sale is closed (and thus is consummated) by the transfer of property that the short seller already owns or property that the short seller purchases for the purpose of satisfying the obligation from the short sale. If, however, a taxpayer satisfies its obligation created under a short sale by transferring property borrowed from another lender, the transfer of the borrowed property does not close the short sale.

In Richardson v. Commissioner, 42 B.T.A. 830, 840 (1940), aff’d, 121 F.2d 1 (2d Cir. 1941), the taxpayer borrowed stock to sell short. With respect to a portion of the borrowed stock,
the taxpayer subsequently borrowed other stock from another lender to satisfy the obligation that resulted from the original borrowing. The taxpayer later satisfied the obligation under the second borrowing by transferring shares that he purchased. The Board of Tax Appeals required the taxpayer to recognize the gain or loss in the year in which the obligation from the second borrowing was satisfied, and the Board calculated the amount of the gain or loss on the short sale by reference to the purchase price of the stock used to satisfy the second borrowing. Although the opinion does not discuss the effect of using borrowed shares to satisfy an obligation to replace other shares previously borrowed from another lender, it is implicit in the computation of gain or loss that the satisfaction was not treated as closing the short sale.

Section 1.1233–1(a) does not require a different result. When a taxpayer transfers borrowed property to satisfy its initial obligation under a short sale, the taxpayer’s short sale obligation is not “finally discharged.” Here, the obligation of TP to deliver 100 shares of XYZ stock continues to exist, and thus Broker B’s delivery of borrowed stock to Broker A on TP’s behalf does not close the Short Sale under § 1.1233–1(a).

(2) Section 1259 Transition Rule

Section 1259(a)(1) provides that, if there is a constructive sale of an appreciated financial position, the taxpayer must recognize gain as if the position were sold, assigned, or otherwise terminated at its fair market value on the date of the constructive sale. “Appreciated financial position” is defined in § 1259(b)(1) as including a position with respect to stock if there would be gain were the position sold, assigned, or otherwise terminated at its fair market value. Pursuant to § 1259(c)(1)(A), a taxpayer is treated as having made a constructive sale of an appreciated financial position if the taxpayer enters into a short sale of the same or substantially identical property.

Under § 1001(d)(2) of the Taxpayer Relief Act of 1997 (the transition rule), if “before June 9, 1997, the taxpayer entered into any transaction which is a constructive sale of any appreciated financial position, and . . . . before the close of the 30-day period beginning on the date of the enactment of this Act [August 5, 1997] or before such later date as may be specified by the Secretary of the Treasury, such transaction and position are clearly identified in the taxpayer’s records as offsetting, such transaction and position shall not be taken into account in determining whether any other constructive sale after June 8, 1997, has occurred. The preceding sentence shall cease to apply as of the date such transaction is closed or the taxpayer ceases to hold such position.” Section 1001(d)(2) of the Taxpayer Relief Act of 1997, 1997–4 (Vol. 1) C.B. 1, 121.

In May 1997, when the value of the XYZ stock exceeded its basis, TP entered into the Short Sale. Thus, TP entered into a transaction that is described in § 1259(c)(1), but, because the Short Sale was entered into before June 9, 1997, no gain was recognized under § 1259(a)(1).

Furthermore, before the close of the 30-day period beginning on August 5, 1997, TP clearly identified the XYZ stock and the Short Sale in its books and records as offsetting positions. Thus, the XYZ stock and the Short Sale fall within the transition rule, and, until either TP ceases to hold the XYZ stock or the Short Sale is closed, neither the XYZ stock nor the Short Sale is taken into account in determining whether any constructive sale has occurred after June 8, 1997.

In January 2004, when TP replaces the obligation to Broker A with the obligation to Broker B, TP continues to hold the XYZ stock, and the Short Sale has not been closed for purposes of § 1.1233–1(a). Accordingly, the transition rule continues to apply to the Short Sale and the XYZ stock.

HOLDINGS

(1) When, as a result of the Short Sale, TP is obligated to transfer stock to Broker A and TP satisfies the obligation by causing Broker B to transfer stock that TP borrows from Broker B, the transfer of the borrowed stock does not close the Short Sale under § 1.1233–1(a).

(2) Because replacing the obligation to Broker A with the obligation to Broker B does not close the Short Sale under § 1.1233–1(a), the transfer does not cause the transition rule to cease to apply to either the Short Sale or the XYZ stock.

DRAFTING INFORMATION

The principal author of this revenue ruling is Kate Sleeth of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Ms. Sleeth at (202) 622–3920 (not a toll-free call).

Section 1341.—Computation of Tax Where Taxpayer Restores Substantial Amount Held Under Claim of Right

26 CFR 1.1341–1: Restoration of amounts received or accrued under claim of right.

(Also § 263A.)

Treatment of environmental remediation expenses under section 1341. This ruling holds that amounts paid or incurred in the current taxable year to remediate environmental contamination that occurred in prior taxable years do not qualify for treatment under section 1341 of the Code.

Rev. Rul. 2004–17

ISSUES

Do amounts paid or incurred in the current taxable year to remediate environmental contamination that occurred in prior taxable years qualify for treatment under § 1341 of the Internal Revenue Code?

FACTS

Situation 1

N manufactures products that it sells to wholesalers and retailers. N’s manufacturing process creates hazardous waste. N uses an accrual method of accounting and the calendar taxable year. From the inception of its business in 1950 until 1979, N buried the hazardous waste on land that it owned in accordance with then applicable state, federal, and local environmental laws. N accounted for waste disposal costs as a deductible expense under § 162.

Significantly stricter state, federal, and local hazardous waste disposal laws were enacted in later years. In 2004, in order to comply with current environmental laws,
N incurs expenses for all necessary services to eliminate soil and water contamination caused by the buried waste, transport the waste to a waste disposal facility that complies with current environmental laws, and restore the land.

Situation 2

The facts are the same as in Situation 1 except that N accounted for waste disposal costs as a production cost in calculating its inventory costs for all years.

**LAW AND ANALYSIS**

Section 1341 applies if: (1) the taxpayer included an item in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to the item, (2) a deduction is allowable to the taxpayer for the taxable year because it was established after the close of the taxable year (or years) of inclusion that the taxpayer did not have an unrestricted right to the item or to a portion of the item, and (3) the amount of the deduction exceeds $3,000. Section 1341(a)(1)–(3).

If § 1341 applies, the chapter 1 tax for the taxable year equals the lesser of: (1) the tax for the taxable year computed with the current deduction, or (2) the tax for the taxable year computed without the deduction, less the decrease in tax for the prior taxable year (or years) that would have occurred if the item or portion thereof had been excluded from gross income in the prior taxable year (or years). Section 1341(a)(4) and (5). Section 1341 ensures that the taxpayer’s position is not worse than the position the taxpayer would have been in if the taxpayer had not included the item or portion thereof in gross income in the earlier year (except for the time value of money).

Section 1.1341–1(a)(1) of the Income Tax Regulations provides that § 1341 applies if the taxpayer is entitled to a deduction of more than $3,000 because of the restoration to another of an item that was included in the taxpayer’s gross income for a prior taxable year (or years) under a claim of right.

Under the claim of right doctrine, a taxpayer that receives an amount under a claim of right without restriction on disposition must include the amount in gross income in the taxable year received, notwithstanding that the taxpayer’s right to retain the amount received may be uncertain and the taxpayer subsequently may be required to restore the amount to the rightful owner. *North American Oil Consol. v. Burner*, 286 U.S. 417, 424 (1932).

In *United States v. Lewis*, 340 U.S. 590 (1951), the Supreme Court concluded that a taxpayer who was required under the claim of right doctrine to include a bonus in income in the taxable year received, and who had to repay part of the bonus in a later year, could not amend his tax return for the earlier year. The taxpayer’s only remedy was to deduct the amount repaid in the taxable year in which the taxpayer restored it to the payor. The Court followed the principle that income is properly reported under the claim of right doctrine in the year received, consistent with a tax system based on annual rather than transactional accounting. See *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 364, 365 (1931).

The application of the claim of right doctrine may result in an inequity when, because of changes in tax rates or other circumstances, the tax increase resulting from the income inclusion in the earlier year exceeds the tax decrease that results from the deduction in the later year. Congress enacted § 1341 to ameliorate this inequity in cases such as *Lewis*, in which a taxpayer receives an amount that it is required in a later taxable year to restore or repay to another claimant. See S. Rep. No. 1622, 83d Cong. 2d Sess. 118 (1954) (“Under present law if a taxpayer is obligated to repay amounts which he had received in a prior year and included in income because it appeared that he had an unrestricted right to such amounts, he may take a deduction in the year of restitution”) (emphasis added); H.R. Rep. No. 1337, 83d Cong. 2d Sess. 86 (1954) (same).

Section 1341(a)(2) requires that it be established after the close of the taxable year or years that the taxpayer did not have an unrestricted right to the item of gross income or portion thereof. To satisfy this test the taxpayer must repay or restore the item or portion of the item to another claimant. Section 1.1341–1(a)(1); see also *Chernin v. United States*, 149 F.3d 805 (8th Cir. 1998) (relying on a “legislative history [that] is replete with references to repayment, restoration, and restitution”); S. Rep. No. 1622, 83d Cong. 2d Sess. at 118; H.R. Rep. No. 1337, 83d Cong. 2d Sess. at 86.

For purposes of § 1341, to restore an item included in income, the repayment must arise out of the same circumstances, terms, and conditions as the original payment of the item to the taxpayer. *Griffiths v. United States*, 54 Fed. Cl. 198 (2002). The fact that the amount of the repayment bears no relationship to the amount included in income indicates that the repayment does not arise from the same or specific circumstances, terms, and conditions as the original transaction. *Bailey v. Commissioner*, 756 F.2d 44 (6th Cir. 1985); *Uhlenbrock v. Commissioner*, 67 T.C. 818 (1977).

In both Situation 1 and Situation 2, the environmental remediation costs N incurs in 2004 do not qualify for treatment under § 1341(a). N did not include an item in gross income that N is repaying or restoring in a later year. In these situations, the item of gross income for purposes of §1341(a) is the proceeds received from the sale of N’s products from 1950 to 1979. See Rev. Rul. 72–28, 1972–1 C.B. 269. During 1950 to 1979, N had an unrestricted right to the proceeds received from the sale of N’s products during those years. In 2004, N’s right to the sales proceeds received during 1950 to 1979 remains unrestricted. N’s payment of the environmental remediation costs does not restore in a later taxable year any portion of the proceeds received from the original sale of N’s products in 1950 through 1979. Moreover, N’s obligation to incur the environmental remediation costs does not arise from the same or specific circumstances, terms, or conditions as the original sale of N’s products in 1950 to 1979. The amount of N’s environmental remediation costs bears no relation to the amount of proceeds received from the sale of N’s products in 1950 to 1979. Accordingly, N’s payment of environmental remediation costs in 2004 is not a repayment or restoration of an item included in gross income. N’s environmental remediation costs do not satisfy the repayment or restoration requirement of § 1341(a)(2).

Section 1341(a)(2) also requires, as a prerequisite to § 1341 treatment, that a deduction must be allowable to the taxpayer for the repayment or restoration of the item included in income. Section 1341 itself provides no right to a deduction.
Instead, the deduction must be allowable under another provision of the Code. Section 1.1341–1(a)(1); Wood v. United States, 863 F.2d 417, 420 (5th Cir. 1989); MidAmerican Energy Co. v. Commissioner, 114 T.C. 570, 583 (2000), aff'd, 271 F.3d 740 (8th Cir. 2001).

Inventory costs under § 263A are recovered through cost of goods sold when the inventory is sold. Section 1.263A–1(c)(4). Costs of goods sold, or inventory costs, are not deductions but are properly treated as adjustments to gross income. Section 1.61–3(a). Environmental remediation costs incurred by reason of a production activity must be included in inventory costs. See Rev. Rul. 2004–18, 2004–8 I.R.B. 509 (clarifying Rev. Rul. 94–38, 1994–1 C.B. 35); § 1.263A–1(e)(3). Thus, under § 263A, N’s environmental remediation costs are inventory costs, not deductions. Furthermore, in Situation 2, because the environmental remediation costs N incurs in 2004 would have been accounted for under N’s method of accounting as inventory costs in 1950 through 1979 if incurred in those earlier years, the costs are properly treated as inventory costs under N’s method of accounting when incurred in 2004. Therefore, N’s environmental remediation costs do not qualify for treatment under § 1341 because the costs are inventory costs and do not satisfy the deduction requirement of § 1341.

DRAFTING INFORMATION

The principal author of this revenue ruling is Forest Boone of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue ruling, contact Mr. Boone at 202–622–4960 (not a toll-free call).

Section 6103.—Confidentiality and Disclosure of Returns and Return Information

26 CFR 301.6103(l)–1: Disclosure of returns and return information for purposes other than tax administration.

T.D. 9111

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 301

Definition of Agent for Certain Purposes

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the definition of agent for certain purposes. The final regulations clarify that the term agent in certain provisions of section 6103 of the Internal Revenue Code (Code) includes contractors. Clarification that the term agent includes contractors is necessary for the purpose of bringing certain statutory grants of disclosure authority into alignment with the reality of many agencies’ operations. Agencies generally procure the services of third parties under public contracting laws, which do not necessarily incorporate common law concepts of agent. This clarification is also consistent with Congressional intent. For example, the Senate Finance Committee, in amending section 6103(m)(2), stated, “[a]gents are those who are engaged directly in performing or assisting in collection functions for the federal government, presumably, private collection agencies who have contracted with the government to collect claims ... .” S. Rep. No. 97–378, at 15 (1982).

This clarification does not provide any new disclosure authority, nor does it authorize the disclosure of return information to contractors that Congress has not previously specifically authorized in the Code.

FOR FURTHER INFORMATION CONTACT: Helene R. Newsome, 202–622–4570 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 301 under section 6103(l) and (m) of the Code. On February 1, 2002, the Federal Register published a notice of proposed rulemaking (REG–120135–01, 2002–1 C.B. 552 [67 FR 4938]) regarding the definition of agent for certain purposes. No public comments or requests for hearing were received. The Treasury decision adopts the regulations as proposed.

Generally, returns and return information are confidential under section 6103 of the Code unless a specific statutory exception applies. In cases of non-tax-related disclosures, returns and return information generally may be disclosed only to officers and employees of Federal, state, and local government agencies, and not to contractors or agents of such agencies. In certain limited circumstances, however, Congress has permitted disclosures to “agents” of these agencies. See section 6103(l)(6)(B), (l)(12), (m)(2), (m)(4), (m)(5), (m)(7).

This document contains final regulations that clarify that the term agent in section 6103(l) and (m) includes contractors. Clarification that the term agent includes contractors is necessary for the purpose of bringing certain statutory grants of disclosure authority into alignment with the reality of many agencies’ operations. Agencies generally procure the services of third parties under public contracting laws, which do not necessarily incorporate common law concepts of agent. This clarification is also consistent with Congressional intent. For example, the Senate Finance Committee, in amending section 6103(m)(2), stated, “[a]gents are those who are engaged directly in performing or assisting in collection functions for the federal government, presumably, private collection agencies who have contracted with the government to collect claims ... .” S. Rep. No. 97–378, at 15 (1982).

This clarification does not provide any new disclosure authority, nor does it authorize the disclosure of return information to contractors that Congress has not previously specifically authorized in the Code.
With regard to protection of taxpayer data, agents/contractors are subject to safeguard requirements, redisclosure prohibitions, and civil and criminal penalties for unauthorized disclosures. Accordingly, the regulations do not have an impact on taxpayer privacy.

**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) and (d) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel of the Small Business Administration for comment on its impact on small businesses.

**Drafting Information**

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

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**Adoption of Amendments to the Regulations**

Accordingly, 26 CFR part 301 is amended as follows:

**PART 301 — PROCEDURE AND ADMINISTRATION**

Paragraph 1. The authority citation for part 301 is amended by adding entries in numerical order to read as follows:

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

Section 301.6103(l)–1 also issued under 26 U.S.C. 6103(q).

Section 301.6103(m)–1 also issued under 26 U.S.C. 6103(q). * * *

Par. 2. Section 301.6103(l)–1 is added to read as follows:

§301.6103(l)–1 Disclosure of returns and return information for purposes other than tax administration.

(a) Definition. For purposes of applying the provisions of section 6103(l) of the Internal Revenue Code, the term agent includes a contractor.

(b) Effective date. This section is applicable January 6, 2004.

Par. 3. Section 301.6103(m)–1 is added to read as follows:

§301.6103(m)–1 Disclosure of taxpayer identity information.

(a) Definition. For purposes of applying the provisions of section 6103(m) of the Internal Revenue Code, the term agent includes a contractor.

(b) Effective date. This section is applicable January 6, 2004.

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


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


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**Section 6662.—Imposition of Accuracy-Related Penalty**

26 CFR 1.6662–2: Accuracy-related penalty.

**T.D. 9109**

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

Establishing Defenses to the Imposition of the Accuracy-Related Penalty

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that affect the defenses available to the imposition of the accuracy-related penalty when taxpayers fail to disclose reportable transactions or fail to disclose that they have taken a return position based on the conclusion that a regulation is invalid. The final regulations are intended to promote disclosure of reportable transactions and positions based on the conclusion that a regulation is invalid by narrowing a taxpayer’s ability to establish good faith and reasonable cause as a defense. The final regulations also clarify the existing regulations with respect to the facts and circumstances to be considered in determining whether a taxpayer acted with reasonable cause and in good faith.

DATES: Effective Dates: These regulations are effective December 30, 2003.

Applicability Dates: These regulations apply to returns filed after December 31, 2002, with respect to transactions entered into on or after January 1, 2003.

FOR FURTHER INFORMATION CONTACT: Jamie G. Bernstein at (202) 622–4940 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1. On December 31, 2002, the IRS and the Treasury Department published in the Federal Register proposed amendments to the regulations (REG–126016–01, 2003–1 C.B. 486 [67 FR 79894]) under sections 6662 and 6664 of the Internal Revenue Code (Code). No public hearing was requested or held. Written and electronic comments responding to the notice of proposed rulemaking were received. After consideration of all the comments, the proposed regulations under sections 6662 and 6664 are adopted as amended by this Treasury decision. The revisions are discussed below.

Explanation of Revisions and Summary of Comments

These final regulations generally adopt the provisions of the proposed regulations. The changes to the proposed regulations reflected in these final regulations, as well
1. Applicability of Disclosure Regulations Under Section 6011 and Effective Date

These final regulations were proposed to apply to returns filed after December 30, 2002, with respect to transactions entered into on or after January 1, 2003, to coincide with temporary regulations relating to disclosure, promulgated under section 6011 and applicable for transactions entered into on or after January 1, 2003 (the Temporary Disclosure Regulations). The Temporary Disclosure Regulations were published in the Federal Register on October 22, 2002. See 67 FR 64799 (T.D. 9017, 2002–2 C.B. 815) and 67 FR 64840 (REG–103735–00, 2002–2 C.B. 832) (October 22, 2002). Final regulations under section 6011 were published on March 4, 2003, and apply to transactions entered into on or after February 28, 2003. See 68 FR 10161, 10163 (T.D. 9046, 2003–1 C.B. 614) (March 4, 2003) (the Final Disclosure Regulations). The Final Disclosure Regulations define reportable transactions more narrowly than the Temporary Disclosure Regulations. For transactions entered into on or after January 1, 2003, and before February 28, 2003, the taxpayer may apply the Final Disclosure Regulations instead of the Temporary Disclosure Regulations. Revisions throughout these final regulations refer to the definition of reportable transaction in §1.6011–4(b) or 1.6011–4T(b), as applicable, to accommodate situations in which the Temporary Disclosure Regulations apply to a transaction.

One commentator suggested that the final regulations under sections 6662 and 6664 apply to transactions entered into on or after February 28, 2003, because that date is the effective date for the Final Disclosure Regulations. See 68 FR 10161, 10163 (March 4, 2003). The final regulations do not adopt this recommendation. The proposed regulations under sections 6662 and 6664 provided adequate notice that failure to comply with the Temporary or Final Disclosure Regulations could limit the penalty defenses available under sections 6662 and 6664.

2. Applicability of the Reasonable Cause and Good Faith Defense

The proposed regulations prohibited reliance on tax advice to establish a reasonable cause and good faith defense to the accuracy-related penalties if a taxpayer failed to disclose a reportable transaction pursuant to the Final or Temporary Disclosure Regulations, as applicable. Three commentators suggested that it is inappropriate to preclude a taxpayer from relying on the advice of a tax advisor in circumstances in which the taxpayer does not lack good faith in failing to disclose a reportable transaction. The Treasury Department and the IRS believe that good faith requires taxpayers to be forthcoming and that taxpayers should construe the Final and Temporary Disclosure Regulations broadly in favor of disclosure. Nonetheless, there may be circumstances in which a taxpayer does not lack good faith in failing to disclose a reportable transaction. Accordingly, the final regulations revise the proposed regulations to provide that a taxpayer’s failure to disclose a reportable transaction is a strong indication that the taxpayer failed to act in good faith, which would bar relief under section 6664(c).

These final regulations also adopt the requirement in the proposed regulations that a taxpayer may not rely on an opinion or advice that a regulation is invalid to establish that the taxpayer acted with reasonable cause and in good faith unless the taxpayer adequately disclosed its position that the regulation is invalid. One commentator suggested that this provision is inappropriate because it would be difficult for a taxpayer to discern whether its position is contrary to a regulation without consulting with a tax advisor. This suggestion was rejected because the requirement of revised §1.6664–4(c)(2)(iii) does not apply to situations in which a taxpayer has taken a position that is merely contrary to a regulation, but instead applies to situations in which a taxpayer has taken a return position based on advice or an opinion that a regulation is invalid.

3. Definition of Advice

One commentator suggested that the proposed regulations more clearly define what constitutes professional advice or opinion. Section 1.6664–4(c)(2) defines the term advice. Neither the proposed nor the final regulations change the definition of the term advice.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because 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. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these regulations were 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 Jamie Bernstein, Office of the Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART I—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 1.6662–0 is amended by adding an entry for §1.6662–2(d)(5) to read as follows:

§1.6662–0 Table of Contents.

§1.6662–2 Accuracy-related penalty.

(d) * * *


* * *
§1.6662–2 Accuracy-related penalty.

(d) ***(1)*** Except as provided in paragraphs (d)(3), (4) and (5) of this section and the last sentence of this paragraph (d)(2), the provisions of §§1.6662–1 through 1.6662–4 and §1.6662–7 (as revised to reflect the changes made to the accuracy-related penalty by the Omnibus Budget Reconciliation Act of 1993) and of §1.6662–5 apply to returns the due date of which (determined without regard to extensions for time for filing) is after December 31, 1993.

(2) ** Nevertheless, a taxpayer who takes a position (other than with respect to a reportable transaction, as defined in §1.6011–4(b) or §1.6011–4T(b), as applicable) contrary to a revenue ruling or notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on its merits. See §1.6694–2(b) of the income tax return preparer penalties regulations for a description of the realistic possibility standard.

Par. 4. Section 1.6662–3 is amended by revising paragraph (a), the last sentence of paragraph (b)(2), and the first sentence of paragraph (c)(1) to read as follows:

§1.6662–3 Negligence or disregard of rules or regulations.

(a) In general. If any portion of an underpayment, as defined in section 6664(a) and §1.6664–2, of any income tax imposed under subtitle A of the Internal Revenue Code that is required to be shown on a return is attributable to negligence or disregard of rules or regulations, there is added to the tax an amount equal to 20 percent of such portion. The penalty for disregarding rules or regulations does not apply, however, if the requirements of paragraph (c)(1) of this section are satisfied and the position in question is adequately disclosed as provided in paragraph (c)(2) of this section (and, if the position relates to a reportable transaction as defined in §1.6011–4(b) or §1.6011–4T(b), as applicable), the transaction is disclosed in accordance with §1.6011–4 (or §1.6011–4T, as applicable), or to the extent that the reasonable cause and good faith exception to this penalty set forth in §1.6664–4 applies. In addition, if a position with respect to an item (other than with respect to a reportable transaction, as defined in §1.6011–4(b) or §1.6011–4T(b), as applicable) is contrary to a revenue ruling or notice (other than a notice of proposed rulemaking) issued by the Internal Revenue Service and published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter), this penalty does not apply if the position has a realistic possibility of being sustained on its merits. See §1.6694–2(b) of the income tax return preparer penalties regulations for a description of the realistic possibility standard.

Par. 5. Section 1.6662–4(g)(1)(iv) is amended by removing the reference to “§1.6664–4(e)” and adding the reference “§1.6664–4(f)” in its place.

Par. 6. Section 1.6664–0 is amended by:

2. Redesignating the entries for §1.6664–4(d), (e), (f), and (g), as §1.6664–4(e), (f), (g), and (h), respectively.
3. Adding a new entry for §1.6664–4(d).

The revisions and additions read as follows:

§1.6664–0 Table of contents.

§1.6664–1 Accuracy-related and fraud penalties; definitions and special rules.

(b) ** * * *

(2) ** * * *

(i) For returns due after September 1, 1995.

(ii) For returns filed after December 31, 2002.

§1.6664–4 Reasonable cause and good faith exception to section 6662 penalties.

(c) ** * * *

(1) ** * * *

(iii) Reliance on the invalidity of a regulation.

(d) Underpayments attributable to reportable transactions.

Par. 7. Section 1.6664–1 is amended by:

1. Redesignating the text of paragraph (b)(2) as (b)(2)(i).
2. Adding a new paragraph heading for newly designated paragraph (b)(2)(i).
3. Adding paragraph (b)(2)(ii).

The revisions and additions are as follows:

§1.6664–1 Accuracy-related and fraud penalties; definitions and special rules.

(b) ** * * *

(2) ** * * *

(i) For returns due after September 1, 1995. ** * * *
For returns filed after December 31, 2002. Sections 1.6664–4(c) (relating to relying on opinion or advice) and (d) (relating to underpayments attributable to reportable transactions) apply to returns filed after December 31, 2002, with respect to transactions entered into on or after January 1, 2003. Except as provided in paragraph (b)(2)(i) of this section, §1.6664–4 (as contained in 26 CFR part 1 revised April 1, 2003) applies to returns filed with respect to transactions entered into before January 1, 2003.

Par. 8. Section 1.6664–4 is amended by:

1. Removing the language “(g) of this section” from the last sentence of paragraph (a) and adding the language “(h) of this section” in its place.

2. Revising paragraph (c)(1) introductory text and the last sentence of paragraph (c)(1)(i).

3. Adding paragraph (c)(1)(iii).

4. Redesignating paragraphs (d), (e), (f) and (g) as paragraphs (e), (f), (g) and (h), respectively.

5. Adding a new paragraph (d).

6. Removing the language “(e)” wherever it appears in newly designated paragraphs (f)(1), (f)(2)(i), (f)(2)(ii), (f)(3), and (f)(4) and adding the language “(f)” in its place.

7. Removing the language “(g)” wherever it appears in newly designated paragraphs (h)(1), (h)(1)(i), (h)(2), and (h)(3) and adding the language “(h)” in its place.

The revisions and additions read as follows:

§1.6664–4 Reasonable cause and good faith exception to section 6662 penalties.

* * * *

(c) Reliance on opinion or advice—(1) Facts and circumstances; minimum requirements. All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law. For example, the taxpayer’s education, sophistication and business experience will be relevant in determining whether the taxpayer’s reliance on tax advice was reasonable and made in good faith. In no event will a taxpayer be consider to have reasonably relied in good faith on advice (including an opinion), unless the requirements of this paragraph (c)(1) are satisfied. The fact that these requirements are satisfied, however, will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a tax advisor) in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.

(i) * * * In addition, the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or reasonably should know, to be relevant to the proper tax treatment of an item.

* * * *

(d) Underpayments attributable to reportable transactions. If any portion of an underpayment is attributable to a reportable transaction, as defined in §1.6011–4(b) (or §1.6011–4T(b), as applicable), then failure by the taxpayer to disclose the transaction in accordance with §1.6011–4 (or §1.6011–4T, as applicable) is a strong indication that the taxpayer did not act in good faith with respect to the portion of the underpayment attributable to the reportable transaction.

* * * *

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. 75126)
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.
CI—City.
COOP—Cooperative.
Cl.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.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FX—Foreign corporation.
G.C.M.—Chief Counsel’s Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
P.H.C—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.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferer.
TFR—Transferor.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
X—Corporation.
Y—Corporation.
Z—Corporation.
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Key to Abbreviations:
Ann Announcement
CD Court Decision
DO Delegation Order
EO Executive Order
PL Public Law
PTE Prohibited Transaction
Exemption
RP Revenue Procedure
RR Revenue Ruling
SPR Statement of Procedural Rules
TC Tax Convention
TD Treasury Decision
TDQ Treasury Department Order

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