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

REG–117969–00, page 533.
Proposed regulations amend previously proposed regulations that provided a functional definition of "statutory merger or consolidation" under section 368(a)(1)(A) of the Code. These proposed regulations delete the requirement that transactions must be carried out under domestic law in order to qualify as statutory mergers or consolidations. A public hearing is scheduled for May 19, 2005.

Proposed regulations amending the income tax regulations under various provisions of the Code to account for statutory mergers and consolidations under section 368(a)(1)(A) (including reorganizations described in section 368(a)(2)(D) and (E)) involving one or more foreign corporations. The regulations are issued concurrently with proposed regulations (REG–117969–00) that would amend the definition of a reorganization under section 368(a)(1)(A) to include certain statutory mergers or consolidations effected pursuant to foreign law. A public hearing is scheduled for May 19, 2005.

For purposes of the Archer MSA pilot program, under section 220(j)(2) of the Code, 2004 is not a cut-off year.

ADMINISTRATIVE

Partnership mergers. This ruling informs taxpayers that the Treasury Department and the Service intend to issue regulations under sections 704(c)(1)(B) and 737 of the Code implement the principles of Rev. Rul. 2004–43. Rev. Rul. 2004–43 revoked.

This notice provides interim guidance relating to section 6707A of the Code, Penalty for failure to include reportable transaction information with return, as added by the American Jobs Creation Act of 2004. This notice states that a taxpayer may incur a penalty under section 6707A with respect to each failure to disclose a reportable transaction within the time, in the form and manner, provided by section 6011 and its regulations.

This notice provides interim guidance relating to section 6662A of the Code, Imposition of accuracy-related penalty on understatements with respect to reportable transactions, section 6662, Imposition of accuracy-related penalty on underpayments, and section 6664, Definitions and special rules.

Income attributable to domestic production activities. This notice provides interim guidance to taxpayers regarding the deduction for income attributable to domestic production activities under section 199 of the Code. Section 199 was enacted as part of the American Jobs Creation Act of 2004, and allows a deduction equal to 3 percent (for 2005 and 2006) of the lesser of the qualified production activities income of the taxpayer for the taxable year, or the taxable income of the taxpayer for the taxable year, subject to certain limits. The applicable percentage rises to 6 percent for 2007, 2008, and 2009, and 9 percent for 2010 and subsequent years.

(Continued on the next page)
This notice provides that the Treasury Department and the Service intend to issue regulations involving partnerships under sections 704(c)(1)(B) and 737 of the Code implementing the principles of Rev. Rul. 2004–43, and that the regulations will be effective for distributions occurring after the date on which the notice is released to the public.

Like-kind exchange of a principal residence. This procedure provides guidance on applying the exclusion of gain from the sale or exchange of a principal residence under section 121 of the Code and the nonrecognition of gain from the exchange of like-kind property under section 1031 to a single exchange of property.
The IRS Mission

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

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

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

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

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

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

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

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

Section 121.—Exclusion of Gain From Sale of Principal Residence

26 CFR 1.121–1: Exclusion of gain from sale or exchange of a principal residence.

Guidance is provided on applying the exclusion of gain from the sale or exchange of a principal residence under § 121 of the Code and the nonrecognition of gain from the exchange of like-kind property under § 1031 of the Code to a single exchange of property. See Rev. Proc. 2005-14, page 528.

Section 704.—Partner’s Distributive Share

Partnership mergers. This ruling informs taxpayers that the Treasury Department and the Service intend to issue regulations under sections 704(c)(1)(B) and 737 of the Code implementing the principles of Rev. Rul. 2004–43. Rev. Rul. 2004–43 revoked.

Rev. Rul. 2005–10

Rev. Rul. 2004–43, 2004–18 I.R.B. 842, issued on April 12, 2004, addresses the application of §§ 704(c)(1)(B) and 737 to § 704(c) gain or loss that is created in an assets-over partnership merger. Rev. Rul. 2004–43 holds that § 704(c)(1)(B) applies to newly created § 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over partnership merger, but does not apply to newly created reverse § 704(c) gain or loss resulting from a revaluation of property in the continuing partnership.

Some commentators have argued that Rev. Rul. 2004–43 is not consistent with the current regulations under §§ 704(c)(1)(B) and 737, and that the conclusions in the ruling should not be applied retroactively. In response to these comments, the Treasury Department and the Service intend to issue regulations under §§ 704(c)(1)(B) and 737 implementing the principles of Rev. Rul. 2004–43. The regulations will be effective for distributions occurring after January 19, 2005. See Notice 2005–15, published in this issue of the Internal Revenue Bulletin.

EFFECT ON OTHER REVENUE RULING(S)

Rev. Rul. 2004–43 is revoked.

DRAFTING INFORMATION

The principal author of this revenue ruling is Laura Fields of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Ms. Fields at (202) 622–3050 (not a toll-free call).

Section 1031.—Exchange of Property Held for Productive Use or Investment

Guidance is provided on applying the exclusion of gain from the sale or exchange of a principal residence under § 121 of the Code and the nonrecognition of gain from the exchange of like-kind property under § 1031 of the Code to a single exchange of property. See Rev. Proc. 2005-14, page 528.
Part III. Administrative, Procedural, and Miscellaneous

New Penalty Section 6707A and Rescission Authority

Notice 2005–11

The purpose of this notice is to alert taxpayers to new section 6707A of the Internal Revenue Code. This notice announces that the Internal Revenue Service and the Treasury Department will issue regulations under section 6707A, which will apply to returns and statements the due date for which is after October 22, 2004, and provides guidance regarding the imposition and rescission of penalties under section 6707A. This notice also invites comments from the public regarding rules and standards relating to section 6707A.

BACKGROUND AND PRIOR LAW

Section 6011 and the regulations thereunder require a taxpayer that has participated in a reportable transaction to disclose certain information with respect to the reportable transaction with its tax return. Section 1.6011–4(b) of the Income Tax Regulations describes six categories of reportable transactions. One category of reportable transactions is a transaction that is the same as, or substantially similar to, one of the types of transactions that the Internal Revenue Service has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a “listed transaction.” Section 1.6011–4(b)(2).

Section 1.6011–4(d) requires that a taxpayer file a disclosure statement on Form 8886, Reportable Transaction Disclosure Statement, for each reportable transaction in which the taxpayer participated. Section 1.6011–4(e)(1) provides that a reportable transaction disclosure statement is due when the taxpayer files an original or amended return that reflects the taxpayer’s participation in a reportable transaction. The taxpayer also must send a copy of the disclosure statement to the IRS Office of Tax Shelter Analysis (OTSA) at the same time that the taxpayer first files a disclosure statement with a return. In certain circumstances, a taxpayer may be deemed to have satisfied its disclosure obligations by filing Schedule M–3, Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More, as provided by Rev. Proc. 2004–45, 2004–31 I.R.B. 140 (August 2, 2004).


Prior to the enactment of section 6707A, there was no monetary penalty for the failure by a taxpayer to disclose a reportable transaction.

THE AMERICAN JOBS CREATION ACT OF 2004

The American Jobs Creation Act of 2004, P.L. 108–357, 118 Stat. 1418 (the Act) was enacted on October 22, 2004. Section 811 of the Act added section 6707A to the Code to provide a monetary penalty for the failure to include on any return or statement any information required to be disclosed under section 6011 with respect to a reportable transaction.

Section 6707A(b)(1) provides that the penalty for failure to include information with respect to a reportable transaction, other than a listed transaction, is $10,000 in the case of a natural person, and $50,000 in any other case. Section 6707A(b)(2) provides that the penalty for failure to include information with respect to a listed transaction is $100,000 in the case of a natural person, and $200,000 in any other case.

Section 6707A(d)(1) grants the Commissioner authority to rescind all or a portion of any penalty imposed by section 6707A if (1) the violation relates to a reportable transaction that is not a listed transaction and (2) rescission of the penalty would promote compliance with the requirements of the Code and effective tax administration. Section 6707A(d)(2) provides that the Commissioner’s determination whether to rescind the penalty may not be reviewed in any judicial proceeding. The legislative history to section 6707A provides that “the IRS Commissioner or his delegate can rescind (or abate) the penalty.” H.R. Conf. Rep. No. 755, 108th Cong., 2d Sess. at 373 (2004).

Section 6707A(e) also provides that a person that is required to file periodic reports under section 13 or 15(d) of the Securities Exchange Act of 1934, or required to be consolidated with another person for purposes of those reports, must disclose the requirement to pay the following penalties in the reports to the Securities and Exchange Commission for the periods specified by the Secretary: (1) the penalty under section 6707A for failure to disclose a listed transaction; (2) the 30 percent penalty under section 6662A for an understatement attributable to an undisclosed listed transaction or undisclosed reportable avoidance transaction; and (3) the 40 percent penalty under section 6662 for a gross valuation misstatement if the 30 percent penalty under section 6662A would have applied, but for the application of section 6662A(e)(2)(c)(ii). Section 6707A(e) also provides that the failure to make a disclosure on reports filed with the Securities and Exchange Commission as required by the Secretary shall be treated as a failure to include information with respect to a listed transaction for which the penalty under section 6707A applies.

The penalty under section 6707A is in addition to any other potentially applicable penalties, including accuracy-related penalties under sections 6662 and 6662A. The penalty under section 6707A will be imposed regardless of whether the transaction results in an underpayment of tax.

Section 6707A is effective for returns and statements the due date for which is after October 22, 2004.

INTERIM GUIDANCE

The Internal Revenue Service and the Treasury Department intend to issue regulations providing rules under section 6707A. Because section 6707A is effective for returns and statements the due date for which is after October 22, 2004, however, the Service and Treasury are providing the following interim guidance regarding the imposition and rescission of penalties under section 6707A. These
interim rules will apply until further guidance is issued.

A. Imposition of the Section 6707A Penalty

The Service will impose a penalty under section 6707A with respect to each failure to disclose a reportable transaction within the time and in the form and manner provided by section 6011 and the regulations thereunder. Accordingly, a taxpayer will be subject to a penalty under section 6707A for: (1) the failure to attach a reportable transaction disclosure statement to an original or amended return; or (2) the failure to provide a copy of a disclosure statement to OTSA, if required. A taxpayer that fails to attach a reportable transaction disclosure statement to an original or amended return and fails to provide a copy of a required disclosure statement to OTSA will be subject to a single penalty under section 6707A. The following examples illustrate this provision:

Example 1: Taxpayer T was required to attach a Form 8886 to its original return for the 2005 taxable year and to send a copy of the Form 8886 to OTSA at the time it filed its original return. T failed to attach the Form 8886 to its return and failed to send a copy of the Form 8886 to OTSA. Taxpayer T is subject to a penalty under section 6707A for a failure to disclose because Taxpayer T failed to comply with both of the disclosure requirements. A penalty under section 6707A also would apply if T had failed to comply with either of the two requirements.

Example 2: Same as Example 1, except that T subsequently filed an amended return for 2005 that reflects Taxpayer T’s participation in the reportable transaction. Taxpayer T failed to attach a Form 8886 to the amended return as required by section 1.6011–4(e)(1). Accordingly, Taxpayer T is subject to an additional penalty under section 6707A for failing to disclose a reportable transaction.

The penalty under section 6707A applies to each failure to provide a disclosure statement that is required to be attached to an original or amended return filed after October 22, 2004 (with a copy sent to OTSA, if required), regardless of whether the original return was due on or before October 22, 2004. Under section 1.6011–4(e)(1), a reportable transaction disclosure statement is due upon the filing of a return or amended return reflecting a taxpayer’s participation in a reportable transaction. Accordingly, a penalty under section 6707A will not be imposed until a taxpayer fails to provide the required disclosure statement with an original or amended return, or fails to provide a copy to OTSA, if applicable, even if the return is filed after the due date. In addition, a penalty under section 6707A will not be imposed if the disclosure statement is attached to a return that is filed after the due date for filing the return unless the taxpayer fails to provide a copy of the disclosure statement to OTSA, if applicable.

B. Recission Authority

If it has been determined that a taxpayer failed to disclose a reportable transaction and a penalty is imposed under section 6707A, section 6707A(d) authorizes the Commissioner to rescind all or any portion of a penalty imposed under section 6707A only if (1) the violation relates to a reportable transaction other than a listed transaction and (2) rescission of the penalty would promote compliance with the requirements of the Code and effective tax administration. In determining whether rescission would promote compliance with the requirements of the Code and effective tax administration, the Commissioner (or his delegate) will take into account all of the relevant facts and circumstances, including: (1) whether the taxpayer has a history of complying with the tax laws; (2) whether the violation results from an unintentional mistake of fact; and (3) whether imposing the penalty would be against equity and good conscience. The Commissioner’s determination whether to rescind a penalty in whole or in part is not reviewable by the IRS Appeals Division or any court.

REQUEST FOR COMMENTS

The Service and Treasury invite interested persons to submit comments regarding rules and standards relating to section 6707A, including the factors that should be considered in exercising the rescission authority under section 6707A(d). Comments are also requested on how voluntary, but untimely disclosures (e.g., if a taxpayer failed to make a required disclosure upon filing a return, but subsequently submits the required disclosure statement) should be treated in applying the section 6707A penalty. Comments are encouraged to be submitted by February 28, 2005, to: Internal Revenue Service, CC:PA:LPD:PR (Notice 2005–11), room 5203, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions also may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (Notice 2005–11), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS e-mail address: notice.comments@irs.e-mail.address:notice.comments@irs.e-mail.address.

DRAFTING INFORMATION

The principal author of this notice is Matthew S. Cooper of the Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division. For further information regarding this notice, contact Matthew S. Cooper at 202–622–4940 (not a toll-free call).

Temporary Rules Under Section 6662A and Sections 6662 and 6664, as Amended

Notice 2005–12

The purpose of this notice is to alert taxpayers to the recent enactment of section 6662A and amendments to sections 6662 and 6664 of the Internal Revenue Code, provide interim guidance relating to these provisions and invite comments from the public regarding the rules and standards relating to section 6662A and sections 6662 and 6664, as amended.

BACKGROUND

The American Jobs Creation Act of 2004, Pub. L. No. 108–357, 118 Stat. 1418 (the Act), was enacted on October 22, 2004. Section 812 of the Act added section 6662A, which provides a new penalty for understatements with respect to reportable transactions. Section 812 also added section 6664(d), which provides a defense to the penalty under section 6662A if the taxpayer acted with reasonable cause and in good faith. Sections 812 and 819 of the Act amended section 6662(d) to modify the accuracy-related penalty under section 6662(d) for substantial understatements of income tax.
(1) Section 6662A, Imposition of Accuracy-Related Penalty on Understatements with Respect to Reportable Transactions.

Section 812 of the Act added section 6662A to the Code, which provides that a 20-percent accuracy-related penalty may be imposed on any reportable transaction understatement. Under section 6662A, a “reportable transaction understatement” means the sum of (1) the product of (A) the amount of the increase (if any) in taxable income which results from a difference between the proper tax treatment of an item to which section 6662A applies and the taxpayer’s treatment of such item (as shown on the taxpayer’s return of tax), and (B) the highest rate of tax imposed by section 1 (section 11 in the case of a corporation), and (2) the amount of the decrease (if any) in the aggregate amount of credits determined under subtitle A which results from a difference between the taxpayer’s treatment of an item to which section 6662A applies (as shown on the taxpayer’s return of tax) and the proper tax treatment of such item.

The penalty provided by section 6662A applies only (1) to listed transactions and (2) to reportable transactions (other than a listed transaction) if a significant purpose of the transaction is the avoidance or evasion of Federal income tax. In addition, a higher 30-percent penalty applies to a reportable transaction understatement if a taxpayer does not adequately disclose, in accordance with regulations prescribed under section 6011, the relevant facts affecting the tax treatment of the item giving rise to the reportable transaction understatement. The reasonable cause and good faith defense is not available with respect to the 30-percent penalty. See I.R.C. §§ 6662A(c) and 6664(d)(2)(A).

Section 6662A(e)(3) sets forth a special rule for amended returns. The tax treatment on an amendment or supplement to a return is not taken into account in determining the amount of a reportable transaction understatement if the amendment or supplement is filed after the earlier of (1) the date the taxpayer is first contacted by the IRS regarding an examination of the return or (2) any other date specified by the Secretary.

(2) Section 6662, Imposition of Accuracy-Related Penalty on Underpayments.

Section 6662(d) imposes a 20-percent accuracy-related penalty for any substantial understatement of income tax. Under section 6662(d)(1)(B), as amended, in the case of a corporation (other than an S corporation or a personal holding company), there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the lesser of (1) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, $10,000), or (2) $10,000,000. In the case of all other taxpayers, an understatement is substantial if it exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000.

Under section 6662(d)(2), an understatement is the excess of (i) the amount of tax required to be shown on the return for the taxable year over (ii) the amount of tax imposed which is shown on the return, reduced by any rebate. This excess is determined without regard to items to which section 6662A applies. The reportable transaction understatement, however, is added to the understatement calculated under section 6662(d)(2) for purposes of determining whether an understatement is substantial under section 6662(d)(1). Under section 6662A(e)(1)(B), in the case of an understatement, the addition to tax under section 6662(a) applies only to the excess of the amount of the substantial understatement over the aggregate amount of the reportable transaction understatements. Accordingly, the accuracy-related penalty attributable to substantial understatement of income tax does not apply to an understatement on which the section 6662A penalty is imposed.

Section 6662A does not apply to any portion of an understatement on which the section 6663 fraud penalty or the section 6662(h) accuracy-related penalty for a gross valuation misstatement is imposed. Section 6662(e) (substantial valuation misstatement) does not apply to any portion of an understatement on which a penalty under section 6662A is imposed.

Under section 6662(d)(2), as amended, the understatement with respect to any item attributable to a tax shelter item, including tax shelter items of taxpayers other than corporations, will not be reduced even if the taxpayer has substantial authority and a reasonable belief that the tax treatment of an item attributable to a tax shelter item was more likely than not the proper treatment. The taxpayer may, however, demonstrate reasonable cause and good faith under section 6664(c).

(3) Section 6664, Definitions and Special Rules.

The accuracy-related penalty under section 6662A does not apply with respect to any portion of a reportable transaction understatement if, pursuant to section 6664(d), it is shown that there was reasonable cause and the taxpayer acted in good faith with respect to that portion of the understatement. A taxpayer does not have reasonable cause and did not act in good faith unless (1) the relevant facts affecting the tax treatment of the item are adequately disclosed in accordance with regulations prescribed under section 6011; (2) there is or was substantial authority; and (3) the taxpayer reasonably believed that its treatment of the item was more likely than not the proper tax treatment. A taxpayer is treated as having a reasonable belief only if the belief is based on the facts and the law that exist at the time the return is filed and the belief relates solely to the taxpayer’s chances of success on the merits of the tax treatment of the issue.

An opinion of a tax advisor may not be relied upon to establish the reasonable belief of the taxpayer if the advisor or the opinion is disqualified. A tax advisor is disqualified if the tax advisor (1) is a material advisor under section 6111, as amended, and participates in the organization, management, promotion, or sale of the transaction or is related to any person who so participates; (2) is compensated directly or indirectly by a material advisor with respect to the transaction; (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained; or (4) has any other disqualifying financial interest with respect to the transaction as identified by the Secretary.

An opinion is disqualified if the opinion (1) is based on unreasonable factual or legal assumptions (including assumptions as to future events); (2) unreason-
ably relies on representations, statements, findings or agreements of the taxpayer or any other person; (3) does not identify and consider all relevant facts; or (4) fails to meet any other requirement as the Secretary may prescribe.

INTERIM PROVISIONS

The Treasury Department and the IRS intend to issue regulations implementing the requirements of section 6662A and sections 6662 and 6664, as amended. Section 812 of the Act, which added section 6662A and amended sections 6662 and 6664 is effective for taxable years ending after October 22, 2004. Section 819 of the Act, which separately amended section 6662, is effective for taxable years beginning after October 22, 2004. The Treasury Department and the IRS provide the following interim rules to implement the requirements of sections 6662, 6662A and 6664. These interim rules will apply until further guidance is issued.

(1) Adequate disclosure in accordance with section 6011

As noted above, the 30-percent penalty provided by section 6662A applies to a reportable transaction understatement if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment of the item under section 6011. A taxpayer has adequately disclosed the facts for purposes of section 6662A, and section 6664(d)(2)(A), if the taxpayer has filed a disclosure statement in the form and manner prescribed by Treas. Reg. § 1.6011–4(d) or the taxpayer has been deemed to have satisfied its disclosure obligations under Rev. Proc. 2004–45, 2004–31 I.R.B. 140 (August 2, 2004), as applicable, or any other published guidance prescribing the form and manner of disclosure under section 6011.

(2) Special rule for amended returns

For purposes of determining the amount of any reportable transaction understatement, the IRS will not take into account an amendment or supplement to a return filed after the dates specified in Treas. Reg. § 1.6664–2(c)(3) and Notice 2004–38, 2004–21 I.R.B. 949 (May 24, 2004), or any amendments thereto, which are the dates after which a taxpayer may not file a “qualified amended return.”

(3) Disqualified tax advisor

As stated above, a taxpayer may not rely on the opinion of a disqualified tax advisor to establish reasonable belief under section 6664(d). A disqualified tax advisor is any advisor who (a) is a material advisor (under section 6111, as amended) and who participates in the organization, management, promotion or sale of the transaction or is related (within the meaning of section 267(b) or 707(b)(1)) to any person who so participates, (b) has a disqualified compensation arrangement, or (c) has a disqualifying financial interest identified by the Secretary.

A material advisor is defined in Treas. Reg. § 301.6112–1. In addition, the existing rules under Treas. Reg. § 301.6112–1(c)(2), (c)(3) and (d) (without regard to the provisions relating to a transaction required to be registered under former section 6111), including the minimum fee amounts for listed transactions under Treas. Reg. § 301.6112–1(c)(3)(ii), shall apply. See Notice 2004–80, 2004–50 I.R.B. 963 (December 13, 2004). The definition of material advisor, and the rules described here, will apply for purposes of section 6662A until the IRS issues further guidance.

(a) Organization, Management, Promotion or Sale

A material advisor participates in the “organization” of a transaction if the advisor:

(1) devises, creates, investigates or initiates the transaction or tax strategy;
(2) devises the business or financial plans for the transaction or tax strategy;
(3) carries out those plans through negotiations or transactions with others; or
(4) performs acts relating to the development or establishment of the transaction.

The performance of an act relating to the development or establishment of a transaction includes preparing documents that (A) establish the structure used in connection with the transaction, e.g., a partnership agreement or articles of incorporation, (B) describe the transaction for use in the promotion or sale of the transaction, e.g., an offering memorandum, tax opinion, prospectus, or other document describing the transaction, or (C) register the transaction with any federal, state or local government body.

A material advisor participates in the “management” of a transaction if the material advisor is involved in the decision-making process regarding any business activity with respect to the transaction. Participation in the management of a transaction includes managing assets, directing business activity, or acting as general partner, trustee, director or officer of an entity involved in the transaction.

A material advisor participates in the “promotion or sale” of a transaction if the material advisor is involved in the marketing of the transaction or tax strategy. Marketing activities include: (1) soliciting, directly or through an agent, taxpayers to enter into a transaction or tax strategy using direct contact, mail, telephone or other means; (2) placing an advertisement for the transaction in a newspaper, magazine, or other publication or medium; or (3) instructing or advising others with respect to marketing of the transaction or tax strategy.

Consistent with the legislative history, a tax advisor, including a material advisor, will not be treated as participating in the organization, management, promotion or sale of a transaction if the tax advisor’s only involvement is rendering an opinion regarding the tax consequences of the transaction. In the course of preparing a tax opinion, a tax advisor is permitted to suggest modifications to the transaction, but the tax advisor may not suggest material modifications to the transaction that assist the taxpayer in obtaining the anticipated tax benefits. Merely performing support services or ministerial functions such as typing, photocopying, or printing will not be considered participation in the organization, management, promotion or sale of a transaction.

(b) Disqualified Compensation Arrangements

As stated above, a disqualified tax advisor includes a tax advisor who has a disqualified compensation arrangement. A disqualified compensation arrangement includes (1) an arrangement by which the advisor is compensated directly or indirectly by a material advisor with respect
to the transaction or (2) a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained. See I.R.C. § 6664(d)(3)(B)(ii).

Until further guidance is issued, a tax advisor also will be treated as a disqualified tax advisor, even if not a material advisor, if the tax advisor has a referral fee or a fee-sharing arrangement by which the advisor is compensated directly or indirectly by a material advisor. In addition, an arrangement will be treated as a disqualified compensation arrangement if there is an agreement or understanding (oral or written) with a material advisor of a reportable transaction pursuant to which the tax advisor is expected to render a favorable opinion regarding the tax treatment of the transaction to any person referred by the material advisor. A tax advisor will not be treated as having a disqualified compensation arrangement if a material advisor merely recommends the tax advisor who does not have an agreement or understanding with the material advisor to render a favorable opinion regarding the tax treatment of a transaction.

In addition, a disqualified compensation arrangement includes a fee that is contingent on all or part of the intended tax benefits from the transaction being sustained, including agreements that provide that (1) a taxpayer has the right to a full or partial refund of fees if all or part of the tax consequences from the transaction are not sustained or (2) the amount of the fee is contingent on the taxpayer’s realization of tax benefits from the transaction. Transactions described in Treas. Reg. § 1.6011–4(b)(4)(iii) do not give rise to a disqualified compensation arrangement.

REQUEST FOR COMMENTS

The Treasury Department and the IRS intend to issue regulations implementing section 6662A and the amendments to sections 6662 and 6664 and invite interested persons to submit comments regarding rules and standards under sections 6662, 6662A and 6664 in general and on the specific matters set forth below, including particularly item 2 under “Definition and Special Rules” regarding the extent to which a tax advisor should be permitted to suggest modifications to a transaction without becoming a “disqualified tax advisor.”

Section 6662A. Imposition of Accuracy-Related Penalty on Understatements with Respect to Reportable Transactions.

1. Definition of “reportable transaction understatement”;
2. Coordination of the reportable transaction understatement penalty with the substantial understatement penalty, including the methodology for calculating the excess of the aggregate reportable transaction understatement;
3. Coordination of the reportable transaction understatement penalty with the accuracy-related penalty on underpayments, including the penalty on underpayments attributable to negligence or disregard of rules or regulations, and the fraud penalty; and
4. Special rules for amended returns, including whether rules similar to the rules provided in Rev. Proc. 94–69, 1994–2 C.B. 804, should apply.

Section 6664. Definitions and Special Rules.

1. Definition of “disqualified tax advisor,” including definition of “participates in the management, organization, promotion or sale of a transaction”; 2. Providing suggested modifications regarding the transaction;
3. Definition of “disqualifying financial interest”;
4. Additional requirements relating to “disqualified opinions.”

Comments are encouraged to be submitted by February 28, 2005, to: Internal Revenue Service, CC:PA:LPD:PR (Notice 2005–12), room 5203, P.O. Box 7604, Ben Franklin Station, Washington, DC 20224. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (Notice 2005–12), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS e-mail address: notice.comments@irsconsel.treas.gov.

DRAFTING INFORMATION

The principal author of this notice is Heather L. Dostaler of the Office of Associate Chief Counsel (Procedure & Administration), Administrative Provisions and Judicial Practice Division. For further information regarding this notice, contact Heather L. Dostaler at (202) 622–4940 (not a toll-free call).
Section 199.—Income Attributable to Domestic Production Activities

Notice 2005–14

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SECTION 1. PURPOSE

The Internal Revenue Service and Treasury Department currently are developing regulations under § 199 of the Internal Revenue Code, enacted as part of the American Jobs Creation Act of 2004, Pub. L. No. 108–357 (the Act), regarding the deduction relating to income attributable to domestic production activities. This notice provides interim guidance on which taxpayers may rely until the regulations are issued. The Service and Treasury Department expect that the regulations will incorporate the rules set forth in this notice and will be effective for taxable years beginning after December 31, 2004, the effective date of § 199. See § 102(e) of the Act. This notice requests comments on the interim guidance provided herein and any additional guidance that should be provided in regulations. Comments must be received by March 31, 2005.

SECTION 2. OVERVIEW OF § 199

.01 In General. (1) Section 199(a)(1) allows a deduction equal to 9 percent (3 percent in the case of taxable years beginning in 2005 and 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of (a) the qualified production activities income (QPAI) of the taxpayer for the taxable year, or (b) taxable income (determined without regard to § 199) for the taxable year (or, in the case of an individual, under § 199(d)(2), adjusted gross income).

(2) Section 199(b)(1) limits the deduction for a taxable year to 50 percent of the W–2 wages paid by the taxpayer during the calendar year that ends in such taxable year. For this purpose, § 199(b)(2) defines the term “W–2 wages” to mean the sum of the aggregate amounts the taxpayer is required under § 6051(a)(3) and (8) to include on the Forms W–2 of the taxpayer’s employees during the calendar year ending during the taxpayer’s taxable year. Section 199(b)(3) provides that the Secretary shall prescribe rules for the application of § 199(b) in the case of an acquisition or disposition of a major portion of either a trade or business or a separate unit of a trade or business during the taxable year.

.02 Qualified Production Activities Income. (1) Under § 199(c)(1), QPAI is the excess of domestic production gross receipts (DPGR) over the sum of: (a) the cost of goods sold (CGS) allocable to such receipts; (b) other deductions, expenses, or losses directly allocable to such receipts; and (c) a ratable portion of deductions, expenses, and losses not directly allocable to such receipts or another class of income.

(2) Section 199(c)(2) provides that the Secretary shall prescribe rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining QPAI.

(3) Section 199(c)(3) provides special rules for determining costs in computing QPAI. Under these special rules, any item or service brought into the United States is treated as acquired by purchase, and its cost is treated as not less than its value immediately after it enters the United States. A similar rule applies in determining the adjusted basis of leased or rented property when the lease or rental gives rise to DPGR. If the property has been exported by the taxpayer for further manufacture, the increase in cost or adjusted basis must not exceed the difference between the value of the property when exported and its value when brought back into the United States after further manufacture.

(4) Section 199(c)(4)(A) defines DPGR to mean the taxpayer’s gross receipts that are derived from: (a) any lease, rental, license, sale, exchange, or other disposi-
tion of (i) qualifying production property (QPP) that was manufactured, produced, grown, or extracted (MPGE) by the taxpayer in whole or in significant part within the United States; (ii) any qualified film produced by the taxpayer; or (iii) electricity, natural gas, or potable water produced by the taxpayer in the United States; (b) construction performed in the United States; or (c) engineering or architectural services performed in the United States for construction projects in the United States. Section 199(c)(4)(B) exempts from DPGR gross receipts of the taxpayer that are derived from: (a) the sale of food and beverages prepared by the taxpayer at a retail establishment; and (b) the transmission or distribution of electricity, natural gas, or potable water.

(5) Section 199(c)(5) defines QPP to mean: (a) tangible personal property; (b) any computer software; and (c) any property described in § 168(f)(3) (certain sound recordings).

(6) Section 199(c)(6) defines a qualified film to mean any property described in § 168(f)(3) if not less than 50 percent of the total compensation relating to production of the property is compensation for services performed in the United States by actors, production personnel, directors, and producers. The term does not include property with respect to which records are required to be maintained under 18 U.S.C. § 2257 (generally, films, videotapes, or other matter that depict actual sexually explicit conduct and are produced in whole or in part with materials that have been mailed or shipped in interstate or foreign commerce, or are shipped or transported or are intended for shipment or transportation in interstate or foreign commerce).

(7) Section 199(c)(7) provides that DPGR does not include any gross receipts of the taxpayer derived from property leased, licensed, or rented by the taxpayer for use by any related person. A person is treated as related to another person if both persons are treated as a single employer under either § 52(a) or (b) (without regard to § 1563(b)), or § 414(m) or (o).

.03 Pass-thru Entities. (1) Section 199(d)(1) provides that, in the case of an S corporation, partnership, estate or trust, or other pass-thru entity, § 199 generally is applied at the shareholder, partner, or similar level, except as otherwise provided in rules applicable to individuals and patrons of cooperatives. Section 199(d)(1) further provides that the Secretary shall prescribe rules for the application of § 199, including rules relating to: (a) restrictions on the allocation of the deduction to taxpayers at the partner or similar level; and (b) additional reporting requirements.

(2) Notwithstanding the general rule that § 199 is applied at the shareholder, partner, or similar level, § 199(d)(1)(B) provides that, for purposes of applying the wage limitation of § 199(b), a shareholder, partner, or similar person that is allocated QPAI from an S corporation, partnership, estate, trust, or other pass-thru entity is also treated as having been allocated W–2 wages from such entity in an amount equal to the lesser of: (i) such person’s allocable share of such wages (without regard to this rule) as determined under regulations prescribed by the Secretary; or (ii) 2 times 9 percent (3 percent in the case of taxable years beginning in 2005 and 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the QPAI allocated to such person for the taxable year.

.04 Individuals. In the case of individuals, § 199(d)(2) provides that the deduction is equal to the applicable percent of the lesser of the taxpayer’s (1) QPAI for the taxable year, or (2) adjusted gross income (AGI) for the taxable year determined after applying §§ 86, 135, 137, 219, 221, 222, and 469, and without regard to § 199.

.05 Patrons of Certain Cooperatives. (1) Section 199(d)(3) provides special rules under which a taxpayer receiving certain patronage dividends or certain qualified per-unit retain allocations from a cooperative (to which subchapter T applies) engaged in the MPGE, in whole or in significant part, or in the marketing, of any agricultural or horticultural product is allowed a deduction under § 199 with respect to the amount of the patronage dividends or qualified per-unit retain allocations that are: (a) allocable to the portion of the cooperative’s QPAI that would be deductible by the cooperative; and (b) designated as such by the cooperative in a written notice mailed to its patrons during the payment period described in § 1382. Such an amount, however, does not reduce the taxable income of the cooperative under § 1382.

(2) In determining the portion of the cooperative’s QPAI that would be deductible by the cooperative, the cooperative’s taxable income is computed without taking into account any deduction allowable under § 1382(b) or (c) (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions) and, in the case of a cooperative engaged in marketing agricultural and horticultural products, the cooperative is treated as having MPGE, in whole or in significant part, any QPP marketed by the cooperative that its patrons have MPGE.

.06 Expanded Affiliated Groups. (1) Section 199(d)(4)(A) provides that all members of an expanded affiliated group (EAG) are treated as a single corporation for purposes of § 199. Section 199(d)(4)(B) provides that an EAG is an affiliated group as defined in § 1504(a), determined by substituting “50 percent” for “80 percent” each place it appears, and without regard to § 1504(b)(2) and (4).

(2) Section 199(d)(4)(C) provides that, except as provided in regulations, the § 199 deduction is allocated among the members of the EAG in proportion to each member’s respective amount (if any) of QPAI.

.07 Trade or Business Requirement. Section 199(d)(5) provides that § 199 is applied by taking into account only items that are attributable to the actual conduct of a trade or business.

.08 Alternative Minimum Tax. Section 199(d)(6) provides rules to coordinate the deduction allowed under § 199 with the alternative minimum tax (AMT) imposed by § 55. The deduction is allowed for purposes of the AMT, except that the deduction is equal to the applicable percent of the lesser of the taxpayer’s (1) QPAI, determined without regard to subchapter A, Part IV, of the Code; or (2) alternative minimum taxable income (AMTI). For purposes of the preceding sentence, in the case of an individual, AGI (determined without regard to § 199) shall be substituted for AMTI.

.09 Authority to Prescribe Regulations. Section 199(d)(7) authorizes the Secretary to prescribe such regulations as are necessary to carry out the purposes of § 199.
SECTION 3. EXPLANATION OF INTERIM GUIDANCE

.01 In General. Section 199 provides a deduction from gross income for an applicable percentage of QPAI subject to certain limits. Section 199 raises a number of complex issues. In general, the interim guidance provided in this notice is intended to balance the goals of: (1) ensuring compliance with the intent and purpose of § 199; and (2) providing clear, administrable rules that minimize, to the extent possible, the administrative burden on taxpayers and the Service.

.02 Wage Limitation. (1) In general. Section 4.02(1) of this notice provides rules that are used in determining the amount of “W–2 wages” of a taxpayer. Section 4.02(1) provides that for purposes of § 199(b)(2), the term “taxpayer” means “employer.” Section 4.02(1) provides that only amounts from Forms W–2, “Wage and Tax Statement,” issued for employees of the taxpayer for employment by the taxpayer are included in calculating this amount. For purposes of this calculation, employees of the taxpayer are limited to employees as defined by § 3121(d)(1) and (d)(2) (that is, officers of a corporate taxpayer and employees of the taxpayer under the common law rules). Section 4.02(1)(b) provides generally that any discussion of the term “wages” in this notice is solely for purposes of § 199 and has no application in determining whether amounts are wages for purposes of the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), federal income tax withholding, or any other wage related determination.

(2) Wages paid by other entities. Section 4.02(1) of this notice provides that a taxpayer may take into account wages paid and reported by other entities to employees of that taxpayer for employment by that taxpayer. Thus, a taxpayer may take into account wages paid by agents of the taxpayer on behalf of the taxpayer to employees of the taxpayer that are included on Forms W–2 issued by the agent. A taxpayer also may take into account wages paid by a person defined as an employer under § 3401(d)(1), to employees of the taxpayer if the wages are included on Forms W–2 issued by the § 3401(d)(1) employer.

(3) Acquisitions and dispositions of a trade or business (or major portion). Section 4.02(1)(d) of this notice provides that if a taxpayer (the successor) acquires the major portion of a trade or business or the major portion of a separate unit of a trade or business from another taxpayer (the predecessor), the successor may not take into account wages paid to common law employees of the predecessor employer in respect of services rendered to the predecessor employer, even if those wages are reported on Forms W–2 furnished by the successor.

(4) Non-duplication rule. Section 4.02(1)(e) of this notice includes a non-duplication rule, which provides that if amounts that are treated as W–2 wages for any taxable year may not be treated as W–2 wages for any other taxable year. Thus, an amount of nonqualified deferred compensation that is treated as W–2 wages under the Unmodified Box Method in section 4.02(2)(b)(i) for a taxable year may not be treated as W–2 wages in any other taxable year.

(5) Definition of W–2 wages. (a) In general. Section 4.02(2) of this notice provides rules for determining the “W–2 wages” of a taxpayer. The term “W–2 wages” includes amounts that are required to be included on statements under § 6051(a)(3) and (8) with respect to employees of the taxpayer. Because § 6051(a)(3) and (8) include the total amount of wages as defined in § 3401(a), the total amount of elective deferrals (within the meaning of § 402(g)(3)), the compensation deferred under § 457, and (for tax years beginning after December 31, 2005) the amount of designated Roth contributions (as defined in § 402A), there is no single box on the Form W–2 that necessarily includes all these items of information without including other items. Therefore, no single box on the Form W–2 meets the § 199(b)(2) definition of W–2 wages.

(b) Methods for calculating W–2 wages. Because no single box on Form W–2 satisfies the definition of W–2 wages under § 199(b)(2), section 4.02(2)(b) of this notice provides three alternative methods for calculating W–2 wages only for purposes of § 199. The first option allows for a simplified calculation while the last two options provide greater accuracy. Under the first option, a taxpayer may treat as the taxpayer’s W–2 wages under § 199(b)(2) the lesser of (A) the total entries in Box 1 of all Forms W–2 filed with the Social Security Administration (SSA) by the taxpayer with respect to employees of the taxpayer or (B) the total entries in Box 5 of all Forms W–2 filed with the SSA by the taxpayer with respect to employees of the taxpayer. Under the second option, the W–2 wages are calculated by subtracting from the total amounts reported in Box 1 of Forms W–2 with respect to employees of the taxpayer (1) amounts that are included in Box 1 that are not wages under § 3401(a) and (2) items that are treated as wages under § 3402(a) (for example, supplemental unemployment compensation benefits), and then adding those elective deferrals that are reported in Box 12 of Forms W–2 with Codes D, E, F, G, and S. Under the third option, a taxpayer may track the actual amount of wages subject to federal income tax withholding, subtract supplemental unemployment compensation benefits that were included in this amount, and then add specific elective deferrals that are reported in Box 12 of Forms W–2 with Codes D, E, F, G, and S.

.03 Determining Qualified Production Activities Income. Section 4.03 of this notice provides rules for determining a taxpayer’s QPAI for the taxable year. This notice provides that QPAI is determined on an item-by-item basis (and not, for example, on a division-by-division, a product line-by-product line, or a transaction-by-transaction basis) and is the sum of the QPAI derived by the taxpayer from each item. For purposes of this determination, QPAI from each item may be positive or negative. Section 4.04 provides rules for determining a taxpayer’s DPGR, the definition of the terms “gross receipts,” “manufactured, produced, grown, or extracted,” “by the taxpayer,” “in whole or in significant part,” and “derived from the sale, rental, license, sale, exchange, or other disposition of qualifying production property,” as well as rules for determining whether property qualifies as QPP (that is, tangible personal property, computer software, and sound recordings). See section 3.04 for an explanation of these rules. Section 4.05 provides rules for determining a taxpayer’s costs (including CGS) for purposes of computing QPAI. See section 3.05 for an explanation of the rules relating to costs. Generally, if a taxpayer is...
engaged exclusively in the manufacture of QPP within the United States and has no other sources of income, it is anticipated that QPAI will equal taxable income.

.04 Determining Domestic Production Gross Receipts. (1) In general. Section 4.04 of this notice generally provides rules for determining DPGR. A taxpayer must determine the portion of its total gross receipts that are DPGR. For example, if a taxpayer manufactures QPP at a facility inside the United States (that otherwise qualifies under § 199) and QPP at a facility outside the United States, the taxpayer generally must determine the portion of its gross receipts that are attributable to QPP manufactured inside the United States and the portion of its gross receipts that are attributable to QPP manufactured outside the United States to determine the taxpayer’s DPGR. However, section 4.03(2) provides a safe harbor under which a taxpayer with less than 5 percent of total gross receipts from items other than DPGR may treat all gross receipts as DPGR and is therefore not required to allocate its gross receipts. For example, interest and late fees relating to QPP manufactured in the United States by a taxpayer and sold by the taxpayer on credit are not DPGR, but may be treated as DPGR if the taxpayer’s interest and late fees, when aggregated with other non-DPGR, are collectively less than 5 percent of the taxpayer’s total gross receipts. The Service and Treasury Department do not believe that the interim guidance should mandate a single method of determining DPGR because the Service and Treasury Department have not identified a single method that would be appropriate for all taxpayers. Accordingly, section 4.03(2) provides that a taxpayer’s method for determining DPGR and non-DPGR must be a reasonable method that accurately identifies the gross receipts derived from activities described in § 199(c)(4) based on all of the information available to the taxpayer to substantiate the allocation. Among the factors that the Service will take into consideration in determining whether a taxpayer’s method is reasonable is whether the taxpayer is using the most accurate information available to the taxpayer; the relationship between the gross receipts and the base chosen; the accuracy of the method chosen as compared with other possible methods; whether the method is used by the taxpayer for internal management or other business purposes; whether the method is used for other federal, state, or foreign income tax purposes; the time, burden, and cost of using various methods; and whether the taxpayer applies the method consistently from year to year. For example, a taxpayer that uses a specific identification method (that is, a method that specifically identifies where the item was MPGE) for any other purpose is required to use that method to determine DPGR. Similarly, a taxpayer that has the information readily available to use a specific identification method even if it does not use that method for any other purpose generally is required to use a specific identification method to determine DPGR and the taxpayer’s use of a different, less accurate method to determine DPGR generally is not considered reasonable. However, a taxpayer that does not currently use a specific identification method for any other purpose and does not have the information readily available to use the method generally is not required to use that method to determine DPGR. See section 3.05 for an explanation of rules relating to the allocation of costs.

(2) Definition of “gross receipts.” For purposes of § 199, section 4.04(2) of this notice defines the term “gross receipts” using a definition that is derived from the definition under § 1.448–1T(f)(2)(iv)(A). In general, “gross receipts” for the taxable year are those that are properly recognized under the taxpayer’s accounting method for federal income tax purposes.

(3) Definition of “manufactured, produced, grown, or extracted.” (a) In general. In determining how this notice should define MPGE under § 199(c)(4)(A)(i)(I), the Service and Treasury Department considered how those terms have been defined under § 954 (see § 1.954–3(a)(4)(i) for the definition of manufactured or produced), and how the same or similar terms have been defined for purposes of § 38 (see § 1.48–1(d)(2)) and § 263A (see § 263A(g)(1) and § 1.263A–2(a)(1)(i)). Even though these and similar terms are used in other parts of the Code, the Service and Treasury Department believe that for this purpose the terms MPGE must be construed in light of the specific policies underlying § 199. Because the Service and Treasury Department believe that Congress intended for the deduction under § 199 to be available to taxpayers for a wide variety of production activities, section 4.04(3) of this notice defines MPGE broadly to include all of the activities specifically listed in §§ 199(c)(4)(A)(i)(I) and 263A(g)(1), and in §§ 1.48–1(d)(2) and 1.263A–2(a)(1)(i) (hereinafter referred to as “MPGE activities”). This interpretation is solely for purposes of § 199, based on the authority provided to the Secretary under § 199(d)(7), and does not affect the construction of these terms in other parts of the Code (for example, § 954(a)(1)(A)).

(b) Consistency with § 263A. The Service and Treasury Department believe that the term “producer” has been interpreted broadly under § 263A and includes within its scope all of the MPGE activities. Accordingly, the Service and Treasury Department believe that if a taxpayer claims it has MPGE QPP for the taxable year for purposes of § 199(c)(4)(A)(i)(I), it is fundamentally inconsistent for the taxpayer to claim it is not a “producer” under § 263A with respect to the QPP for the taxable year. Therefore, section 4.04(3)(b) of this notice provides that a taxpayer that has MPGE QPP for the taxable year should also consistently treat itself as a producer under § 263A with respect to the QPP for the taxable year unless the taxpayer is not subject to § 263A under the Code, regulations, or other published guidance. Taxpayers that currently are not properly accounting for their production activities under § 263A, and that wish to change their method of accounting to comply with the producer requirements of § 263A, must follow the procedures of Rev. Proc. 97–27, 1997–1 C.B. 680 (as modified and amplified by Rev. Proc. 2002–19, 2002–2 C.B. 696, as amplified and clarified by Rev. Proc. 2002–54, 2002–2 C.B. 432), or Rev. Proc. 2002–9, 2002–1 C.B. 327 (as modified and clarified by Announcement 2002–17, 2002–1 C.B. 561, modified and amplified by Rev. Proc. 2002–19, 2002–1 C.B. 696, and amplified, clarified, and modified by Rev. Proc. 2002–54, 2002–2 C.B. 432), whichever applies.

(4) Definition of “by the taxpayer.” With the exception of the rules applicable to an EAG, the Service and Treasury Department believe that the requirement of § 199(c)(4)(A)(i) that property be MPGE “by the taxpayer” means that only one taxpayer may claim the deduction under
§199 with respect to the same function performed with respect to the same property. For example, if A enters into an agreement with an unrelated customer B to manufacture 100 widgets for B, only one of the taxpayers is treated as having MPGE the widgets for purposes of §199(c)(4)(A)(i)(I). Section 4.04(4) of this notice provides that in contract manufacturing situations, if one taxpayer performs activities that constitute the MPGE of QPP or the production of a qualified film, electricity, natural gas, or potable water (collectively “qualifying activity”) pursuant to a contract with an unrelated party, then only the taxpayer that has the benefits and burdens of ownership of the property under federal income tax principles during the period the qualifying activity occurs is treated as engaging in the qualifying activity. This standard is based on the principles under §936 and §263A. In considering which standard to apply in contract manufacturing situations, the Service and Treasury Department concluded that it is not appropriate to treat property as being manufactured by the customer in a contract manufacturing situation if the customer does not have the benefits and burdens of owning the property under federal income tax principles during the period the qualifying activity occurs. This rule applies even if the customer exercises direct supervision and control over the activities of the contractor or is treated as a producer of the property pursuant to §263A(g)(2) for other reasons. If a contractor does not have the benefits and burdens of owning the property under federal income tax principles during the period the qualifying activity occurs, the contractor is more appropriately viewed as performing a service for the customer. As a result, a contractor that does not satisfy the “by the taxpayer” requirements of §199(c)(4)(A)(i) is considered to be deriving gross receipts from the provision of services and the receipts are not considered to be “derived from any lease, rental, license, sale, exchange, or other disposition of” the property within the meaning of §199(c)(4)(A)(i) (see section 4.04(7)(a)). Thus, a taxpayer that does not have the benefits and burdens of ownership of the property under federal income tax principles during the period the qualifying activity occurs does not qualify under the contract manufacturing rule for purposes of §199. To illustrate this rule, if, in the example above, A owns the widgets during the period the qualifying activity occurs (that is, A bears the benefits and burdens of ownership under federal income tax principles), the widgets will be treated as manufactured by A and not the unrelated customer B for purposes of §199(c)(4)(A)(i)(I). Conversely, if B is the owner of the widgets (that is, B bears the benefits and burdens under federal income tax principles) during the period the qualifying activity occurs, the widgets will be treated as manufactured by B, not A, for purposes of §199(c)(4)(A)(i)(I). Under this rule, either A or B may qualify for the deduction, but both cannot obtain the benefit of the deduction for the same activity. No inference is intended concerning the definition of “by the taxpayer” or “contract manufacturing” for purposes of any other provision of the Code.

(5) Definition of “in whole or in significant part.” (a) In general. To qualify for the §199 deduction, QPP must be MPGE “in whole or in significant part by the taxpayer within the United States.” Under §199, the gross receipts that are considered DPGR are not limited to the gross receipts attributable to QPP MPGE entirely by a taxpayer. For example, if a taxpayer purchases partially manufactured QPP from another taxpayer and the taxpayer satisfies the “in whole or in significant part” requirement with respect to the manufacture of the QPP, the taxpayer’s gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of that QPP will be considered DPGR. If the taxpayer satisfies the “in whole or in significant part” requirement with respect to its United States manufacturing activity associated with that QPP, the taxpayer’s gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of that QPP will be considered DPGR. Similarly, if a taxpayer manufactures QPP in significant part in the United States and exports the goods for further manufacture outside the United States, the taxpayer’s gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of that QPP will be considered DPGR, regardless of whether the QPP is imported back into the United States prior to the lease, rental, license, sale, exchange, or other disposition of the QPP (and assuming all other requirements of §199(c) are met). See section 4.04(7) of this notice for a discussion of the definition of “derived from the lease, rental, license, sale, exchange, or other disposition of qualifying production property.”

(b) Substantial in nature. Section 4.04(5)(b) of this notice provides, generally, that the “in whole or in significant part” requirement is satisfied if the taxpayer’s MPGE activity within the United States with respect to the QPP is “substantial in nature.” Whether a taxpayer’s MPGE activity is “substantial in nature” for purposes of §199 generally depends upon all of the facts and circumstances, including the relative value added by, and relative cost of, the taxpayer’s MPGE activity in the United States, the nature of the property, and the nature of the MPGE activity that the taxpayer performs in the United States. Although this “substantial in nature” requirement applies on a facts and circumstances basis like the “substantial in nature” requirement in §1.954–3(a)(4)(ii), this “substantial in nature” requirement is not the same as the requirements underlying the “not the property which it purchased” standard in §1.954–3(a)(4). In particular, the substantial transformation test of §1.954–3(a)(4)(ii) is not relevant to the determination of “substantial in nature” for purposes of §199(c)(4)(A)(i)(I). The Service and Treasury Department considered whether the general rule for determining whether the taxpayer satisfies the “in whole or in significant part” requirement should be based upon a single, quantitative criterion, such as relative value, or relative cost, of the United States activity. However, the Service and Treasury Department concluded that such a general rule would not be suitable in all circumstances. For example, assume that a taxpayer purchases gemstones and precious metal and then uses these materials to produce jewelry in the United States (for example, by cutting and polishing the gemstones, melting and shaping the metal, and combining the finished materials). The Service and Treasury Department believe that the taxpayer is properly re-

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garded as manufacturing or producing the QPP in significant part within the United States. The value added by the taxpayer’s United States manufacturing, however, may not be substantial when compared to the value of the final product because of the relatively high value of the purchased materials. Similarly, the cost of the taxpayer’s United States manufacturing may not be substantial when compared to the total cost of the product (and therefore also may not meet the safe harbor discussed below). However, the nature of the product, and the nature of the taxpayer’s United States MPGE activity, is such that the United States MPGE activity is “substantial in nature.” Accordingly, the Service and Treasury Department believe that the “substantial in nature” test should be applied by considering all of the facts and circumstances.

(c) Safe harbor. Section 4.04(5)(c) of this notice provides a safe harbor under which a taxpayer will be treated as MPGE property in whole or in significant part within the United States if, in connection with the property, conversion costs (direct labor and related factory burden) to MPGE the property are incurred by the taxpayer within the United States and the costs account for 20 percent or more of the total CGS of the property. This rule would operate similarly to the safe harbor provided under § 1.954–3(a)(4)(iii) for determining whether, for purposes of computing foreign base company sales income, the sale of property is treated as the sale of a manufactured product rather than the sale of a component part, when purchased components constitute part of the property.

(d) Certain activities and costs disregarded. The Service and Treasury Department believe that, in connection with the MPGE of QPP, packaging, repackaging, labeling, and minor assembly operations should not be considered in applying the general “substantial in nature” test, and that the costs of those activities should not be considered in applying the safe harbor. This rule is similar to the test applied in § 1.954–3(a)(4)(iii). For example, a taxpayer whose United States activities consist solely of affixing a label to a plastic bottle otherwise manufactured entirely outside the United States will not be regarded as having met the “in whole or in significant part” requirement, regardless of the value added to the bottle by the label or the relative cost incurred by the taxpayer with respect to the labeling activity. In addition, the Service and Treasury Department do not believe it is appropriate to regard a taxpayer as meeting the “in whole or in significant part” requirement if the taxpayer manufactures tangible personal property entirely outside the United States, even if the design and development activities that lead to the tangible personal property occur entirely within the United States because the design and development activities with respect to tangible personal property give rise to the creation of an intangible asset. Thus, with respect to tangible personal property, design and development activities also are disregarded for purposes of the general “substantial in nature” test, and the costs of those activities are disregarded for purposes of the safe harbor in section 4.04(5)(c) of this notice. However, with respect to computer software and sound recordings, intangible property that may constitute QPP under § 199, the Service and Treasury Department believe that a significant portion of the “production” may be viewed as design and development (for example, writing the programming code in the case of computer software, and recording and editing the master copy in the case of sound recordings). Accordingly, in the case of computer software and sound recordings, design and development activities are not disregarded for purposes of applying the “substantial in nature” test and the costs of those activities are not disregarded for purposes of the safe harbor in section 4.04(5)(c).

(6) Definition of “United States.” Section 7701(a)(9) generally provides that, for purposes of the Code, the term “United States” when used in a geographical sense includes only the 50 states and the District of Columbia. For purposes of § 199, the term United States follows the § 7701(a)(9) definition and includes the territorial waters of the United States and the seabed and subsoil of those submarine areas that are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources. However, because neither § 199 nor the legislative history explicitly include possessions and territories of the United States or the airspace over the United States and these areas within the definition of United States, the term “United States” does not include possessions and territories of the United States or the airspace over the United States and these areas for purposes of § 199. See, for example, § 638 and § 301.7701(b)–1(c)(2)(ii).

(7) Definition of “derived from the lease, rental, license, sale, exchange, or other disposition of qualifying production property.” (a) In general. Section 4.04(7) of this notice provides that gross receipts “derived from” an activity described in section 4.04(3) are limited to the direct proceeds from the lease, rental, license, sale, exchange, or other disposition of the QPP. Thus, for example, the “derived from the sale of QPP” requirement is met with respect to direct proceeds from the sale of QPP manufactured in whole or in significant part within the United States by a taxpayer for sale (assuming all other requirements of § 199(c) are met), as well as for direct proceeds from the sale of self-constructed QPP manufactured in whole or in significant part in the United States by a taxpayer and used in the taxpayer’s trade or business (assuming all other requirements of § 199(c) are met) (see section 3.05 for a discussion of determining costs with respect to the disposition of self-constructed assets). In addition, business interruption insurance and payments not to produce are treated as gross receipts “derived from the lease, rental, license, sale, exchange, or other disposition of” an activity described in section 4.04(7)(a) to the extent the payments are substitutes for gross receipts that would be so treated (assuming all other requirements of § 199(c) are met). Except as provided in section 4.04(7)(c) with respect to certain advertising income and section 4.04(7)(e) with respect to certain oil and gas partnerships, the Service and Treasury Department believe that no other receipts are within the language of § 199(c)(4)(A)(i). For purposes of the “derived from the lease, rental, license, sale, exchange, or other disposition of” requirement of § 199(c)(4)(A)(i), existing federal income tax law principles apply to determine whether a transaction is, in substance, a lease, rental, license, sale, exchange or other disposition, or whether it is a service. See for example, Rev. Rul 88–65, 1988–2 C.B. 32, which treats a short-term rental as a service. For an
allocation of gross receipts “derived from” construction performed in the United States, see section 3.04(11)(e).

(b) Allocation of gross receipts — embedded services. With certain exceptions discussed below, gross receipts derived from the performance of services do not qualify as DPGR. Accordingly, in the case of the lease, rental, license, sale, exchange, or other disposition of property that contains a service element (embedded service), section 4.04(7)(b) of this notice generally requires that the taxpayer allocate the gross receipts (as well as the costs — see section 4.05) between the property and the embedded service. The portion of the gross receipts that are considered “derived from the lease, rental, license, sale, exchange, or other disposition” of the property may not exceed the selling price of the property without the service element. Section 4.04(7)(b) provides two exceptions to the allocation requirement.

First, a taxpayer may include in DPGR gross receipts from a qualified warranty (that is, a warranty that is provided in connection with the sale of QPP if (1) in the normal course of its business, the charge for the warranty is included in the price charged for the lease, rental, license, sale, exchange, or other disposition of the QPP and (2) the warranty is neither separately offered by the taxpayer nor separately bargained for with the customer (that is, the customer cannot purchase the QPP without the warranty)). This exception is consistent with a similar exception provided in section 3.07 of Rev. Proc. 71–21, 1971–2 C.B. 549 (modified and superseded by Rev. Proc. 2004–34, 2004–22 I.R.B. 991), regarding the deferral of certain advance payments for services. Second, a de minimis amount of gross receipts from embedded services for each item of property may qualify as DPGR. A de minimis amount of gross receipts from embedded services is equal to less than 5 percent of the gross receipts of the property. If one of these exceptions is met, the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of property and the gross receipts from the embedded services are treated as “derived from the lease, rental, license, sale, exchange, or other disposition” of the property and are treated as DPGR (assuming all other requirements of § 199(c) are met). The 5 percent de minimis rule is consistent with § 1.451–5(a)(3), which generally provides that if less than 5 percent of an advance payment for goods is allocable to the provision of services, the portion so allocable will be considered as an advance payment for goods. For purposes of applying this de minimis rule, the gross receipts from a qualified warranty that are included in the price charged for the lease, rental, license, sale, exchange, or other disposition of property are not treated as gross receipts for services.

(c) Advertising income. The Service and Treasury Department believe that advertising income attributable to the sale or other disposition of newspapers and magazines should be considered “derived from” the sale or other disposition of the newspapers and magazines because the advertising income is inextricably linked to the gross receipts derived from the lease, rental, sale, exchange or other disposition of the newspapers and magazines. For example, a newspaper manufacturer’s receipts from an advertiser to publish display advertising or classified advertisements in its newspaper are treated as gross receipts derived from the sale of the newspapers for purposes of § 199 (assuming all other requirements of § 199(c) are met).

(d) Computer software. The determination of whether a transfer of computer software is a sale or exchange of property, a license generating royalty income, or a lease generating rental income is made taking into account all facts and circumstances. The form adopted by the parties to a transaction, the classification of the transaction under copyright law, and the physical or electronic or other medium used to effectuate the transfer of computer software are not determinative. See § 1.861–18.

A service provided using computer software that does not involve a transfer of the computer software does not result in gross receipts that are derived from the lease, rental, license, sale, exchange, or other disposition of computer software. Thus, with respect to computer software that is developed in the United States and sold to customers who take delivery of the software by downloading the software from the Internet, the manufacturer’s gross receipts from the sales are DPGR (assuming all other requirements of § 199(c) are met). Except as provided in the safe harbor described in section 3.04(7)(b) of this notice, gross receipts derived by a taxpayer from software that is merely offered for use to customers online for a fee are not DPGR. In addition, gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of computer software do not include gross receipts derived from: (i) providing customer support in connection with the sale of computer software; (ii) online services; or (iii) providing Internet access or telephone services over the Internet. These receipts are not DPGR because these receipts are attributable to the provision of a service and are not derived from the lease, rental, license, sale, exchange, or other disposition of the software.

(8) Definition of “qualifying production property.” (a) In general. Section 199(c)(5) provides that the term “qualifying production property” includes: (1) tangible personal property; (2) computer software; and (3) sound recordings.

(b) Tangible personal property. The definition of “tangible personal property” provided in section 4.04(8)(b) of this notice is derived primarily from, and is generally consistent with, the definition of that term under § 1.48–1(c). Consistent with § 1.48–1(c), section 4.04(8)(b) provides that local law is not controlling for purposes of determining whether property is tangible personal property under § 199(c)(5)(A). In addition to many of the items specifically referenced in § 1.48–1(c), section 4.04(8)(b) includes in the term “tangible personal property” videocassettes, computer diskettes, books, and similar items. See § 1.263A–2(a)(2)(ii). No inference is intended concerning whether these items are tangible or intangible property for purposes of any other section of the Code (for example, § 197). Treating these items as tangible personal property is consistent with the definitions provided for “computer software,” “sound recordings,” and “qualified films,” that do not include the tangible personal property (if any) in which computer software, a sound recording, or a qualified film is fixed. As a result, “tangible personal property” excludes any property that falls within the definition of computer software, a sound recording, or a qualified film. For example, a sale of a computer game on a CD-ROM has both a tangible personal property element (the disc) and a computer software element (the program fixed on the disc), but a sale...
of the same program effected instead by an internet download involves computer software only.

(c) Computer software. (i) In general. The definition of “computer software” provided in section 4.04(8)(c) of this notice is derived from the definition of that term under § 1.199–2(c)(4)(iv), but also includes the machine-readable coding for video games and similar programs, regardless of whether the program is designed to operate on a “computer” (as defined under § 168(i)(2)(B)). The term “computer software” includes all property described in section 4.04(8)(c). Thus, DPGR includes the gross receipts from computer software that was developed by the taxpayer, provided the gross receipts are derived from the lease, rental, license, sale, exchange, or other disposition of computer software as required by § 199(c)(4)(A)(i).

(ii) Tangible personal property not included. “Computer software” does not include diskettes or other tangible property on which machine-readable coding is placed, as the property is considered tangible personal property for purposes of § 199. For example, assume B, who is unrelated to A, develops software outside the United States and licenses the rights to manufacture and distribute the software to A, and A manufactures in the United States compact discs encoded with the software. Assume further that A sells the compact discs encoded with the software. A’s gross receipts from the sale of the compact discs are derived in part from the sale of tangible personal property (the compact discs), and in part from the sale of computer software. Therefore, A must allocate its gross receipts between those attributable to the software (which are not DPGR because the software was developed outside the United States) and those attributable to the compact discs (which are DPGR, assuming all other requirements of § 199(c) are met).

(d) Sound recordings. Section 199(c)(5)(C) provides that QPP includes any property described in § 168(f)(4). Section 4.04(8)(d) of this notice defines the term “sound recording” consistent with § 168(f)(4). Consistent with the definitions of computer software and qualified films, the definition of “sound recording” does not include tangible personal property in which the sound recording is fixed, such as a compact disc. This interpretation does not affect any other section of the Code (for example, § 168(f)(4)). Consequently, the results in the examples provided in section 3.04(8)(c)(ii) would be the same if, instead of software, the examples involved the production of sound recordings and compact discs that contain the sound recordings.

(9) Definition of “qualified film.” (a) In general. Section 199(c)(6) provides that the term “qualified film” means any property described in § 168(f)(3). Accordingly, section 4.04(9) of this notice defines a “qualified film” to include any motion picture film or video tape (other than certain sexually explicit visual depictions), as well as live or delayed television programming (see H.R. Conf. Rep. No. 755, 108th Cong., 2d Sess. 273 (fn. 30) (2004) (Conference Report) (hereinafter referred to collectively as “film”)) if not less than 50 percent of the total compensation relating to the production of the property is compensation for services performed in the United States by actors, production personnel, directors, and producers. Qualified films include all property described in section 4.04(9). Consistent with the definitions of “computer software” and “sound recordings,” the definition of “qualified film” is limited to the master copy of the film (or other copy from which the holder is licensed to make and produce copies), and does not include tangible personal property embodying the qualified film, such as DVDs or videocassettes. This interpretation does not affect any other section of the Code (for example, § 168(f)(3)). In no event will ticket sales for viewing qualified films constitute DPGR. Thus, for example, if A produces a qualified film, fixes the film to a tangible medium purchased from an unrelated taxpayer, and leases or licenses the qualified film and medium containing the qualified film to unrelated commercial theaters, A’s gross receipts from the lease or license of the qualified film are “derived from” (i) the lease of tangible personal property (the tangible medium on which the copy is fixed), that are not DPGR, and (ii) the license of the qualified film (the right to publicly display the film), that are DPGR. If, instead, A licenses a qualified film to unrelated taxpayer B, and B reproduces the film on DVDs or videocassettes manufactured by B in the United States, B’s gross receipts from the sale of the DVDs and videocassettes are “derived from” the sale of (i) tangible personal property (the DVDs and videocassettes), that are DPGR, and (ii) the qualified film (the motion picture fixed on the DVDs and cassettes), that are not DPGR. A taxpayer that merely writes a screenplay or other similar material is not considered to have produced a qualified film under § 199(c)(4)(A)(i)(II). Therefore, amounts that a taxpayer receives from the sale of a script or screenplay, even if it is developed into a qualified film, are not gross receipts “derived from” a qualified film. In addition, revenue from the sale of film-themed merchandise is revenue from the sale of tangible personal property, and not gross receipts “derived from” a qualified film. Finally, gross receipts derived from a license of the right to use the film characters are not gross receipts “derived from” a qualified film.

(b) Production personnel. For purposes of § 199(c)(6), the term “production personnel” includes all personnel (other than actors, directors, and producers) who are directly involved in the production of the film. Thus, “production personnel” under section 4.04(9)(a) of this notice include writers, choreographers and composers providing services during the production of a film, casting agents, camera operators, set designers, lighting technicians, make-up artists, and others whose activities are directly related to the production of the film. “Production personnel” do not include, however, individuals whose activities are ancillary to the production, such as advertisers and promoters, distributors, studio administrators and managers,
gas, or potable water, must allocate its
plains that an integrated producer that both
requirements of § 199(c) are met). DPGR
in the United States (assuming all other
does not include, however, gross receipts
other disposition of electricity, natural gas,
or potable water produced by the taxpayer
taxpayer uses that method consistently.
In the case of a taxpayer that excludes
method that excludes participations and residuals from
adjusted basis of the qualified film, the taxpayer must use the same estimate of
capitalizes participations and residuals into
the adjusted basis of the qualified film, the taxpayer must use the same estimate of
requirements of § 199 that it uses for purposes of
In the case of a taxpayer that
production activities with respect
§ 167(g)(7)(D)(i), the taxpayer must deter-
determination the compensation expected to be
paid as participations and residuals based
the total forecasted income used in
determining income forecast depreciation.
(d) Determination of 50 percent. The Service and Treasury Department do not
believe that a single method of allocating compensation between services performed
within the United States and services performed outside the United States is ap-
propriate for all taxpayers. Accordingly, section 4.04(9)(c) of this notice provides
that a taxpayer may use any reasonable method of making the allocation. Among
the factors to be considered in determining whether a taxpayer’s method of allocating
compensation is reasonable is whether the taxpayer uses that method consistently.
(10) Electricity, natural gas, and potable water. (a) In general. DPGR includes gross receipts derived from any
lease, rental, license, sale, exchange, or
other disposition of electricity, natural gas,
or potable water produced by the taxpayer
in the United States (assuming all otherrequirements of § 199(c) are met). DPGR
does not include, however, gross receipts of the taxpayer derived from the transmis-
sion or distribution of these items. The Conference Report at 272–3 (fn. 28) ex-
plains that an integrated producer that both
produces and delivers electricity, natural gas, or potable water, must allocate its
gross receipts between: (i) production that
qualifies as DPGR; and (ii) distribution and transmission (that do not qualify as
DPGR). Thus, section 4.04(10)(d) of this
notice generally requires such allocation.
However, if less than 5 percent of a tax-

do not include, however, gross receipts
derived from the sale of electricity, natural gas, or potable water areattributable to the transmission and distribution of such electricity, natural gas,
or potable water, then the gross receipts derived from that sale that are attributable
to the transmission and distribution of such items will be treated for purposes of
§ 199 as being DPGR.
(b) Natural gas. Section 4.04(10)(b) of this notice defines the term “natural gas”
in a manner consistent with § 613A(e)(2)
and generally includes only natural gas
extracted from a natural deposit. Thus,
natural gas would not include, for example,
methane gas extracted from a land-fill.
Consistent with the Conference Re-
port at 272–3 (fn. 28), section 4.04(10)(b)
provides that, in the case of natural gas,
production activities include all activities
involved in extracting natural gas from the
ground and processing the gas into
pipeline quality gas.
(c) Potable water. Section 4.04(10)(c)
of this notice provides that, consistent
with the Conference Report at 272–3
(fn. 28), production activities with respect
to potable water include the acquisition,
collection, and storage of raw water (un-
treated water), transportation of raw water
to a water treatment facility, and treat-
ment of raw water at such a facility. Thus,
gross receipts derived from any of these
activities performed in the United States
are included in DPGR (assuming all otherrequirements of § 199(c) are met). DPGR
does not include, however, gross receipts derived from the storage of potable wa-
ter after completion of treatment of the
potable water, or delivery of potable water
to customers. The Service and Treasury
Department believe that Congress inten-
ded for the provision relating to potable
water to apply to water utilities, not to
taxpayers engaged in the trade or business of
producing bottled water. As a result,
for purposes of § 199 the production of
bottled water will be treated as the produc-
tion of tangible personal property under
§ 199(c)(5)(A) and not the production of
potable water under § 199(c)(4)(A)(ii)(III).
Accordingly, with respect to a taxpayer
that produces bottled water in the United
States, the gross receipts from which
would otherwise qualify as DPGR, DPGR
also includes the gross receipts attributable
to the distribution of the bottled water and
no allocation between the production and
distribution of the bottled potable water is required.
(11) Definition of “construction performed in the United States.” (a) Construc-
tion of real property. Section 4.04(11)(a)
of this notice defines the term “construction” under § 199(c)(4)(A)(ii) to mean the
construction of real property (that is, resi-
dential and commercial buildings (includ-
ing items that are structural components of
such buildings), inherently permanent
structures other than tangible property in
the nature of machinery, inherently perma-
nent land improvements, and infrastructure).
Section 4.04(11)(a) makes clear that
local law is not controlling for purposes of
determining whether or not property is
real property for purposes of “construction” under § 199(c)(4)(A)(ii). See
Conference Report at 271 (fn. 26). Tangible
personal property (as defined under sec-
4.04(8)(b)) (for example, appliances,
furniture and fixtures) that is sold as part
of a construction project is not considered
real property for this purpose. Under sec-
4.04(11)(a), however, if more than 95
percent of the total gross receipts derived by a taxpayer from a construction project
are attributable to real property (as defined
in § 1.263A–8(c)), the total gross receipts
derived by the taxpayer from the project
are DPGR from construction (assuming all
other requirements of § 199 are met).
(b) Activities constituting construction.
The Service and Treasury Department
believe the term “construction” includes
most activities that are typically performed in connection with the erection or substan-
tial renovation of real property, but does
not include tangential services such as
hauling trash and debris, and delivering
materials, even if the tangential services
are essential for construction. However,
if a taxpayer performing construction also,
in connection with the construction project, provides tangential services such as
delivering materials to the construction
site and removing its construction
debris, the gross receipts derived from
such tangential services are DPGR. Im-
proving land (for example, grading and
landscaping) and painting are activities that are considered “construction,” but
only if they are performed in connection
with other activities (whether or not by
the same taxpayer) that constitute the erection or substantial renovation of real property.
The term “construction” does not include any activity that is within the definition of “engineering and architectural services” (see section 4.04(11)(b) of this notice).

(c) Definition of “infrastructure.”

The term “infrastructure,” for purposes of § 199, includes roads, power lines, water systems, railroad spurs, and communications facilities. See § 168(j)(4)(C)(ii). The term also includes sewers, sidewalks, cable, and wiring. See § 1.263A–12(e)(2)(iii). The term also includes inherently permanent oil and gas platforms.

(d) Definition of “substantial renovation.”

The Service and Treasury Department believe that the standard to be applied in determining whether there has been a substantial renovation of real property is the standard applied under § 263(a) to determine whether a taxpayer’s activities result in permanent improvements or betterments of property, such that the cost of the activities must be capitalized. Accordingly, consistent with the rules under § 263(a), section 4.04(11)(d) of this notice defines the term “substantial renovation” to mean the renovation of a major component or substantial structural part of real property that materially increases the value of the property, substantially prolongs the useful life of the property, or adapts the property to a new or different use. See § 263(a) and the regulations thereunder.

(e) Derived from construction.

(i) In general.

The definitions provided in section 4.04(12) of this notice of the terms “engineering services” and “architectural services” for purposes of § 199(c)(4)(A)(iii) are the same as those provided in § 1.924(a)–1T(e)(5) and –1T(e)(6) without regard to the special rules of § 1.924(a)–1T(e)(2) and –1T(e)(3). Section 199(c)(4)(A)(iii) provides that such services must be performed in the United States for a construction project in the United States. This notice requires that: (1) the engineering or architectural services relate to real property; (2) the services be performed in the United States; and (3) the taxpayer providing these services be able to substantiate that the services relate to a construction project within the United States.

(ii) Performance of services in the United States.

Section 4.04(12)(d) of this notice provides a safe harbor under which, if, in connection with a construction project in the United States, the gross receipts derived from engineering or architectural services (1) performed outside the United States or (2) related to property other than real property are less than 5 percent of the total gross receipts derived from engineering or architectural services performed by the taxpayer with respect to the same construction project, the receipts will be treated as DPGR derived from engineering or architectural services performed in the United States for a construction project in the United States (assuming all other requirements of § 199(c) are met).

(ii) Taxpayers deriving gross receipts from construction.

The Service and Treasury Department believe that it is appropriate, in certain situations, for more than one taxpayer to be regarded as deriving gross receipts from construction with respect to the same activity and the same construction project. For example, if X (who is not in the trade or business of construction and is the owner, under federal income tax principles, of a building within the United States) retains Y (a general contractor) to oversee a “substantial renovation” of the building, and Y retains Z (a subcontractor) to install a new electrical system in the building as part of that substantial renovation, the amounts that Y receives from X, and amounts that Z receives from Y, qualify as DPGR. The proceeds that X receives from the subsequent sale of the building do not qualify as DPGR because X did not engage in any activity constituting construction.

(12) Definition of “engineering and architectural services.”

(a) In general.

The Service and Treasury Department believe that DPGR “derived from construction” performed in the United States are gross receipts derived from “any lease, rental, license, sale, exchange, or other disposition of” property. The Service and Treasury Department believe that gross receipts from the rental of real property that the taxpayer constructs are not derived from construction, but are instead compensation for the use or forbearance of the property. Accordingly, in the case of construction, DPGR does not include gross receipts from the lease or rental of constructed real property. However, DPGR may include the proceeds of a sale, exchange, or other disposition of real property constructed in the United States (whether or not the property is sold immediately after construction is completed) if all other requirements of § 199(c) are met. DPGR also includes compensation received for construction services performed in the United States (assuming all other requirements of § 199(c) are met).

(b) Performance of services in the United States.

To determine its QPAI for the taxable year, a taxpayer must reduce its DPGR by the amount of CGS directly allocable
to DPGR, the amount of deductions, expenses, and losses (deductions) directly allocable to DPGR and a ratable portion of other deductions not directly allocable to DPGR, or another class of income. Section 199(c)(2) directs the Secretary to prescribe rules for the proper allocation of these items. The legislative history of § 199 indicates that, when appropriate, these rules should be similar to, and consistent with, the relevant cost allocation rules provided by §§ 263A and 861. A taxpayer’s costs must be determined using the taxpayer’s accounting method for federal income tax purposes. Section 4.05 of this notice provides rules for determining CGS directly allocable to DPGR and rules to determine deductions allocated and apportioned to DPGR. Pursuant to the authority granted by § 199(c)(2), the cost determination rules provided in section 4.05 do not differentiate between deductions directly allocable to DPGR under § 199(c)(1)(B)(ii) and other deductions that are not directly allocable to DPGR or another class of gross income under § 199(c)(1)(B)(iii).

(2) Allocation of cost of goods sold. Section 4.05(2) of this notice provides rules for determining the CGS directly allocable to DPGR. Generally, CGS must be specifically identified with, or directly traced to, DPGR in accordance with the taxpayer’s books and records. However, if the taxpayer’s books and records do not allow the taxpayer to identify the CGS directly allocable to DPGR, the taxpayer may use a reasonable method to allocate CGS between DPGR and other gross receipts. If a method is used to allocate gross receipts between DPGR and non-DPGR, the taxpayer may not use a different method for purposes of allocating CGS. For purposes of § 199, CGS includes the cost of inventoriable goods sold during the year as well as the adjusted basis of noninventory property sold or exchanged during the year.

(3) Allocation and apportionment of deductions. (a) Three alternative methods. Section 4.05 of this notice provides three methods for allocating and apportioning deductions. Under the first method (the § 861 method), which is available to all taxpayers, a taxpayer determines the deductions allocated and apportioned to DPGR by applying the allocation and apportionment rules provided by §§ 1.861–8 through 1.861–17 and §§ 1.861–8T through 1.861–14T (the § 861 regulations) subject to the provisions of this notice. This notice provides special rules for apportioning certain charitable deductions and research and experimentation deductions. The Service and Treasury Department recognize that these allocation and apportionment rules may be burdensome to certain taxpayers that otherwise would not be required to use these rules, particularly for taxpayers that are not currently using the section 861 cost allocation regime. Accordingly, section 4.05 provides two alternative apportionment methods for certain taxpayers, with a goal of minimizing the need for smaller taxpayers to devote additional resources to compliance. Any taxpayer with average annual gross receipts of $25,000,000 or less may use the simplified deduction method. Under the simplified deduction method, a taxpayer’s deductions generally are ratably apportioned between DPGR and other receipts based on relative gross receipts. The Service and Treasury Department invite comments on the appropriateness of the gross receipts threshold for use of the simplified deduction method. Alternatively, a qualifying small taxpayer may use the small business simplified overall method to allocate CGS and deductions to DPGR. A qualifying small taxpayer is a taxpayer that has average annual gross receipts of $5,000,000 or less or a taxpayer that is eligible to use the cash method as provided in Rev. Proc. 2002–28, 2002–1 C.B. 815. For purposes of the simplified deduction method and the small business simplified overall method, a taxpayer meets the applicable average annual gross receipts test if the average annual gross receipts of the taxpayer for the 3 taxable years (or, if fewer, the taxable years during which the taxpayer was in existence) preceding the current taxable year do not exceed the applicable gross receipts threshold. Preceding taxable years are included even if one or more of such taxable years began before the effective date of § 199. In the case of any taxable year of less than 12 months (a short taxable year), the gross receipts must be annualized by (a) multiplying the gross receipts for the short period by 12 and (b) dividing the result by the number of months in the short period. Whether the members of an EAG may use the simplified deduction method or the small business simplified overall method is determined by reference to the average annual gross receipts of the EAG. To compute the average annual gross receipts of an EAG, the gross receipts of each member of the EAG for its taxable year that ends with or within the taxable year of the member that is computing its § 199 deduction are aggregated, regardless of whether the computing member or the non-computing member was a member of the EAG during its entire taxable year. A member of an EAG that qualifies to use the simplified deduction method or the small business simplified overall method may do so only if all members of the EAG agree to and use the same method.

(b) Treatment of certain deductions. Section 4.05(3)(b) of this notice clarifies that certain deductions do not reduce DPGR or gross income attributable to DPGR under any of the three methods. A loss generated by the sale of property reduces DPGR or gross income attributable to DPGR only if the proceeds from the sale of the property are, or would have been, included in DPGR. A deduction allowed under § 172 for a net operating loss is not allocated or apportioned to DPGR or gross income attributable to DPGR. Under § 199(d)(5), deductions not attributable to the actual conduct of a trade or business are not taken into account under § 199 and, therefore, are not allocated or apportioned to DPGR or gross income attributable to DPGR.

.06 Application of § 199 to Pass-thru Entities. (1) In general. In the case of an S corporation, partnership, estate or trust, or other pass-thru entity, § 199 is applied at the partner, shareholder or similar level. The Service and Treasury Department believe that Congress intended § 199 to be applied in a manner consistent with the economic arrangement of the owners of a pass-thru entity. The Service and Treasury Department believe that this objective can be accomplished by allowing each owner to compute its § 199 deduction by taking into account its distributive or proportionate share of the items (including items of income, gain, loss, deduction, cost of goods sold allocated to such items of income, and gross receipts that are included in such items of income) allocated or attributable, in accordance with section 4.06 of this notice, to the pass-thru entity’s activities described in § 199(c)(4)
(qualified production activities), provided the items are not otherwise disallowed by the Code. For purposes of computing the § 199(b) limitation, an owner’s share of W–2 wages of a pass-thru entity is the lesser of the owner’s allocable share of the pass-thru entity’s W–2 wages or 2 times the applicable percentage of the owner’s QPAI computed taking into account only the items of the pass-thru entity allocated to the owner for the taxable year. The owner of the pass-thru entity will aggregate its items of income or expense (including W–2 wages) allocated or attributable to the pass-thru entity’s qualified production activities, including those expenses incurred by the owner of the pass-thru entity directly that are allocated to the pass-thru entity’s qualified production activities, and the owner’s items of income or expense (including W–2 wages) allocated or attributable to its other qualified production activities.

(2) Gain or loss from the disposition of an interest in a pass-thru entity. Because the sale of an interest in a pass-thru entity does not reflect the realization of QPAI by that entity, QPAI generally does not include gain or loss recognized on the sale, exchange or other disposition of an interest in the entity. However, if § 751(a) or (b) applies, gain or loss allocated to assets of the partnership the sale, exchange, or other disposition of which would give rise to an item of QPAI is taken into account in computing the partner’s § 199 deduction.

(3) Effective date of § 199 for pass-thru entities. Section 199(e) provides that § 199 applies for taxable years beginning after December 31, 2004. Accordingly, section 4.06(3) of this notice provides that § 199 only applies to taxable years of pass-thru entities that begin on or after January 1, 2005. The Service and Treasury Department recognize that a pass-thru entity will need to provide certain information to its patrons to allow the patrons to compute the § 199 deduction. The Service and Treasury Department intend to provide rules relating to such information reporting by cooperatives in future guidance.

.08 Expanded Affiliated Groups. (1) In general. All members of an EAG are treated as a single corporation for purposes of § 199. An EAG is an affiliated group as defined in § 1504(a), determined by substituting “50 percent” for “80 percent” each place it appears, and without regard to § 1504(b)(2) and (4). Therefore, a single § 199 deduction is computed for the EAG and then that deduction is allocated among members of the EAG.

(2) Computation of expanded affiliated group’s § 199 deduction. (a) In general. The Service and Treasury Department believe that the § 199 deduction of the EAG must be computed by aggregating each member’s taxable income or loss, QPAI, and W–2 wages. For this purpose, a member’s QPAI is the member’s DPGR less the sum of the CGS allocable to the receipts and other costs required to be allocated under section 4.05 of this notice. For purposes of this determination, a member’s QPAI may be positive or negative. A member’s taxable income or loss and QPAI shall be determined by reference to the member’s methods of accounting. However, pursuant to § 199(c)(7)(A), a member’s DPGR shall not include any gross receipts of the member derived from property leased, licensed, or rented by it for use by any related person as defined in § 199(c)(7)(B).

(b) Attribution of activities. For purposes of determining whether gross receipts are DPGR, the Service and Treasury Department believe that each member of an EAG should be treated as conducting the activities conducted by each other member of the EAG. Thus, if Corporation X and Corporation Y are members of the same EAG and X manufactures QPP in the United States and sells the QPP to Y and Y then sells the same item to an unrelated party, X’s production activities are attributed to Y. Accordingly, the proceeds of X’s sale to Y and Y’s sale to the unrelated party are DPGR for X and Y, respectively (assuming all other requirements of § 199 are met).

(c) Anti-avoidance rule. Although transactions between members of an EAG are disregarded in computing the EAG’s § 199 deduction only to the extent provided in § 199(c)(7), if a transaction between members of an EAG is engaged in or structured with a principal purpose of qualifying for, or modifying the amount of, the § 199 deduction for one or more members of the EAG, adjustments must be made to eliminate the effect of the transaction on the computation of the § 199 deduction.

(3) Allocation of expanded affiliated group’s § 199 deduction. The EAG’s § 199 deduction is allocated among members of the EAG in proportion to each member’s QPAI, if any, regardless of whether the EAG member has taxable income or loss for the taxable year and regardless of whether the EAG member has W–2 wages for the taxable year. For this purpose, if a member has negative QPAI, the QPAI of the member shall be treated as zero.

(4) Special rules for consolidated groups. The Service and Treasury Department believe that, for purposes of § 199, if an EAG includes members of a consolidated group (as defined in § 1.1502–1(h)), the members of the consolidated group should be treated as a single member of the EAG. Therefore, if an EAG includes corporations that are members of a consolidated group and corporations that are not members of a consolidated group, in computing the taxable income limitation of the EAG, the consolidated taxable income of the consolidated group, not the separate taxable income of the members of the consolidated group, is taken into account. If all of the members of an EAG are members of the same consolidated group, the consolidated group’s § 199 deduction is determined based on the group’s consolidated taxable income or loss, not the separate taxable income or loss of its members. The § 199 deduction of a consolidated group (or the § 199 deduction allocated to a consolidated group that is a member of an EAG) must be allocated to the members of the consolidated group in proportion to each consolidated group member’s QPAI, if any, regardless of whether the consolidated group member has separate taxable income or loss for the taxable year and regardless of whether the member has W–2 wages for the taxable year. For purposes of allocating the § 199 deduction of a consolidated group among...
its members, if a consolidated group member has negative QPAI, the QPAI of the member shall be treated as zero.

(5) Identification of members of the expanded affiliated group. The Service and Treasury Department believe that whether a corporation is a member of an EAG must be determined on a daily basis. Therefore, a corporation may be a member of an EAG on January 1 but not a member of the EAG on January 2. If a corporation becomes or ceases to be a member of an EAG, the corporation is treated as becoming or ceasing to be a member of the EAG at the end of the day on which its status as a member changes.

(6) Allocation of income and loss. A corporation that is a member of an EAG for only a portion of its taxable year must allocate its taxable income or loss, QPAI, and W–2 wages between the portion of the taxable year during which it is a member of the EAG and the portion of the taxable year during which it is not a member of the EAG. In general, this allocation of items must be made by using the pro rata allocation method described in section 4.09(6)(a)(i) of this notice. However, the corporation may elect to use the closing of the books method described in section 4.09(6)(a)(ii). Section 4.09(6)(a)(iii) prescribes rules for the time and manner of making the election to use the closing of the books method.

(a) Pro rata allocation method. Under the pro rata allocation method, an equal portion of each of the taxable income or loss, QPAI, and W–2 wages for the taxable year is assigned to each day of the corporation’s taxable year. Then, those items assigned to those days during which the corporation was a member of the EAG are aggregated.

(b) Closing of the books method. Under the closing of the books method, taxable income or loss, QPAI, and W–2 wages for the period during which the corporation was a member of the EAG are computed by treating the corporation’s taxable year as two separate taxable years, the first of which ends at the close of the day on which the corporation’s status as a member of the EAG changes and the second of which begins at the beginning of the day after the corporation’s status as a member of the EAG changes.

(7) Total § 199 deduction for a corporation that is a member of an expanded affiliated group for some or all of its taxable year. If a corporation is a member of an EAG for its entire taxable year, the corporation’s § 199 deduction for the taxable year is the amount of the § 199 deduction of the EAG allocated to the corporation by the EAG. If a corporation is a member of an EAG for a portion of its taxable year, and is either not a member of any EAG, or is a member of another EAG, or both, for another portion of the taxable year, the corporation’s § 199 deduction for the taxable year is the sum of its § 199 deductions for each portion of the taxable year.

(8) Computation of § 199 deduction for members of Expanded Affiliated Group with different taxable years. If members of an EAG have different taxable years, in computing the § 199 deduction of a member (the “computing member”), with respect to each member of the EAG, the computing member is required to take into account the taxable income or loss, QPAI, and W–2 wages that are both (1) attributable to the period during which the member of the EAG and the computing member are both members of the EAG, and (2) taken into account in a taxable year that begins after the effective date of § 199 and ends with or within the taxable year of the computing member with respect to which the § 199 deduction is computed.

SECTION 4. INTERIM GUIDANCE

.01 In General. Under § 199(a)(1), a taxpayer may deduct an amount equal to 9 percent (3 percent in the case of taxable years beginning in 2005 and 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of the taxpayer’s QPAI (as defined in section 4.03 of this notice) for the taxable year, or the taxpayer’s taxable income (determined without regard to § 199) for the taxable year. For purposes of the preceding sentence, the definition of taxable income under § 63 shall apply.

.02 Wage Limitation. (1) Rules of application. (a) In general. Pursuant to § 199(b)(1), the amount of the deduction allowable to the taxpayer under § 199(a) for any taxable year shall not exceed 50 percent of the W–2 wages of the taxpayer. For this purpose, except as provided in section 4.02(1)(c) of this notice, the Forms W–2 used in determining the amount of W–2 wages are those issued for the calendar year ending during the taxpayer’s taxable year for wages paid to employees (or former employees) of the taxpayer for employment by the taxpayer. For this purpose and for purposes of section 4.02, employees of the taxpayer are limited to employees of the taxpayer as defined in § 3121(d)(1) and (d)(2) (that is, officers of a corporate taxpayer and employees of the taxpayer under the common law rules). For purposes of § 199(b)(2), the term “taxpayer” means “employer.” In determining W–2 wages a taxpayer may take into account any wages paid by another entity and reported by the other entity on Forms W–2 with the other entity as the employer listed in Box c of the Forms W–2, provided that the wages were paid to employees of the taxpayer for employment by the taxpayer. If the taxpayer is treated as an employer described in § 3401(d)(1) because of control of the payment of wages (that is, the taxpayer is not the common law employer of the payee of the wages), the payment of wages may not be included in determining W–2 wages of the taxpayer. If the taxpayer is paying wages as an agent of another entity to individuals who are not employees of the taxpayer, the wages may not be included in determining the W–2 wages of the taxpayer.

(b) No application in determining whether amounts are wages for employment tax purposes. The discussion of “wages” in this notice is for purposes of § 199 only and has no application in determining whether amounts are wages under § 3121(a) for purposes of the FICA, under § 3306(b) for purposes of the FUTA, under § 3401(a) for purposes of the Collection of Income Tax at Source on Wages (federal income tax withholding), or any other wage related determination.

(c) Application in case of taxpayer with short taxable year. In the case of a taxpayer with a short taxable year, subject to the rules of section 4.02(1)(a) of this notice, the W–2 wages of the taxpayer for the short taxable year shall include those wages paid during the short taxable year to employees of the taxpayer as determined under the tracking wages method. Under the tracking wages method described in section 4.02(2)(b)(iii), the taxpayer must calculate W–2 wages by tracking wages actually paid during the short taxable year to employees, subject to the modifications that in step (B) only the supplemental un-
employment compensation benefits paid during the short taxable year are required to be deducted and that in step (C) of such method only the portions of the amounts reported in Box 12, Codes D, E, F, G, and S actually deferred or contributed during the short taxable year may be included in the W–2 wages.

(d) Acquisition or disposition of a trade or business (or major portion). If a taxpayer (a successor) acquires the major portion of a trade or business or the major portion of a separate unit of a trade or business from another taxpayer (a predecessor), the W–2 wages of each of the successor and predecessor for purposes of computing the § 199 deduction shall be computed pursuant to the rules of this notice, including sections 4.02(1) and 4.02(2) of this notice, regardless of whether the W–2 wages are reported on Forms W–2 furnished by the successor or Forms W–2 furnished by the predecessor.

(e) Non-duplication rule. Amounts that are treated as W–2 wages for a taxable year under any method may not be treated as W–2 wages of any other taxable year.

(2) Definition of “W–2 wages.” (a) In general. Section 199(b)(2) defines W–2 wages for purposes of § 199(b)(1) as the sum of the amounts required to be included on statements under § 6051(a)(3) and (8) with respect to employment of employees of the taxpayer for the calendar year. Thus, the term W–2 wages includes: (i) the total amount of wages as defined in § 3401(a); (ii) the total amount of elective deferrals (within the meaning of § 402(g)(3)); (iii) the compensation deferred under § 457; and (iv) for tax years beginning after December 31, 2005, the amount of designated Roth contributions (as defined in § 402A). Under the 2004 and 2005 Form W–2, the elective deferrals under § 402(g)(3) and the amounts deferred under § 457 directly correlate to coded items reported in Box 12 on Form W–2. Box 12, Code D is for elective deferrals to a § 401(k) cash or deferred arrangement; Box 12, Code E is for elective deferrals under a § 403(b) salary reduction agreement; Box 12, Code F is for elective deferrals under a § 408(k)(6) salary reduction Simplified Employee Pension (SEP); Box 12, Code G is for elective deferrals under a § 457(b) plan; and Box 12, Code S is for employee salary reduction contributions under a § 408(p) SIMPLE (simple retirement account).

(b) Methods for calculating W–2 wages. Taxpayers may use one of three methods in calculating W–2 wages. These three methods are subject to the non-duplication rule provided in section 4.02(1)(e) of this notice, and the tracking wages method is subject to the rule provided in section 4.02(1)(c), if applicable.

(i) Unmodified box method. Under this method, W–2 wages are calculated by taking, without modification, the lesser of:
(A) The total entries in Box 1 of all Forms W–2 filed with the SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer; or
(B) The total entries in Box 5 of all Forms W–2 filed with the SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer.

(ii) Modified Box 1 method. Under this method, the taxpayer makes modifications to the total entries in Box 1 of Forms W–2 filed with respect to employees of the taxpayer. W–2 wages under this method are calculated as follows:
(A) Total the amounts in Box 1 of Forms W–2 with respect to employees of the taxpayer for employment by the taxpayer; 

(B) Subtract from the total in Step (A) amounts that are reported in Box 5 of all Forms W–2 filed with respect to employees of the taxpayer; (C) Add to the amount obtained after Step (B) amounts that are included in Box 1 of Forms W–2 that are not wages for federal income tax withholding purposes and amounts included in Box 1 of Forms W–2 that are treated as wages under § 3402(o) (for example, supplemental unemployment compensation benefits); and

(C) Add to the amount obtained after Step (B) amounts that are reported in Box 12 of Forms W–2 with respect to employees of the taxpayer for employment by the taxpayer that are properly coded D, E, F, G, or S.

(iii) Tracking wages method. Under this method, the taxpayer actually tracks total wages subject to federal income tax withholding and makes appropriate modifications. W–2 wages under this method are calculated as follows:
(A) Total the amounts of wages subject to federal income tax withholding that are paid to employees of the taxpayer for employment by the taxpayer and that are reported on Forms W–2 for the calendar year;

(B) Subtract from the total in Step (A) the supplemental unemployment compensation benefits (as defined in § 3402(o)(2)(A)) that were included in the total in Step A; and

(C) Add to the amount obtained after Step (B) amounts that are reported in Box 12 of Forms W–2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G, or S.

.03 Determining Qualified Production Activities Income. (1) In general. Section 199(c)(1) defines QPAI for any taxable year as an amount equal to the excess (if any) of (A) the taxpayer’s DPGR (as defined in section 4.04 of this notice), over (B) the sum of (i) the CGS that are allocable to such receipts (see section 4.05), (ii) other deductions, expenses, or losses directly allocable to such receipts (see section 4.05), and (iii) a ratable portion of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income (see section 4.05). For purposes of § 199, QPAI is determined on an item-by-item basis (and not, for example, on a division-by-division, product line-by-product line, or transaction-by-transaction basis) and is the sum of QPAI derived by the taxpayer from each item. For purposes of this determination, QPAI from each item may be positive or negative. For example, if a taxpayer manufactures a shirt and a hat in the United States, and the QPAI derived from the manufacture of the shirt is $3 and the QPAI derived from the manufacture of the hat is ($1), the taxpayer’s QPAI is $2.

(2) Allocation of gross receipts. A taxpayer must determine the portion of its gross receipts that are DPGR and the portion of its gross receipts that are not DPGR. For example, if a taxpayer leases, rents, licenses, sells, exchanges, or otherwise disposes of QPP, the gross receipts of which constitute DPGR, and engages in transactions with respect to similar property, the gross receipts of which do not constitute DPGR, the taxpayer must allocate its gross receipts from all the transactions based on a reasonable method that is satisfactory to the Secretary and that accurately identifies the gross receipts that constitute DPGR. Factors taken into consideration in determining whether the method is reasonable include whether the taxpayer uses the most accurate information available; the relationship between the gross receipts and the apportionment base chosen; the accuracy of the method chosen...
as compared with other possible methods; whether the method is used by the taxpayer for internal management or other business purposes; whether the method is used for other federal, state, or foreign income tax purposes; the time, burden, and cost of using various methods; and whether the taxpayer applies the method consistently from year to year. All of a taxpayer’s gross receipts are treated as DPGR if less than 5 percent of the taxpayer’s total gross receipts are non-DPGR (after application of other de minimis safe harbors provided in section 4 of this notice that result in gross receipts being treated as DPGR). If the amount of the taxpayer’s gross receipts that do not qualify as DPGR equals or exceeds 5 percent of the total gross receipts, the taxpayer is required to allocate all gross receipts between DPGR and non-DPGR. For example, if a taxpayer only derives gross receipts from the sale of gasoline refined by the taxpayer in the United States and the sale of gasoline the taxpayer acquired (either by purchase or in exchange for gasoline refined by the taxpayer in the United States) from an unrelated party, the taxpayer must allocate its gross receipts between the gross receipts attributable to the gasoline refined by the taxpayer in the United States (that qualify as DPGR assuming all other requirements of § 199 are met) and the taxpayer’s gross receipts derived from the resale of the acquired gasoline (that do not qualify as DPGR) if 5 percent or more of the taxpayer’s total gross receipts are not from the sale of gasoline refined by the taxpayer in the United States. Similarly, a taxpayer that manufactures the same type of QPP at facilities within the United States and outside the United States must allocate its gross receipts between the receipts from the QPP manufactured in the United States and receipts from the QPP not manufactured in the United States if 5 percent or more of its total gross receipts are non-DPGR.

(3) Treatment of advance payments. If a taxpayer recognizes an advance payment for goods, services, use of property, etc., in gross receipts in a taxable year earlier than the taxable year the goods, services, use of property, etc., to which the advance payment relates are delivered, performed, provided, etc., the taxpayer must accurately identify based on a reasonable method that is satisfactory to the Secretary whether the receipts (and correspond-

ing CGS and expenses) qualify as DPGR. See section 4.03(2) of this notice for the factors taken into consideration in determining whether the taxpayer’s method is reasonable.

.04 Determining Domestic Production Gross Receipts. (1) In general. Section 199(c)(4)(A) defines DPGR as the gross receipts (as defined in section 4.04(2) of this notice) of the taxpayer that are derived from (as defined in section 4.04(7)):

(a) Any lease, rental, license, sale, exchange, or other disposition of:

(i) QPP (as defined in section 4.04(8)) that is MPGE (as defined in section 4.04(3)) by the taxpayer (as defined in section 4.04(4)) in whole or in significant part (as defined in section 4.04(5)) within the United States (as defined in section of 4.04(6)),

(ii) Any qualified film (as defined in section 4.04(9)) produced by the taxpayer (in accordance with section 4.04(9)), or

(iii) Electricity, natural gas, or potable water (as defined in section 4.04(10)) produced by the taxpayer in the United States (in accordance with section 4.04(10)),

(b) Construction (as defined in section 4.04(11)) performed in the United States (in accordance with section 4.04(11)), or

(c) Engineering or architectural services (as defined in section 4.04(12)) performed in the United States for construction projects in the United States (in accordance with 4.04(12)).

(2) Definition of “gross receipts.” The term “gross receipts” means the taxpayer’s receipts for the taxable year that are recognized under the taxpayer’s method of accounting used in that taxable year for federal income tax purposes. For this purpose, gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments, and from incidental or outside sources. For example, gross receipts include interest (including original issue discount and tax-exempt interest within the meaning of § 103), dividends, rents, royalties, and annuities, regardless of whether the amounts are derived in the ordinary course of the taxpayer’s trade of business. Gross receipts are not reduced by CGS or by the cost of property sold if such property is described in § 1221(a)(1), (2), (3), (4) or (5). Gross receipts do not include the repayment of a loan or similar instrument (for example, a repayment of the principal amount of a loan held by a commercial lender) and, except to the extent of gain recognized, do not include gross receipts derived from a non-recognition transaction such as a § 1031 exchange. Finally, gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority. If, in contrast, the tax is imposed on the taxpayer under the applicable law, then gross receipts include the amounts received that are allocable to the payment of such tax.

(3) Definition of “manufactured, produced, grown, or extracted.” (a) In general. The terms MPGE in § 199(c)(4)(A)(i)(I) include activities relating to manufacturing, producing, growing, extracting, installing, developing, improving, and creating QPP; making QPP out of scrap, salvage, or junk material as well as from new or raw material by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles; cultivating soil, raising livestock, fishing, and mining minerals. The terms also include storage, handling or other processing activities (other than transportation activities) within the United States related to the sale, exchange or other disposition of agricultural products, provided the products are consumed in connection with, or incorporated into, the MPGE of QPP whether or not by the taxpayer. For example, assume A, B, and C are unrelated taxpayers. A owns grain storage bins in the United States in which it stores for a fee B’s corn that was grown in the United States. B sells its corn to C. C processes B’s corn into corn syrup in the United States. The gross receipts from A’s, B’s, and C’s activities are DPGR from the MPGE of QPP.

(b) Consistency with § 263A. A taxpayer that has MPGE QPP for the taxable year should treat itself as a producer under § 263A with respect to the QPP for the taxable year unless the taxpayer is not subject to § 263A under the Code, regulations, or other published guidance. A taxpayer that currently is not properly ac-
counting for its production activities under § 263A, and wishes to change its method of accounting to comply with the producer requirements of § 263A, must follow the procedures of Rev. Proc. 97–27 or Rev. Proc. 2002–9, whichever applies.

(4) Definition of “by the taxpayer.” With the exception of the rules provided in section 4.09(2)(b) of this notice applicable to an EAG, if one taxpayer performs a qualifying activity under § 199(c)(4)(A)(i) pursuant to a contract with another party, then only the taxpayer that has the benefits and burdens of ownership of the property under federal income tax principles during the period the qualifying activity occurs is treated as engaging in the qualifying activity.

(5) Definition of “in whole or in significant part.” (a) In general. QPP described in § 199(c)(4)(A)(i) must be MPGE in whole or in significant part by the taxpayer within the United States. Except in the case of a related person transaction under § 199(c)(7), DPGR includes all of the taxpayer’s gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of QPP for which the taxpayer MPGE the QPP in whole or in significant part in the United States. For example, if a taxpayer imports QPP that is partially manufactured, the taxpayer completes the manufacture of the QPP in the United States, and the taxpayer’s completion of the manufacturing of the QPP in the United States satisfies the “in significant part” requirement, then the taxpayer’s gross receipts from the sale of the QPP qualify as DPGR (assuming all other requirements of § 199(c) are met). In addition, if a taxpayer manufactures QPP in significant part in the United States and exports the QPP for further manufacture outside the United States, the taxpayer’s gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of that QPP will be considered DPGR, regardless of whether the QPP is imported back into the United States prior to the lease, rental, license, sale, exchange, or other disposition of the QPP (assuming all other requirements of § 199(c) are met). If a taxpayer enters into a contract with another party and the taxpayer has the benefits and burdens of ownership of the QPP under federal income tax principles during the period the MPGE activity occurs and the taxpayer is considered to MPGE the QPP under § 199, then the taxpayer must determine whether the MPGE performed by the other party on behalf of the taxpayer is performed in whole or in significant part within the United States.

(b) Substantial in nature. QPP will be treated as MPGE in significant part by the taxpayer within the United States if the MPGE of the QPP performed by the taxpayer within the United States is substantial in nature taking into account all the facts and circumstances, including the relative value added by, and relative cost of, the taxpayer’s MPGE activity in the United States, the nature of the property, and the nature of the MPGE activity that the taxpayer performs in the United States. For example, if property is MPGE by the taxpayer outside the United States or by an unrelated party within the United States and the property is used as a component part of the QPP produced by the taxpayer within the United States, the QPP (including the component part) will be treated as MPGE in significant part by the taxpayer within the United States if the production of the QPP performed by the taxpayer within the United States is substantial in nature. In addition, if a taxpayer purchases unrefined oil extracted outside the United States by an unrelated party and the taxpayer refines the oil in the United States, the refining of the oil by the taxpayer in the United States will be treated as MPGE that is substantial in nature within the United States. However, packaging, repackaging, labeling, and minor assembly operations do not qualify as substantial in nature. In addition, development activities and the creation or licensing of intangibles do not qualify as substantial in nature for any QPP other than computer software and sound recordings.

(c) Safe harbor. A taxpayer will be treated as having MPGE property in whole or in significant part within the United States if, in connection with the property, conversion costs (direct labor and related factory burden) to MPGE the property are incurred by the taxpayer within the United States and the costs account for 20 percent or more of the total CGS of the property. For purposes of this safe harbor, development costs and the cost of any intangibles do not qualify as conversion costs for any QPP other than computer software and sound recordings. In addition, the costs of packaging, repackaging, labeling, and miscellaneous conversion costs do not qualify as conversion costs.

(6) Definition of “United States.” For purposes of § 199, the term “United States” includes the 50 states, the District of Columbia, the territorial waters of the United States, and the seabed and subsoil of those submarine areas that are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources. The term “United States” does not include possessions and territories of the United States or the airspace over the United States and these areas.

(7) Definition of “derived from the lease, rental, license, sale, exchange, or other disposition of qualifying production property.” (a) In general. The term “derived from the lease, rental, license, sale, exchange, or other disposition of qualifying production property” is defined as, and limited to, the gross receipts directly from the lease, rental, license, sale, exchange, or other disposition of QPP. For example, “derived from the sale of QPP” includes gross receipts from the sale of QPP manufactured in whole or in significant part in the United States by a taxpayer for sale, as well as gross receipts from the sale of self-constructed QPP manufactured in whole or in significant part in the United States by a taxpayer and used in the taxpayer’s trade or business before being sold. In addition, the proceeds from business interruption insurance and payments not to produce are treated as gross receipts “derived from the lease, rental, license, sale, exchange, or other disposition of QPP” to the extent that they are substitutes for gross receipts that would qualify as DPGR. The value of property received in an exchange of QPP that was MPGE by the taxpayer for QPP that was MPGE by an unrelated taxpayer is DPGR for the taxpayer. The value of property acquired by a taxpayer in exchange for QPP is gross receipts derived from an exchange of the QPP, and is DPGR if the QPP was MPGE by the taxpayer in whole or in significant part within the United States. However, any gross receipts from the subsequent sale by the taxpayer of the property that the taxpayer acquired in the exchange are not DPGR, because the taxpayer did not MPGE the property acquired in the ex-
change, even if that property is QPP that had been MPGE within the United States by the other party to the exchange.

(b) Allocation of gross receipts — embedded services. Except with respect to construction or engineering or architectural services described in § 199(c)(4)(ii) and (iii), gross receipts “derived from” the performance of services do not qualify as DPGR. In the case of an embedded service, that is, a service the price of which is included in the amount charged for the lease, rental, license, sale, exchange, or other disposition of property, DPGR includes only the receipts from the lease, rental, license, sale, exchange, or other disposition of the property and not any receipts attributable to the embedded service (assuming all other requirements of § 199(c) are met). There are two exceptions to this general rule regarding embedded services. First, a taxpayer may include in DPGR (assuming all other requirements of § 199(c) are met) gross receipts from a qualified warranty (that is, a warranty that is provided in connection with the sale of QPP if (1) in the normal course of its business, the charge for the warranty is included in the price charged for the lease, rental, license, sale, exchange, or other disposition of the QPP and (2) the warranty is neither separately offered by the taxpayer nor separately bargained for with the customer (that is, the customer cannot purchase the QPP without the warranty)). Second, a de minimis amount of gross receipts from embedded services for each item of property may qualify as DPGR. A de minimis amount of gross receipts from embedded services is less than 5 percent of the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of the property. For purposes of applying this de minimis test, gross receipts from qualified warranties are not treated as gross receipts for services.

(c) Advertising income. Gross receipts that are “derived from” the sale or other disposition of newspapers and magazines include advertising income. For example, a newspaper manufacturer’s gross receipts from an advertiser to publish display advertising or classified advertisements in its newspaper are treated as gross receipts derived from the sale of the newspapers (assuming all other requirements of § 199 are met).

(d) Computer software. Gross receipts derived from computer software (as defined in section 4.04(8)(c)) do not include gross receipts derived from Internet access services, online services, customer support, telephone services, games played through a website, provider-controlled software online access services, and other services that do not constitute the lease, rental, license, sale, exchange, or other disposition of computer software that was developed by the taxpayer.

(e) Exception for certain oil and gas partnerships. If a partnership is engaged solely in the extraction, refining, processing, etc., of oil or gas and distributes the oil or gas or products derived from the oil or gas (products) to its partners who then sell the oil or gas or products, then, for purposes of § 199, the gross receipts derived by the partners from the sale of the oil or gas or products are treated as gross receipts derived by the partnership from the MPGE of QPP. The partnership must follow the rules provided in section 4.06 of this notice regarding the application of § 199 to pass-thru entities to ensure that the costs attributable to oil or gas or products are properly taken into account.

(8) Definition of “qualifying production property.” (a) In general. Qualifying production property includes: (1) tangible personal property, as defined in section 4.04(8)(b); (2) computer software, as defined in section 4.04(8)(c); and (3) sound recordings, as defined in section 4.04(8)(d).

(b) Tangible personal property. The term “tangible personal property” is any tangible property other than land, buildings, (including items that are structural components of such buildings) and any property described under § 199(c)(4)(A)(i)(II) and (III), or § 199(c)(5)(B) and (C). Thus, qualified films, computer software, and sound recordings are not tangible personal property regardless of whether they are fixed on a tangible medium. However, the tangible medium on which the property is fixed (for example, a videocassette, a computer diskette, or other similar tangible item) is tangible personal property. In determining whether property is “tangible personal property,” the fact that property is personal property or tangible property under local law is not controlling. Conversely, property may be tangible personal property for purposes of § 199(c)(5)(A) even though under local law the property is considered a fixture and therefore real property. Thus, property such as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs that is contained in or attached to a building constitutes tangible personal property for purposes of § 199(c)(5)(A). Further, property that is in the nature of machinery (other than structural components of a building) is tangible personal property even though located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, is considered tangible personal property. A structure that is property in the nature of machinery or is essentially an item of machinery or equipment is not an inherently permanent structure and is tangible personal property. In the case, however, of a building or inherently permanent structure that includes property in the nature of machinery as a structural component, the property in the nature of machinery is real property. The term “tangible personal property” does not include the creation of copyrighted material such as a manuscript in a form other than in a tangible medium.

(c) Computer software. The term “computer software” means any program or routine or any sequence of machine-readable code that is designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine. Computer software also includes the machine-readable coding for video games and similar programs, regardless of whether the program is designed to operate on a “computer” (as defined in § 168(i)(2)(B)). If the medium in which the software is contained, whether written, magnetic, or otherwise, is tangible, then such medium is considered tangible personal property for purposes of § 199. Therefore, if a taxpayer develops a software program that it reproduces and sells on diskettes, the program fixed on the diskette is treated as computer software, and the diskette is treated as tangible personal property. Computer programs of all classes, for example, operating systems, executive systems, monitors, compilers and translators, assembly routines, and...
utility programs as well as application programs, are included. Computer software also includes any incidental and ancillary rights that are necessary to effect the acquisition of the title to, the ownership of, or the right to use the computer software, and that are used only in connection with that specific computer software. Such incidental and ancillary rights are not included in the definition of trademark or trade name under § 1.197–2(b)(10)(i).

For example, a trademark or trade name that is ancillary to the ownership or use of a specific computer software program in the taxpayer’s trade or business and is not acquired for the purpose of marketing the computer software is included in the definition of computer software and is not included in the definition of trademark or trade name. Computer software does not include any data or information base unless the data base or item is in the public domain and is incidental to a computer program. For this purpose, a copyrighted or proprietary data or information base is treated as in the public domain if its availability through the computer program does not contribute significantly to the cost of the program. For example, if a word-processing program includes a dictionary feature that may be used to spell-check a document or any portion thereof, the entire program (including the dictionary feature) is computer software regardless of the form in which the dictionary feature is maintained or stored.

(d) Sound recordings. The term “sound recordings” means any works that result from the fixation of a series of musical, spoken, or other sounds. If the medium (such as compact discs, tapes, or other phonorecordings) in which the sounds are embodied is tangible, the medium is considered tangible personal property for purposes of § 199. Therefore, the sale of an audio cassette involves both a sound recording (the sounds fixed on the tape) and tangible personal property (the cassette itself). See section 4.04(8)(c) of this notice. The term “sound recordings” does not include the creation of copyrighted material in a form other than a sound recording, such as lyrics or music written on paper or other similar material.

(9) Definition of “qualified film.” (a) In general. The term “qualified film” means any motion picture film, video tape, or live or delayed television programming if not less than 50 percent of the total compensation relating to the production of the property is compensation for services performed in the United States by actors, production personnel, directors, and producers. The term “production personnel” includes writers, choreographers and composers providing services during the production of a film, casting agents, camera operators, set designers, lighting technicians, make-up artists, and others whose activities are directly related to the production of the film. “Production personnel” do not include, however, individuals whose activities are ancillary to the production, such as advertisers and promoters, distributors, studio administrators and managers, studio security personnel, and personal assistants to actors. If the medium on which a qualified film is fixed is tangible (such as a DVD), such medium is treated as tangible personal property. Therefore, a DVD copy of a motion picture consists of both a qualified film (the motion picture content embodied in the disc) and tangible personal property (the disc itself).

(b) Compensation for services. The term “compensation for services” means all payments for services performed by actors, production personnel, directors, and producers, including participations and residuals. In the case of a taxpayer that uses the income forecast method of § 167(g) and capitalizes participations and residuals into the adjusted basis of the qualified film, the taxpayer must use the same estimate of participations and residuals for purposes of § 199 that it uses for purposes of § 167(g). In the case of a taxpayer that excludes participations and residuals from adjusted basis of the qualified film under § 167(g)(7)(D)(i), the taxpayer must determine the compensation expected to be paid as participations and residuals based on the total forecasted income used in determining income forecast depreciation.

(c) Determination of 50 percent. A taxpayer may use any reasonable method of making the allocation. Among the factors to be considered in determining whether a taxpayer’s method of allocating compensation is reasonable is whether the taxpayer uses that method consistently.

(d) Exception. A “qualified film” does not include property with respect to which records are required to be maintained under 18 U.S.C. § 2257. Section 2257 of Title 18 requires maintenance of certain records with respect to any book, magazine, periodical, film, videotape, or other matter that (1) contains one or more visual depictions made after November 1, 1990, of actual sexually explicit conduct and (2) is produced in whole or in part with materials that have been mailed or shipped in interstate or foreign commerce, or is shipped or transported or is intended for shipment or transportation in interstate or foreign commerce.

(10) Electricity, natural gas, and potable water. (a) In general. DPGR includes gross receipts derived from any lease, rental, license, sale, exchange, or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States (assuming all other requirements of § 199(c) are met). DPGR does not include gross receipts of the taxpayer derived from the transmission or distribution of these items.

(b) Natural gas. The term “natural gas” includes only natural gas extracted from a natural deposit and does not include, for example, methane gas extracted from a landfill. In the case of natural gas, production activities include all activities involved in extracting natural gas from the ground and processing the gas into pipeline quality gas.

(c) Potable water. The term “potable water” means unbottled drinking water. In the case of potable water, production activities include the acquisition, collection, and storage of raw water (untreated water), transportation of raw water to a water treatment facility, and treatment of raw water at such a facility. Gross receipts attributable to any of these activities are included in DPGR (assuming all other requirements of § 199(c) are met). DPGR does not include, however, gross receipts derived from the storage of potable water after completion of treatment of the potable water, or delivery of potable water to customers.

(d) Exceptions. In the case of an integrated producer that both produces and delivers electricity, natural gas, or potable water, the taxpayer must allocate its gross receipts between production (DPGR) and distribution and transmission (non-DPGR). However, if less than 5 percent of a taxpayer’s gross receipts derived from a sale of electricity, natural gas, or potable water are attributable to the transmission or distribution of the elec-
tricity, natural gas, or potable water, then the gross receipts derived from that sale that are attributable to the transmission and distribution of the electricity, natural gas, or potable water will be treated for purposes of § 199 as being DPGR (assuming all other requirements of § 199(c) are met).

(i) **Electricity.** Gross receipts attributable to the transmission of electricity from the generating facility to a point of local distribution and gross receipts attributable to the distribution of electricity to final customers are not DPGR.

(ii) **Natural gas.** Gross receipts attributable to the transmission of pipeline quality gas from a natural gas field (or from a natural gas processing plant) to a local distribution company’s citygate (or to another customer) are not DPGR. Likewise, gross receipts of a local gas distribution company attributable to distribution from the citygate to the local customers are not DPGR.

(iii) **Potable water.** Gross receipts attributable to the storage of potable water after completion of treatment of the potable water, as well as gross receipts attributable to the transmission and distribution of potable water, are not DPGR.

(11) **Definition of “construction performed in the United States.”** (a) Construction of real property. The term “construction” means the construction or erection of real property (that is, residential and commercial buildings (including items that are structural components of such buildings), inherently permanent structures other than tangible personal property in the nature of machinery (see section 4.04(8)(b) of this notice), inherently permanent land improvements, and infrastructure) by a taxpayer that is in a trade or business that is considered construction for purposes of the North American Industry Classification System (NAICS codes). Tangible personal property (as defined under section 4.04(8)(b)) (for example, appliances, furniture and fixtures) that is sold as part of a construction project is not considered real property for this purpose. However, if more than 95 percent of the total gross receipts derived by a taxpayer from a construction project are derived from real property (as defined in § 1.263A–8(c)), then the total gross receipts derived by the taxpayer from the project are DPGR from construction (assuming all other requirements of § 199(c) are met). In determining whether property is “real property,” the fact that property is real property under local law is not controlling. Conversely, property may be real property for purposes of § 199(c)(4)(A)(ii) even though under local law the property is considered tangible personal property.

(b) **Activities constituting construction.** Activities constituting construction include activities performed in connection with a project to erect or substantially renovate real property, but do not include tangential services such as hauling trash and debris, and delivering materials, even if the tangential services are essential for construction. However, if the taxpayer performing construction also, in connection with the construction project, provides tangential services such as delivering materials to the construction site and removing its construction debris, the gross receipts derived from the tangential services are DPGR. Improving land (for example, grading and landscaping) and painting are activities constituting construction only if these activities are performed in connection with other activities (whether or not by the same taxpayer) that constitute the erection or substantial renovation of real property. The taxpayer engaged in these activities must make a reasonable inquiry to determine whether the activity relates to the erection or substantial renovation of real property. The term “construction” does not include any activity that is within the definition of “engineering and architectural services” (see section 4.04(12) of this notice).

(c) **Definition of “infrastructure.”** The term “infrastructure” includes roads, power lines, water systems, railroad spurs, communications facilities, sewers, sidewalks, cable, and wiring. The term also includes inherently permanent oil and gas platforms.

(d) **Definition of “substantial renovation.”** The term “substantial renovation” means the renovation of a major component or substantial structural part of real property that materially increases the value of the property, substantially prolongs the useful life of the property, or adapts the property to a new or different use.

(e) **“Derived from construction.”** Assuming all other requirements of § 199(c) are met, DPGR derived from the construction of real property performed in the United States includes the proceeds from the sale, exchange, or other disposition of real property constructed by the taxpayer in the United States (whether or not the property is sold immediately after construction is completed). DPGR derived from the construction of real property also includes compensation for the performance of construction services by the taxpayer in the United States. However, DPGR derived from the construction of real property does not include gross receipts from the lease or rental of real property constructed by the taxpayer or gross receipts attributable to the sale or other disposition of land.

(12) Definition of “Engineering and architectural services.” (a) In general. DPGR includes gross receipts derived from engineering or architectural services performed in the United States for construction projects in the United States (assuming all other requirements of § 199(c) are met). The engineering or architectural services must relate to real property, must be performed in the United States, and the taxpayer providing these services must be able to substantiate that the services relate to a construction project within the United States. DPGR includes gross receipts derived from engineering or architectural services even if the planned construction project is not undertaken or is not completed (subject to the taxpayer substantiating that the services relate to a construction project that would have been within the United States if it had been undertaken and assuming all other requirements of § 199(c) are met).

(b) **Engineering services.** Engineering services in connection with any construction project include any professional services requiring engineering education, training, and experience and the application of special knowledge of the mathematical, physical, or engineering sciences to those professional services such as consultation, investigation, evaluation, planning, design, or responsible supervision of construction for the purpose of assuring compliance with plans, specifications, and design.

(c) **Architectural services.** Architectural services in connection with any construction project include the offering or furnishing of any professional services such as consultation, planning, aesthetic and structural design, drawings and specifications, or responsible supervision of
construction (for the purpose of assuring compliance with plans, specifications, and design) or erection, in connection with any construction project.

(d) De minimis exception for performance of services in the United States. If gross receipts derived from engineering or architectural services (1) performed outside the United States or (2) related to property other than real property for a construction project inside the United States total less than 5 percent of the total gross receipts of the taxpayer derived from engineering or architectural services performed by the taxpayer with regard to the same construction project, such receipts will be treated as DPGR.

(13) Exception for sales of certain food and beverages. DPGR does not include gross receipts of the taxpayer that are derived from the sale of food or beverages prepared by the taxpayer at a retail establishment. A “retail establishment” is defined as real property leased, occupied, or otherwise used by the taxpayer in its trade or business of selling food or beverages to the public at which retail sales are made. A facility at which food or beverages are prepared will not be treated as a retail establishment if less than 5 percent of the food or beverages that are sold at that facility during the taxable year are retail sales. If a taxpayer’s facility is a retail establishment, then, as a matter of administrative grace, the taxpayer may allocate its gross receipts between gross receipts derived from the retail sale of the food and beverages prepared and sold at the retail establishment (which are non-DPGR) and gross receipts derived from the wholesale sale of the food and beverages prepared at the retail establishment (which are DPGR). The exception for sales of certain food and beverages also applies to food and beverages for non-human consumption.

(14) Related persons. Section 199(c)(7) provides that DPGR does not include any gross receipts of the taxpayer derived from property leased, licensed, or rented by the taxpayer for use by any related person. A person is treated as related to another person if both persons are treated as a single employer under either § 52(a) or (b) (without regard to § 1563(b)), or § 414 (m) or (o).

.05 Determining Costs. (1) In general. To determine its QPAI for the taxable year, a taxpayer must reduce its DPGR by the amount of CGS directly allocable to DPGR, the amount of deductions directly allocable to DPGR and a ratable portion of other deductions not directly allocable to DPGR, or another class of income. Section 4.05(2) of this notice provides rules for determining CGS directly allocable to DPGR. Section 4.05(3) provides rules for determining the deductions allocated and apportioned to DPGR and a ratable portion of deductions not directly allocable to DPGR or another class of income. Section 4.05(3) generally provides that a taxpayer must determine deductions allocated and apportioned to DPGR using the rules of the regulations under § 861 of the Code. Section 4.05(3) provides, however, that a taxpayer with average annual gross receipts of $25,000,000 or less may determine deductions allocable to DPGR using the simplified deduction method. Section 4.05(4) provides a simplified overall method that a qualifying small taxpayer may use to allocate and apportion CGS and deductions to DPGR. Consistent with the rule in section 4.09(1) that treats all members of an EAG as a single corporation for purposes of § 199, whether the members of an EAG may use the simplified deduction method or the small business simplified overall method is determined at the EAG level. In addition, a member of an EAG that may use the simplified deduction method or the small business simplified overall method may do so only if all members of the EAG agree to and use the same method.

(2) Cost of goods sold allocable to domestic production gross receipts. (a) In general. Section 199(c)(1)(B)(i) requires a taxpayer to reduce DPGR by the CGS directly allocable to DPGR. A taxpayer must allocate CGS in accordance with this section 4.05(2) of this notice or, if applicable, section 4.05(4). CGS is equal to beginning inventory plus purchases and production costs incurred during the taxable year less ending inventory. For purposes of § 199, CGS allocable to DPGR includes the costs that would have been included in ending inventory under the principles of §§ 263A, 471, and 472 if the goods sold during the taxable year were on hand at the end of the taxable year. CGS allocable to DPGR includes inventory valuation adjustments such as writedowns under the lower of cost or market method. For purposes of § 199, CGS also includes the adjusted basis of noninventory property, the gross receipts from the sale or other disposition of which are included in DPGR.

(b) Allocating cost of goods sold. If a taxpayer can identify from its books and records CGS allocable to DPGR, CGS allocable to DPGR is that amount. However, if a taxpayer’s books and records do not allow the taxpayer to identify CGS allocable to DPGR, the taxpayer must use a reasonable method to allocate CGS between DPGR and other gross receipts. If a taxpayer uses a method to allocate gross receipts between DPGR and non-DPGR, the taxpayer may not use a different method for purposes of allocating CGS. In other cases, whether an allocation method is reasonable is based on all of the facts and circumstances including the relationship between CGS and the base chosen; the accuracy of the method chosen as compared with other possible methods; whether the method is used by the taxpayer for internal management and other business purposes; whether the method is used for other federal or state income tax purposes; the availability of costing information; and the time, burden, and cost of using various methods. Depending on the facts and circumstances, reasonable methods may include methods based on gross receipts, number of units sold, number of units produced, or total production costs.

(c) Special rules for imported items or services. Under § 199(c)(3), the cost of any item or service brought into the United States is treated as not less than its value immediately after it entered the United States for purposes of determining the CGS to be used in the computation of QPAI. When an item or service is brought into the United States that had been exported by the taxpayer for further manufacture, the increase in cost may not exceed the difference between the value of the property when exported and the value of the property when brought back into the United States after further manufacture. For this purpose, the value of property is its customs value as defined in § 1059A(b)(1).

(3) Other deductions allocable or apportionable to domestic production gross receipts. (a) In general. Section 199(c)(1)(B)(ii) and (iii) requires a taxpayer to reduce DPGR by deductions that are directly allocable to DPGR, and a ratable portion of deductions that are not
directly allocable to DPGR or another class of income. Any cost that may not be taken into account in computing taxable income for the taxable year is not treated as a deduction for purposes of this section. A taxpayer generally must allocate and apportion these deductions using the rules provided in the § 861 regulations, subject to the rules provided in this section 4.05(3) (the § 861 method). In lieu of the § 861 method, a taxpayer with average annual gross receipts of $25,000,000 or less may apportion these deductions using the simplified deduction method. A taxpayer electing the simplified deduction method must use that method for all deductions. See also section 4.05(4) for the small business simplified overall method available to a qualified small taxpayer.

(b) Rules that apply to all allocation and apportionment methods. (i) In general. The rules provided in section 4.05(3)(b)(ii) through (v) apply to losses, net operating losses, and certain other deductions when allocating and apportioning deductions to DPGR or gross income attributable to DPGR under the § 861 method (section 4.05(3)(c)), the simplified deduction method (section 4.05(3)(d)), or the small business simplified overall method (section 4.05(4)).

(ii) Losses. A deduction under § 165 for a loss related to property (including theft, casualty, or abandonment losses) is allocated or apportioned to DPGR or gross income attributable to DPGR only if the proceeds from the sale of the property are, or would have been, included in DPGR.

(iii) Net operating losses. A deduction allowed under § 172 for a net operating loss is not allocated or apportioned to DPGR or gross income attributable to DPGR.

(iv) Deductions not attributable to the actual conduct of a trade or business. Deductions not attributable to the actual conduct of a trade or business are not allocated or apportioned to DPGR or gross income attributable to DPGR. See § 199(d)(5). For example, the standard deduction provided by § 63(c) and the deduction for personal exemptions provided by § 151 are not allocated or apportioned to DPGR or gross income attributable to DPGR.

(v) Deductions related to de minimis gross receipts and embedded services included in domestic production gross receipts. If a taxpayer is permitted to treat non-DPGR as DPGR pursuant to a safe harbor or de minimis rule provided in this notice (e.g., section 4.03(2) or section 4.04(10)(d) of this notice), deductions related to such non-DPGR treated as DPGR must be allocated or apportioned to DPGR or gross income attributable to DPGR. If the gross receipts related to embedded services are included in DPGR under section 4.04(7), the deductions related to providing such services must be allocated or apportioned to DPGR or gross income attributable to DPGR.

(c) Section 861 method. (i) In general. A taxpayer must allocate and apportion its deductions using the allocation and apportionment rules provided by the § 861 regulations, subject to the modifications provided in section 4.05(3)(b)(ii) through (v) and section 4.05(3)(c)(ii) and (iii) of this notice. Under this method, § 199 is treated as an “operative section” described in § 1.861–8(f). Accordingly, the taxpayer applies the rules of the § 861 regulations to allocate and apportion deductions (including its distributive shares of deductions) to gross income attributable to DPGR. Generally, the taxpayer allocates deductions to the relevant class of gross income and apportions (if necessary) such deductions within the class of gross income between gross income attributable to DPGR (the statutory grouping) and other income (the residual grouping). The § 861 regulations generally are applied on a single entity basis, although the rules are applied on the basis of the affiliated group (as determined under the § 861 regulations) for certain expenses such as interest expense and research and experimental expenses. Consistent with these rules, allocation and apportionment of deductions generally are determined on an aggregate basis by the owner of the pass-thru entity. See for example, §§ 1.861–9T(e) and -17(f).

If the taxpayer uses the allocation and apportionment rules of the § 861 regulations for another operative section of the Code, it must use the same method of allocation and the same principles for apportionment for purposes of all operative sections (subject to, in the case of the § 861 method, the rules provided in section 4.05(3)(b)(ii) through (v) and section 4.05(3)(c)(ii) and (iii) of this notice). See § 1.861–8(f)(2)(i).

(ii) Deductions for charitable contributions. Deductions for charitable contributions (as allowed under §§ 170, 873(b)(2), and 882(c)(1)(B)) must be ratably apportioned between gross income attributable to DPGR and other gross income based on the relative amounts of gross income. For individuals, this provision applies solely to deductions for charitable contributions that are attributable to the actual conduct of a trade or business.

(iii) Research and experimental expenditures. Research and experimental expenditures must be allocated and apportioned in accordance with § 1.861–17. Because an apportionment based on geographic sources is not required for purposes of § 199, the exclusive apportionment rule of § 1.861–17(b) does not apply for purposes of the § 861 method.

(d) Simplified deduction method. A taxpayer with average annual gross receipts (as defined in section 4.05(5) of this notice) of $25,000,000 or less may use the simplified deduction method. Under the simplified deduction method, except as provided in section 4.05(3)(b) of this notice, a taxpayer’s deductions are ratably apportioned between DPGR and non-DPGR based on relative gross receipts. Accordingly, the amount of deductions apportioned to DPGR is equal to the same proportion of the deductions that the amount of DPGR bears to total gross receipts. In the case of an owner of a pass-thru entity, the simplified deduction method (including whether the method may be used) is applied at the level of the owner’s pass-thru entity taking into account the owner’s DPGR, receipts, and other items from all sources including its distributive or allocable share of those items of the pass-thru entity.

(4) Small business simplified overall method. (a) In general. A qualifying small taxpayer may use the small business simplified overall method to allocate and apportion CGS and deductions between DPGR and non-DPGR. Under the small business simplified overall method, a taxpayer’s total CGS and deductions (except as provided in section 4.05(3)(b) of this notice) are ratably apportioned between DPGR and other receipts based on relative gross receipts. Accordingly, the amount of CGS and deductions apportioned to DPGR is equal to the same proportion of CGS and deductions that the amount of DPGR bears to total gross receipts.

(b) Qualifying small taxpayer. For purposes of section 4.05(4)(a) of this notice,
a qualifying small taxpayer is a taxpayer
that has average annual gross receipts (as
described in section 4.05(5) of this notice)
of $5,000,000 or less or a taxpayer that is
eligible to use the cash method as provided in
(That is, any taxpayer with average annual
gross receipts of $10,000,000 or less that is
not prohibited from using the cash method
under § 448, including a partnership, an S
corporation, a C corporation, or an individ-
ual.)

5 Average annual gross receipts.
For purposes of the simplified deduction
method in section 4.05(3)(d) of this notice
and the small business simplified overall
method in section 4.05(4), average annual
gross receipts means the average annual
gross receipts of the taxpayer for the 3
taxable years (or, if fewer, the taxable
years during which the taxpayer was in
existence) preceding the current taxable
year, even if one or more of such taxable
years began before the effective date of
§ 199. In the case of any taxable year
of less than 12 months (a short taxable year),
the gross receipts shall be annualized by
(a) multiplying the gross receipts for the
short period by 12 and (b) dividing the
result by the number of months in the
short period. Whether the members of an
EAG may use the simplified deduction
method or the small business simplified
overall method is determined by reference to
the average annual gross receipts of the
EAG. To compute the average annual
gross receipts of an EAG, the gross re-
ceipts of each member of the EAG for its
taxable year that ends with or within the
taxable year of the computing member (as
defined in section 4.09(8) of this notice)
are aggregated, regardless of whether the
computing member or the non-computing
member was a member of the EAG during
its entire taxable year. A member of an
EAG that qualifies to use the simplified
deduction method or the small business
simplified overall method may do so only
if all members of the EAG agree to and
use the same method.

6 Application of § 199 to Pass-thru
Entities. (1) Allocations to partners,
shareholders, and similar interest hold-
ers. (a) Partnerships. (i) Determination at
partner level. The § 199 deduction is
determined at the partner level. As a result,
each partner must compute its deduc-
tion separately. Each partner is allocated,
in accordance with §§ 702 and 704, its
share of items (including items of income,
gain, loss, deduction, cost of goods sold
allocated to such items of income, and
gross receipts that are included in such
items of income) allocated or attributable
to the partnership’s activities described in
§ 199(c)(4) (qualified production ac-
tivities), along with any other items of
income, gain, loss, deduction or credit of
the partnership. To determine its § 199
deduction for the taxable year, a partner
aggregates its share of the items allocated
or attributable to the partnership’s qual-
ified production activities, any expenses
incurred by the partner directly that are
allocated to the partnership’s qualified
production activities, and those items of
the partner that are allocated or attrib-
tuable to qualified production activities
from sources other than the partnership.
A partnership may specially allocate items
of income, gain, loss, or deduction allo-
cated or attributable to the partnership’s
qualified production activities, subject to
the rules of § 1.704–1(b), including the
rules for determining substantial economic
effect under § 1.704–1(b)(2)(iii).

(ii) Expenses. Each partner must take
into account the partner’s distributive
share of expenses allocated to the quali-
fied production activities of the partner-
ship, regardless of whether the partnership
otherwise has taxable income. However,
expenses of a partnership that otherwise
would be taken into account for purposes of
computing the partner’s § 199 deduction
shall only be taken into account if
and to the extent the partner’s distributive
share of the losses and deductions from
all of the partnership’s activities is not
disallowed by §§ 465, 469, 704(d), or any
other provision of the Code. In the event
that only a portion of the partner’s dis-
tributive share of the losses or deductions
are allowed for a taxable year, a propor-
tionate share of the losses or deductions
that reflect expenses allocated to the part-
nership’s qualified production activities,
determined in a manner consistent with
§§ 465, 469 and 704(d), shall be taken into
account for purposes of computing the
§ 199 deduction for that taxable year. To
the extent that any of the disallowed losses
or deductions are allowed in a later taxable
year, the partner shall take into account
a proportionate share of the expenses re-
lected in those losses or deductions in
computing its QPAI for that later taxable
year.

(iii) W–2 wages. Under § 199(d)(1)(B),
a partner’s share of W–2 wages of the part-
nership for purposes of determining the
partner’s § 199(b) limitation is the lesser of
the partner’s allocable share of the wages
(without regard to § 199(d)(1)(B)) as de-
termined under regulations prescribed by
the Secretary, or 2 times 9 percent (3 per-
cent in the case of taxable years beginning
in 2005 and 2006, and 6 percent in the
case of taxable years beginning in 2007,
2008, or 2009) of the QPAI computed tak-
ing into account only the items of the part-
nership allocated to the partner for the tax-
able year of the partnership. In determin-
ing a partner’s share of the W–2 wages of
a partnership, allocations by the partner-
ship of W–2 wages, otherwise meeting the
requirements of § 704(b), shall be taken into
account by the partner for purposes of
§ 199(d)(1)(B). Thus, a partner’s share of
W–2 wages of the partnership is the lesser
of the amount of W–2 wages allocated to
the partner under § 704, or 2 times the
applicable percentage of the QPAI com-
puted taking into account only the items of
the partnership allocated to the partner
for the taxable year of the partnership,
determined at the partner level, in accord-
ance with section 4.06(1)(a)(i) and (ii), by ref-
rence to the partner’s distributive or al-
locable share of the partnership’s items of
income, gain, loss or deduction (including
gross receipts and costs of goods sold), al-
located or attributable to qualified produc-
tion activities, and expenses incurred di-
rectly by the partner which are allocated to
the partnership’s qualified production ac-
tivities, for the taxable year. Each partner
must aggregate the W–2 wages allocated
from the partnership with its W–2 wages
from other sources for purposes of com-
puting the partner’s § 199(b) limitation for
the taxable year. However, if QPAI com-
puted taking into account only the items of
the partnership allocated to the partner
for the taxable year is not greater than zero,
the partner may not take into account any
W–2 wages of the partnership for purposes
of computing the wage limitation under
§ 199(b) for the taxable year.

(b) S corporations. (i) Determination at
S corporation shareholder level. The
§ 199 deduction is determined at the share-
holder level. As a result, each shareholder
must compute its deduction separately.
Each shareholder is allocated, in accordance with § 1366, its pro rata share of items (including items of income, gain, loss, and deduction) allocated or attributable to the qualified production activities of the S corporation. To the extent that such items represent items relevant to the computation of the § 199 deduction (for example, DPGR, CGS, other items allocable to DPGR, or W–2 wages of the S corporation), the shareholder will take such items into account in computing its § 199 deduction. To compute its § 199 deduction for the taxable year, the shareholder will aggregate its pro rata share of items allocated or attributable to qualified production activities of the pass-thru entity, for purposes of computing the shareholder’s § 199 limitation is the lesser of the shareholder’s allocable share of the wages (without regard to § 199(d)(1)(B)) as determined under regulations prescribed by the Secretary, or 2 times 9 percent (3 percent in the case of taxable years beginning in 2005 and 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the QPAI computed taking into account only the items of the S corporation allocated to the shareholder for the taxable year. Each shareholder must aggregate the W–2 wages allocated from the S corporation with its W–2 wages from other sources for purposes of computing its § 199(b) limitation for the taxable year. However, if the shareholder is not allocated positive QPAI computed taking into account only the items of the S corporation allocated to the shareholder for the taxable year, the shareholder may not take into account any W–2 wages of the S corporation for purposes of computing the wage limitation under § 199(b) for the taxable year.

(2) Gain or loss from the disposition of an interest in a pass-thru entity. QPAI generally does not include gain or loss recognized on the sale, exchange, or other disposition of an interest in the entity. However, if § 751(a) or (b) applies, gain or loss allocable to assets of the partnership the sale, exchange, or other disposition of which would give rise to QPAI is taken into account in computing the partner’s § 199 deduction.

(3) Effective date of § 199 for pass-thru entities. Section 199(e) provides that § 199 applies for taxable years beginning on or after January 1, 2005. Accordingly, § 199 does not apply to taxable years of pass-thru entities that begin before January 1, 2005. For example, assume a pass-thru entity has a taxable year beginning July 1, 2004, and ending June 30, 2005, and the owners of the pass-thru entity have taxable years beginning January 1, 2005, and ending December 31, 2005. The provisions of § 199 do not apply to the pass-thru entity until the first date of its first taxable year beginning on or after January 1, 2005. Thus, § 199 applies to the pass-thru entity for its taxable year beginning July 1, 2005. The owners of the pass-thru entity include their allocable or pro rata share of items allocated or attributable to the qualified production activities of the pass-thru entity, for purposes of determining their respective § 199 deductions for their taxable years ending December 31, 2006.

.07 Patrons of Agricultural and Horticultural Cooperatives. Section 199(d)(3) and this section 4.07 apply in the case of a cooperative (to which Part I of Subchapter T applies), that is engaged in (1) the MPGE in whole or in significant part of any agricultural or horticultural product, or (2) the marketing of agricultural or horticultural products. Under § 199(d)(3) and this section, if any amount of a patronage dividend or qualified per-unit retain allocation paid in qualified per-unit retain certificates described in § 1385 is received by a patron from such a cooperative, and such amount is allocable to QPAI of the cooperative that is deductible under § 199(a) and section 4.01 of this notice by the cooperative, then the amount is deductible from the gross income of the patron. Such an amount, however, does not reduce the taxable income of the cooperative under § 1382. In order for the member to qualify for the deduction, § 199(d)(3)(A)(ii) requires the cooperative to designate the patron’s portion of the income allocable to QPAI of the organization in a written notice mailed by the cooperative to its patron during the payment period described in § 1382(d) (that is, no later than the 15th day of the seventh month following the close of the taxable year). In determining the portion of the cooperative’s QPAI that would be deductible by the cooperative under § 199(a) and section 4.01, the cooperative’s taxable income is computed without taking into account any deduction allowable under § 1382(b) or (c) relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions and, in the case of a cooperative engaged in the marketing of agricultural and horticultural products, the cooperative is treated as having MPGE in whole or in significant part any QPP marketed by the cooperative that its patrons have MPGE. For purposes of § 199, agricultural or horticultural products also include fertilizer, diesel fuel and other supplies used in agricultural or horticultural production that are MPGE by the cooperative.

.08 Individuals. In the case of individuals, § 199(d)(2) provides that the deduction is equal to the applicable percent of the lesser of the taxpayer’s (1) QPAI for the taxable year, or (2) adjusted gross income (AGI) for the taxable year determined after
applying §§ 86, 135, 137, 219, 221, 222, and 469, and without regard to § 199.

.09 Expanded Affiliated Groups. (1) In general. All members of an EAG are treated as a single corporation for purposes of § 199. An EAG is an affiliated group as defined in § 1504(a), determined by substituting “50 percent” for “80 percent” each place it appears, and without regard to § 1504(b)(2) and (4).

(2) Computation of expanded affiliated group’s § 199 deduction. (a) In general. The § 199 deduction for an EAG is determined by aggregating each member’s taxable income or loss, QPAI, and W–2 wages. For this purpose, a member’s QPAI is the member’s DPGR less the sum of the CGS allocable to such receipts and other costs required to be allocated under section 4.05 of this notice. For purposes of this determination, a member’s QPAI may be positive or negative. A member’s taxable income or loss and QPAI shall be determined by reference to the member’s method of accounting.

(b) Attribution of activities. Each member of an EAG is treated as conducting the activities conducted by each other member of the EAG. For example, Corporation A and Corporation B are members of the same EAG but do not file a consolidated return. A is engaged solely in the trade or business of manufacturing QPP in the United States. B is a reseller of the QPP manufactured by A. Without regard to the activities conducted by A, B would not qualify for the § 199 deduction. However, because B is a member of the EAG that includes A, B is treated as conducting A’s manufacturing activities. Accordingly, B’s gross receipts attributable to the sale of the QPP it purchases from A are DPGR (assuming all other requirements of § 199 are met).

(c) Anti-avoidance rule. If a transaction between members of an EAG is engaged in or structured with a principal purpose of qualifying for, or modifying the amount of, the § 199 deduction for one or more members of the EAG, adjustments must be made to eliminate the effect of the transaction on the computation of the § 199 deduction.

(3) Allocation of expanded affiliated group’s § 199 deduction. The EAG’s § 199 deduction is allocated among members of the EAG in proportion to each member’s QPAI, if any, regardless of whether the EAG member has taxable income or loss for the taxable year and regardless of whether the EAG member has W–2 wages. For this purpose, if a member has negative QPAI, the QPAI of the member shall be treated as zero.

(4) Special rules for consolidated groups. For purposes of § 199, a consolidated group is treated as a single member of the EAG. Therefore, if an EAG includes corporations that are members of a consolidated group and corporations that are not members of a consolidated group, in computing the taxable income limitation of the EAG, the consolidated taxable income of the consolidated group, not the separate taxable income of the members of the consolidated group, is taken into account. If all of the members of an EAG are members of the same consolidated group, the consolidated group’s § 199 deduction is determined based on the group’s consolidated taxable income or loss, not the separate taxable income or loss of its members. The § 199 deduction of a consolidated group (or the § 199 deduction allocated to a consolidated group that is a member of an EAG) must be allocated to the members of the consolidated group in proportion to each consolidated group member’s QPAI, if any, regardless of whether the consolidated group member has separate taxable income or loss for the taxable year and regardless of whether the member has W–2 wages for the taxable year. For purposes of allocating the § 199 deduction of a consolidated group among its members, if a consolidated group member has negative QPAI, the QPAI of the member shall be treated as zero.

(5) Identification of members of the expanded affiliated group. A corporation must determine whether it is a member of an EAG on a daily basis. If a corporation becomes or ceases to be a member of an EAG, the corporation is treated as becoming or ceasing to be a member of the EAG at the end of the day on which its status as a member changes.

(6) Allocation of income and loss. (a) In general. A corporation that is a member of an EAG for only a portion of its taxable year must allocate its taxable income or loss, QPAI, and W–2 wages between the portion of the taxable year during which it is a member of the EAG and the portion of the taxable year during which it is not a member of the EAG. In general, this allocation of items must be made by using the pro rata allocation method described in section 4.09(6)(a)(i) of this notice. However, the corporation may elect to use the closing of the books method described in section 4.09(6)(a)(ii).

(i) Pro rata allocation method. Under the pro rata allocation method, an equal portion of each of the taxable income or loss, QPAI, and W–2 wages for the taxable year is assigned to each day of the corporation’s taxable year. Then, those items assigned to those days during which the corporation was a member of the EAG are aggregated.

(ii) Closing of the books method. Under the closing of the books method, taxable income or loss, QPAI, and W–2 wages for the period during which the corporation was a member of the EAG are computed by treating the corporation’s taxable year as two separate taxable years, the first of which ends at the close of the day on which the corporation’s status as a member of the EAG changes and the second of which begins at the beginning of the day after the corporation’s status as a member of the EAG changes.

(iii) Making the § 199 closing of the books election. A corporation makes the § 199 closing of the books election by making the following statement: “The § 199 closing of the books election is hereby made with respect to [insert name of corporation and its employer identification number] with respect to the following periods [insert dates of two periods between which items are allocated pursuant to the closing of the books method].” The statement must be filed with the corporation’s timely filed (including extensions) federal income tax return for the taxable year that includes the periods that are subject to the election. Once made, an election under this section 4.09(6)(a)(iii) is irrevocable.

(b) Coordination with rules relating to the allocation of income under § 1.1502–76(b). If § 1.1502–76 (relating to the taxable year of members of a consolidated group) applies to a corporation that is a member of an EAG, any allocation of items required under this section 4.09(6) is made only after the allocation of the corporation’s items pursuant to § 1.1502–76.

(7) Total § 199 deduction for a corporation that is a member of an expanded affiliated group for some or all of its taxable
Year. If a corporation is a member of an EAG for its entire taxable year, the corporation’s § 199 deduction for the taxable year is the amount of the § 199 deduction allocated to the corporation by the EAG. If a corporation is a member of an EAG for a portion of its taxable year, and is either not a member of any EAG, or is a member of another EAG, or both, for another portion of the taxable year, the corporation’s § 199 deduction for the taxable year is the sum of its § 199 deductions for each portion of the taxable year. For example, Corporations X and Y, calendar year corporations, are members of the same EAG for the entire 2005 taxable year. Corporation Z, also a calendar year corporation, is a member of the EAG, of which X and Y are members, for the first half of 2005 and not a member of any EAG for the second half of 2005. During the 2005 taxable year, Z does not join in the filing of a consolidated return. Z makes § 199 closing of the books election. As a result, Z has $100 of QPAI and $80 of taxable income that is allocated to the first half of the taxable year, and ($200) of QPAI and a $150 taxable loss that is allocated to the second half of the taxable year. Taking into account Z’s QPAI and taxable income allocated to the first half of the taxable year pursuant to § 199 closing of the books election, the EAG has positive QPAI and taxable income for the taxable year and W–2 wages in excess of the § 199(b) wage limitation. Because the EAG has both positive QPAI and taxable income and sufficient W–2 wages, and because Z has positive QPAI for the first half of the year, a portion of the EAG’s § 199 deduction is allocated to Z. Z is allowed no § 199 deduction for the second half of the taxable year. Thus, despite the fact that Z has ($100) of QPAI and a $70 taxable loss for the entire 2005 taxable year, Z is still entitled to a § 199 deduction for the taxable year equal to the § 199 deduction allocated to Z as a member of the EAG.

(8) Computation of § 199 deduction for members of expanded affiliated group with different taxable years. If members of an EAG have different taxable years, in determining the § 199 deduction of a member (the “computing member”), with respect to each group member, the computing member is required to take into account the taxable income or loss, QPAI, and W–2 wages that are both (1) attributable to the period during which the member of the EAG and the computing member are both members of the EAG and (2) taken into account in a taxable year that begins after the effective date of § 199 and ends with or within the taxable year of the computing member with respect to which the § 199 deduction is computed.

.10 Trade or Business Requirement. Section 199(d)(5) provides that § 199 is applied by taking into account only items that are attributable to the actual conduct of a trade or business.

.11 Coordination with Alternative Minimum Tax. Section 199(d)(6) provides rules to coordinate the deduction allowed under § 199 with the AMT imposed by § 55. The deduction is allowed for purposes of the AMT, except that the deduction is equal to the applicable percent of the lesser of the taxpayer’s: (1) QPAI, determined without regard to subchapter A, Part IV, of the Code; or (2) AMTI (determined without regard to § 199), for the taxable year. For purposes of the preceding sentence, in the case of an individual, AGI (determined without regard to § 199) shall be substituted for AMTI.

.12 Special rules. (1) Certain non-recognition transactions. Except as provided in section 4.09 of the notice (the rules applicable to EAGs), if property is transferred by the taxpayer to an entity in a transaction to which § 351 or 721 applies, then whether the gross receipts derived by the entity are DPGP shall be determined based on the activities performed by the entity without regard to the activities performed by the taxpayer prior to the contribution of the property to the entity.

(2) Section 1031 exchanges. If a taxpayer exchanges property for replacement property in a transaction to which § 1031 applies, then whether the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of the replacement property are DPGP shall be determined based solely on the activities performed by the taxpayer.

(3) Section 381 transactions. If a corporation (the acquiring corporation) acquires the assets of another corporation (the target corporation) in a transaction to which § 381(a) applies, the acquiring corporation shall be treated as performing those activities of the target corporation with respect to the acquired assets of the target corporation. Therefore, to the extent that the acquired assets of the target corporation would have given rise to DPGP if leased, rented, licensed, sold, exchanged, or otherwise disposed of by the target corporation, then the assets will give rise to DPGP if leased, rented, licensed, sold, exchanged, or otherwise disposed of by the acquiring corporation (assuming all other requirements of § 199(c) are met).

(4) Taxpayers with a 52–53 week taxable year. For purposes of applying § 1.441–2(c)(1) in the case of a taxpayer using a 52–53 week taxable year, any reference in § 199(a)(2) (the phase-in rule) to a taxable year “beginning after” a particular calendar year means a taxable year beginning after December 31st of that year. Similarly, any reference to a taxable year “beginning in” a particular calendar year means a taxable year beginning after December 31st of the preceding calendar year. For example, a 52–53 week taxable year that begins on December 26, 2004, is deemed to begin on January 1, 2005, and the transition percentage for that taxable year is 3 percent.

SECTION 5. EFFECTIVE DATE

This notice applies to taxable years beginning after December 31, 2004.

SECTION 6. REQUEST FOR COMMENTS

.01 In General. The Service and Treasury Department invite taxpayers to submit written comments on issues relating to § 199 and this notice. In particular, the Service and Treasury Department encourage taxpayers to submit written comments on the following issues:

(1) The Service and Treasury Department are aware that several provisions of the Code and regulations require computations based upon taxable income, and that there is confusion concerning the order in which these provisions are to be applied. Taxpayers are invited to submit a list of all provisions of the Code, regulations, and other administrative guidance (if any) that require computations based upon taxable income, and the order in which taxpayers believe they should be applied;

(2) The Service and Treasury Department are concerned that there may be situations in which a contractor does not bear the benefits and burdens of ownership with respect to property (for example, for security reasons), but nevertheless should
be regarded as satisfying the “by the taxpayer” requirement of § 199(c)(4)(A)(i). Taxpayers are invited to submit comments on such situations;

(3) The Service and Treasury Department request comments on the application of §199 to trusts and estates. In particular, comments are requested on whether the apportionment of distributable net income between the trust and estate and its beneficiaries should govern the determination of the §199 deduction for the taxable year, what rules should apply if there is no distributable net income for the taxable year, how these rules should be applied to split-interest trusts, and the information reporting requirements that should be imposed on the trust or estate and its beneficiaries. Comments are also requested on whether the application of §199 to pass-thru entities other than partnerships, S corporations, trusts and estates;

(4) The Service and Treasury Department request comments on whether taxpayers should be able to change any allocation or apportionment method of gross receipts or deductions on an amended return and whether there should be restrictions on a taxpayer’s ability to change from one method to another;

(5) The Service and Treasury Department request comments on whether additional modifications or clarifications to the § 861 method would be appropriate, including modifications relating to the determination of the “affiliated group” for purposes of allocating and apportioning expenses that are allocated and apportioned on an affiliated group basis;

(6) The Service and Treasury Department request comments regarding whether members of an EAG should be required to use the same method of allocating and apportioning deductions to DPGR. If members of an EAG were to be able to use different methods of allocating and apportioning deductions, the Service and Treasury Department request comments regarding whether a member’s ability to use the simplified deduction method or the small business simplified overall method should depend on the average annual gross receipts of that member alone or the aggregate average annual gross receipts of all members of the EAG;

(7) The Service and Treasury Department request comments related to the application of §199 to computer software; and

(8) The Service and Treasury Department invite comments on the appropriateness of the $25,000,000 gross receipts threshold for use of the simplified deduction method.

_02 Addresses for Comments._ Send submissions to: CC:PA:LPD:PR (Notice 2005–14), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Notice 2005–14), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Submissions may also be sent electronically via the Internet to the following e-mail address: Notice.comments@irs.counsel.treas.gov. Include the notice number (Notice 2005–14) in the subject line.

_03 Deadline for Submission of Comments._ Comments must be received on or before March 31, 2005.

SECTION 7. DRAFTING INFORMATION

The principal authors of this notice are Paul Handleman and Lauren Ross Taylor of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Mr. Handleman or Ms. Taylor at (202) 622–3040 (not a toll-free call). For further information regarding the application of §199 to pass-through entities, contact James Quinn of the Office of Associate Chief Counsel (Passthroughs and Special Industries) at (202) 622–3080; regarding the determination of costs generally, contact Scott Rabinowitz of the Office of Associate Chief Counsel (Income Tax and Accounting) at (202) 622–4970; regarding the cost allocation rules under § 861, contact Bethany Ingwalson of the Office of Associate Chief Counsel (International) at (202) 622–3850; regarding expanded affiliated groups, contact Lisa Fuller of the Office of Associate Chief Counsel (Corporate) at (202) 622–7750; or regarding the definition of W–2 wages, contact Alfred Kelley of the Office of Associate Chief Counsel (Tax Exempt and Government Entities) at (202) 622–6040 (not toll-free calls).

**Partnership Anti-Mixing Bowl Regulations**

**Notice 2005–15**

The Internal Revenue Service intends to promulgate regulations under §§ 704 and 737 of the Internal Revenue Code to address the income tax consequences of distributions of property following partnership mergers.

**BACKGROUND**

Rev. Rul. 2004–43, 2004–18 I.R.B. 842, holds that new § 704(c) gain or loss is created when assets are contributed by the transferor partnership to the continuing partnership in an assets-over merger. Rev. Rul. 2004–43 also holds that § 704(c)(1)(B) applies to the newly created § 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over partnership merger, but does not apply to reverse § 704(c) gain or loss resulting from a revaluation of property in the continuing partnership. In addition, Rev. Rul. 2004–43 holds that for purposes of § 737(b), net precontribution gain includes the newly created § 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over partnership merger, but does not include reverse § 704(c) gain or loss resulting from a revaluation of property in the continuing partnership.

Some commentators have argued that Rev. Rul. 2004–43 is not consistent with the current regulations under §§ 704(c)(1)(B) and 737, and that the conclusions in the ruling should not be applied retroactively. In response to these comments, the Treasury Department and the Service intend to issue regulations under §§ 704(c)(1)(B) and 737 implementing the principles of the ruling. The regulations will be effective for distributions occurring after January 19, 2005. Rev. Rul. 2005–10, published in this issue of the Internal Revenue Bulletin, revokes Rev. Rul. 2004–43.
DESCRIPTION OF REGULATIONS

The regulations will apply the principles of Rev. Rul. 2004–43 to distributions of property following assets-over partnership mergers. The regulations will apply to distributions of property with newly created § 704(c) gain or loss whether or not that gain or loss is treated as reverse § 704(c) gain or loss as the result of a revaluation by the transferor partnership. The regulations also will apply to distributions of property with original § 704(c) gain or loss that existed upon contribution to the transferor partnership. However, the regulations will provide that if the transferor partnership in an assets-over merger holds contributed property with original § 704(c) gain or loss, the seven year periods in §§ 704(c)(1)(B) and 737 do not restart with respect to that gain or loss as a result of the merger.

The regulations will provide that § 704(c)(1)(B) does not apply to newly created § 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over partnership merger involving partnerships owned by the same owners in the same proportions. In addition, the regulations will provide that for purposes of § 737, net precontribution gain does not include newly created § 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over partnership merger involving partnerships owned by the same owners in the same proportions. In order for merging partnerships to qualify for the exceptions described in this paragraph, each partner’s percentage interest in the transferor partnership’s capital, profits, losses, distributions, liabilities, and all other items must be the same as the partner’s percentage interest in those items of the continuing partnership.

EFFECTIVE DATES

The regulations will be effective for distributions from partnerships made after January 19, 2005.

REQUEST FOR COMMENTS

Comments are requested regarding whether there are any other commonly owned partnerships that should be excepted from the principles of Rev. Rul. 2004–43, and, if so, under what circumstances the exceptions should apply. Comments are specifically requested regarding the application of §§ 704(c)(1)(B) and 737, including the previously contributed property exception of § 737(d)(1), to a distribution of property, after an assets-over partnership merger, to a partner who had been a partner in the transferor partnership, where the distributed property was held by the transferor partnership prior to the merger. Comments are also requested regarding whether the continuing partnership may apply a § 704(c) method to original § 704(c) gain or loss that is different than the method applied by the transferor partnership, and whether the continuing partnership may apply a § 704(c) method to newly created § 704(c) gain or loss that is different than the method that it applies to original § 704(c) gain or loss.

Comments are also requested regarding whether there are any additional issues that should be addressed in the regulations. For example, comments are requested regarding whether the regulations should apply the principles of §§ 704(c)(1)(B) and 737 to reverse section 704(c) gain or loss. Comments are also requested regarding whether the tiered partnership rule of § 1.704–3(a)(9) of the Income Tax Regulations should be modified or expanded to provide rules, similar to those applicable to assets-over partnership mergers, for the application of §§ 704(c)(1)(B) and 737, as well as § 704(c)(1)(A), to tiered partnership arrangements.

Comments may be submitted on or before July 19, 2005, to Internal Revenue Service, PO Box 7604, Washington, DC 20044, Attn: CC:PA:LPD:PR (Notice 2005–15), Room 5203. Submissions may also be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to the Courier’s Desk at 1111 Constitution Avenue, NW, Washington DC 20224, Attn: CC:PA:LPD:PR (Notice 2005–15), Room 5203. Submissions may also be sent electronically via the internet to the following email address: Notice.comments@irs.counsel.treas.gov. Include the notice number (Notice 2005–15) in the subject line.

The principal author of this notice is Laura Fields of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this notice, contact Ms. Fields at (202) 622–3050 (not a toll-free call).

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability. (Also Part 1, §§ 121, 1031; 1.121–1, 1.1031(a)–1.)


SECTION 1. PURPOSE

This revenue procedure provides guidance on the application of §§ 121 and 1031 of the Internal Revenue Code to a single exchange of property.

SECTION 2. BACKGROUND

.01 Section 121(a) provides that a taxpayer may exclude gain realized on the sale or exchange of property if the property was owned and used as the taxpayer’s principal residence for at least 2 years during the 5-year period ending on the date of the sale or exchange. Section 121(b) provides generally that the amount of the exclusion is limited to $250,000 ($500,000 for certain joint returns). Under § 121(d)(6), any gain attributable to depreciation adjustments (as defined in § 1250(b)(3)) for periods after May 6, 1997, is not eligible for the exclusion. This limitation applies only to depreciation allocable to the portion of the property to which the § 121 exclusion applies. See § 121–1(d)(1).

.02 Section 121(d), as amended by § 840 of the American Jobs Creation Act of 2004, Pub. L. 108–357, provides that, if a taxpayer acquired property in an exchange to which § 1031 applied, the § 121 exclusion will not apply if the sale or exchange of the property occurs during the 5-year period beginning on the date of the acquisition of the property. This provision is effective for sales or exchanges after October 22, 2004.

.03 Under § 1.121–1(e) of the Income Tax Regulations, a taxpayer who uses a portion of a property for residential purposes and a portion of the property for business purposes is treated as using the entire property as the taxpayer’s principal residence for purposes of satisfying the 2-year use requirement if the residential and business portions of the property are within the same dwelling unit. The term “dwelling unit” has the same meaning as
in § 280A(f)(1), but does not include appurtenant structures or other property. If, however, the business portion of the property is separate from the dwelling unit used for residential purposes, the gain allocable to the business portion of the property is not excludable unless the taxpayer has also met the 2-year use requirement for the business portion of the property.

.04 Section 1.121–1(e)(3) provides that, for purposes of determining the amount of gain allocable to the residential and business portions of the property, the taxpayer must allocate the basis and the amount realized using the same method of allocation the taxpayer used to determine depreciation adjustments (as defined in § 1250(b)(3)). Allocation based on the square footage of the residential and business portions of the property is an appropriate method of allocating the basis and the amount realized. Poague v. United States, 66 A.F.T.R.2d (RIA) 5825 (E.D. Va. 1990), aff’d, 947 F.2d 942 (4th Cir. 1991).

.05 Section 1031(a) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment (relinquished property) if the property is exchanged solely for property of like kind (replacement property) that is to be held either for productive use in a trade or business or for investment. Under § 1031(b), if a taxpayer also receives cash or property that is not like-kind property (boot) in an exchange that otherwise qualifies under § 1031(a), the taxpayer must recognize gain to the extent of the boot. Section 1031 does not apply to property that is used solely as a personal residence.

.06 Section 1012 provides that the basis of property is its cost. The basis of property acquired in an exchange is its fair market value, unless otherwise provided in the Code or regulations (for example, § 1031(d)). See Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954).

.07 Under § 1031(d), the basis of the replacement property is the same as the basis of the relinquished property, decreased by the amount of cash received and increased by the amount of gain recognized by the taxpayer in the exchange.

.08 Neither § 121 nor § 1031 addresses the application of both provisions to a single exchange of property. Section 121(d)(5)(B), however, provides rules for applying § 121 and another nonrecognition provision, § 1033, to a single replacement of property. Under § 1033, in general, gain is recognized only to the extent the amount realized from a compulsory or involuntary conversion of property exceeds the cost of qualifying replacement property, and the basis of the replacement property is its cost reduced by the amount of the gain not recognized.

.09 Section 121(d)(5)(B) provides that, in applying § 1033, the amount realized from the sale or exchange of property is treated as the amount determined without regard to § 121, reduced by the amount of gain excluded under § 121. Under § 121(d)(5)(B), the amount realized from an exchange of a taxpayer’s principal residence for purposes of applying § 1033 is the fair market value of the relinquished property reduced by the amount of the gain excluded from gross income under § 121. Thus, Congress concluded that for exchanges meeting the requirements of both § 121 and § 1033, (1) the § 121 exclusion should be applied to gain from the exchange before the application of § 1033, (2) for purposes of determining gain that may be deferred under § 1033, the § 121 exclusion should be applied first against amounts received by the taxpayer that are not reinvested in the replacement property (amounts equivalent to boot that would result in gain recognition absent the application of § 121), and (3) the gain excluded under § 121 should be added in the calculation of the taxpayer’s basis in the replacement property. See S. Rep. No. 830, 88th Cong., 2d Sess. 52–53, 1964–1 C.B. (Part 2) 505, 556–7 (“the basis of the taxpayer in the newly acquired residence will be his basis for the old residence increased by any exclusion of gain obtained by him under the provision which is reinvested in the new residence”); H.R. Rep. No. 749, 88th Cong., 1st Sess. 47, 1964–1 C.B. (Part 2) 125, 171.

SECTION 3. SCOPE

This revenue procedure applies to taxpayers who exchange property that satisfies the requirements for both the exclusion of gain from the exchange of a principal residence under § 121 and the nonrecognition of gain on the exchange of like-kind properties under § 1031. Thus, this revenue procedure applies only to taxpayers who satisfy the held for productive use in a trade or business or for investment requirement of § 1031(a)(1) with respect to the relinquished business property and the replacement business property (as defined below).

SECTION 4. APPLICATION

.01 In general. Taxpayers within the scope of this revenue procedure may apply both the exclusion of gain from the exchange of a principal residence under § 121 and the nonrecognition of gain from the exchange of like-kind properties under § 1031 to an exchange of property by applying the procedures set forth in this section 4.

.02 Computation of gain.

(1) Application of § 121 before § 1031. Section 121 must be applied to gain realized before applying § 1031.

(2) Application of § 1031 to gain attributable to depreciation. Under § 121(d)(6), the § 121 exclusion does not apply to gain attributable to depreciation deductions for periods after May 6, 1997, claimed with respect to the business or investment portion of a residence. However, § 1031 may apply to such gain.

(3) Treatment of boot. In applying § 1031, cash or other non-like kind property (boot) received in exchange for property used in the taxpayer’s trade or business or held for investment (the relinquished business property), is taken into account only to the extent the boot exceeds the gain excluded under § 121 with respect to the relinquished business property.

.03 Computation of basis. In determining the basis of the property received in the exchange to be used in the taxpayer’s trade or business or held for investment (the replacement business property), any gain included under § 121 is treated as gain recognized by the taxpayer. Thus, under § 1031(d), the basis of the replacement business property is increased by any gain attributable to the relinquished business property that is excluded under § 121.

SECTION 5. EXAMPLES

In each example below, the taxpayer is an unmarried individual and the property or a portion of the property has been used in the taxpayer’s trade or business or
Example 1. (i) Taxpayer A buys a house for $210,000 that A uses as A’s principal residence from 2000 to 2004. From 2004 until 2006, A rents the house to tenants and claims depreciation deductions of $20,000. In 2006, A exchanges the house for $10,000 of cash and a townhouse with a fair market value of $460,000 that A intends to rent to tenants. A realizes gain of $280,000 on the exchange.

(ii) A’s exchange of a principal residence that A rents for less than 3 years for a townhouse intended for rental and cash satisfies the requirements of both §§ 121 and 1031. Section 121 does not require the property to be the taxpayer’s principal residence on the sale or exchange date. Because A owns and uses the house as A’s principal residence for at least 2 years during the 5-year period prior to the exchange, A may defer gain under § 121. Because the house is investment property at the time of the exchange, A may defer gain under § 121.

(iii) Under section 4.02(1) of this revenue procedure, A applies § 121 to exclude $250,000 of the $280,000 gain before applying the nonrecognition rules of § 1031. A may defer the remaining gain of $30,000, including the $20,000 gain attributable to depreciation, under § 1031. See section 4.02(2) of this revenue procedure. Although A receives $10,000 of cash (boot) in the exchange, A is not required to recognize gain because the boot is taken into account for purposes of § 1031(b) only to the extent the boot exceeds the amount of excluded gain. See section 4.02(3) of this revenue procedure.

These results are illustrated as follows:

<table>
<thead>
<tr>
<th>Amount realized</th>
<th>Total property</th>
<th>2/3 residential property</th>
<th>1/3 business property</th>
</tr>
</thead>
<tbody>
<tr>
<td>Realized gain</td>
<td>$360,000</td>
<td>$240,000</td>
<td>$120,000</td>
</tr>
<tr>
<td>Basis</td>
<td>$210,000</td>
<td>$140,000</td>
<td>$70,000</td>
</tr>
<tr>
<td>Depreciation adjustment</td>
<td>$ 30,000</td>
<td>$ 30,000</td>
<td>$ 30,000</td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>$180,000</td>
<td>$140,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Realized gain</td>
<td>$180,000</td>
<td>$100,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>Gain excluded under § 121</td>
<td>$100,000</td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td>Gain deferred under § 1031</td>
<td>$ 80,000</td>
<td>$ 80,000</td>
<td></td>
</tr>
</tbody>
</table>

Example 2. (i) Taxpayer B buys a property for $210,000. The property consists of two separate dwelling units (within the meaning of § 1.121–1(e)(2)), a house and a guesthouse. From 2001 until 2006, B uses the house as B’s principal residence and uses the guesthouse as an office in B’s trade or business. Based on the square footage of the respective parts of the property, B allocates 2/3 of the basis of the property to the house and 1/3 to the guesthouse. In 2006, B exchanges the entire property for a residence and a separate property that B intends to use as an office. The total fair market value of B’s replacement properties is $360,000. The fair market value of the replacement residence is $240,000 and the fair market value of the replacement business property is $120,000, which is equal to the fair market value of the relinquished business property. From 2001 to 2006, B claims depreciation deductions of $30,000 for the business use. B realizes gain of $180,000 on the exchange.

(ii) Under § 121, B may exclude gain of $100,000 allocable to the residential portion of the house (2/3 of $360,000 amount realized, or $240,000, minus 2/3 of $210,000 basis, or $140,000) because B meets the ownership and use requirements for that portion of the property. Because the guesthouse is business property separate from the dwelling unit and B has not met the use requirements for the guesthouse, B may not exclude the gain allocable to the guesthouse under § 1.121–1(e). However, because the fair market value of the replacement business property is equal to the fair market value of the relinquished business property and B receives no boot, B may defer the remaining gain of $80,000 (1/3 of $360,000 amount realized, or $120,000, minus $40,000 adjusted basis, which is 1/3 of $210,000 basis, or $70,000, adjusted by $30,000 depreciation) under § 1031. These results are illustrated as follows:

<table>
<thead>
<tr>
<th>Amount realized</th>
<th>Total property</th>
<th>2/3 residential property</th>
<th>1/3 business property</th>
</tr>
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<tbody>
<tr>
<td>Realized gain</td>
<td>$360,000</td>
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<td>Depreciation adjustment</td>
<td>$ 30,000</td>
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</tr>
<tr>
<td>Adjusted basis</td>
<td>$180,000</td>
<td>$140,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Realized gain</td>
<td>$180,000</td>
<td>$100,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>Gain excluded under § 121</td>
<td>$100,000</td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td>Gain deferred under § 1031</td>
<td>$ 80,000</td>
<td>$ 80,000</td>
<td></td>
</tr>
</tbody>
</table>

(iii) Because no portion of the gain attributable to the relinquished business property is excluded under § 121 and B receives no boot and recognizes no gain or loss in the exchange, B’s basis in the replacement business property is equal to B’s basis in the relinquished business property at the time of the exchange ($40,000). B’s basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($240,000).

Example 3. (i) Taxpayer C buys a property for $210,000. The property consists of a house that constitutes a single dwelling unit under § 1.121–1(e)(2). From 2001 until 2006, C uses 2/3 of the house (by square footage) as C’s principal residence and uses 1/3 of the house as an office in C’s trade or business. In 2006, C exchanges the entire property for a residence and a separate property that C intends to use as an office in C’s trade or business. The total fair market value of C’s replacement properties is $360,000. The fair market value of the replacement residence is $240,000 and the fair market value of the replacement business property is $120,000, which is equal to the fair market value of the business portion of the relinquished property. From 2001 to 2006, C claims depreciation deductions of $30,000 for the business use. C realizes gain of $180,000 on the exchange.

(ii) Under § 121, C may exclude the gain of $100,000 allocable to the residential portion of the house (2/3 of $360,000 amount realized, or $240,000, minus 2/3 of $210,000 basis, or $140,000) because C meets the ownership and use requirements for that portion of the property.

(iii) The remaining gain of $80,000 (1/3 of $360,000 amount realized, or $120,000, minus $40,000 adjusted basis, which is 1/3 of $210,000 basis, or $70,000, adjusted by $30,000 depreciation) is allocable to the business portion of the house (the office). Under section 4.02(1) of this revenue procedure, C applies § 121 before applying the nonrecognition rules of § 1031. Under § 1.121–1(e), C may exclude $50,000 of the gain allocable to the office because the office and residence are part of a single dwelling unit. C may not exclude that portion of the gain ($30,000) attributable to depreciation through the office use.
deductions, but may defer the remaining gain of $30,000 under § 1031.

These results are illustrated as follows:

<table>
<thead>
<tr>
<th></th>
<th>Total property</th>
<th>2/3 residential property</th>
<th>1/3 business property</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount realized</td>
<td>$360,000</td>
<td>$240,000</td>
<td>$120,000</td>
</tr>
<tr>
<td>Basis</td>
<td>$210,000</td>
<td>$140,000</td>
<td>$ 70,000</td>
</tr>
<tr>
<td>Depreciation adjustment</td>
<td>$30,000</td>
<td>$ 30,000</td>
<td>$ 30,000</td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>$180,000</td>
<td>$140,000</td>
<td>$ 40,000</td>
</tr>
<tr>
<td>Realized gain</td>
<td>$180,000</td>
<td>$100,000</td>
<td>$ 80,000</td>
</tr>
<tr>
<td>Gain excluded under § 121</td>
<td>$150,000</td>
<td>$100,000</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Gain deferred under § 1031</td>
<td>$30,000</td>
<td>$ 30,000</td>
<td>$ 30,000</td>
</tr>
</tbody>
</table>

(iv) C’s basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($240,000). C’s basis in the replacement business property is $90,000, which is equal to C’s basis in the relinquished business property at the time of the exchange ($40,000), increased by the gain excluded under § 121 attributable to the relinquished business property ($50,000). See section 4.03 of this revenue procedure.

Example 4. (i) The facts are the same as in Example 3 except that C also receives $10,000 of cash in the exchange and the fair market value of the replacement business property is $110,000, which is $10,000 less than the fair market value of the business portion of the relinquished property ($120,000).

(ii) Under § 121, C may exclude the gain of $100,000 allocable to the residential portion of the house (2/3 of $360,000 amount realized, or $240,000, minus 2/3 of $210,000 basis, or $140,000).

(iii) The remaining gain of $80,000 (1/3 of $360,000 amount realized, or $120,000, minus $40,000 adjusted basis) is allocable to the business portion of the house. Under section 4.02(1) of this revenue procedure, C applies § 121 to exclude gain before applying the nonrecognition rules of § 1031. Under § 1.121–1(e), C may exclude $50,000 of the gain allocable to the business portion of the house but may not exclude the $30,000 of gain attributable to depreciation deductions. Under section 4.02(2) of this revenue procedure, C may defer the $30,000 of gain under § 1031. Although C receives $10,000 of cash (boot) in the exchange, C is not required to recognize gain because the boot is taken into account for purposes of § 1031(b) only to the extent the boot exceeds the amount of excluded gain attributable to the relinquished business property. See 4.02(3) of this revenue procedure.

These results are illustrated as follows:

<table>
<thead>
<tr>
<th></th>
<th>Total property</th>
<th>2/3 residential property</th>
<th>1/3 business property</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount realized</td>
<td>$360,000</td>
<td>$240,000</td>
<td>$110,000 + 10,000</td>
</tr>
<tr>
<td>Basis</td>
<td>$210,000</td>
<td>$140,000</td>
<td>$ 70,000</td>
</tr>
<tr>
<td>Depreciation adjustment</td>
<td>$30,000</td>
<td>$ 30,000</td>
<td>$ 30,000</td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>$180,000</td>
<td>$140,000</td>
<td>$ 40,000</td>
</tr>
<tr>
<td>Realized gain</td>
<td>$180,000</td>
<td>$100,000</td>
<td>$ 80,000</td>
</tr>
<tr>
<td>Gain excluded under § 121</td>
<td>$150,000</td>
<td>$100,000</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Gain deferred under § 1031</td>
<td>$30,000</td>
<td>$ 30,000</td>
<td>$ 30,000</td>
</tr>
</tbody>
</table>

(iv) C’s basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($240,000). C’s basis in the replacement business property is $80,000, which is equal to C’s basis in the relinquished business property ($40,000), increased by the gain excluded under § 121 ($50,000), and reduced by the cash ($10,000) received. See section 4.03 of this revenue procedure.

Example 5. (i) The facts are the same as in Example 3 except that the total fair market value of the replacement properties is $540,000. The fair market value of the replacement residence is $360,000, the fair market value of the replacement business property is $180,000, and C realizes gain of $360,000 on the exchange.

(ii) Under § 121, C may exclude the gain of $220,000 allocable to the residential portion of the house (2/3 of $540,000 amount realized, or $360,000, minus 2/3 of $210,000 basis, or $140,000).

(iii) The remaining gain of $140,000 (1/3 of $540,000 amount realized, or $180,000, minus $40,000 adjusted basis) is allocable to the business portion of the house. Under section 4.02(1) of this revenue procedure, C excludes the gain before applying the nonrecognition rules of § 1031. Under § 1.121–1(e), C may exclude $50,000 of the gain allocable to the business portion of the house but may not exclude the $30,000 of gain attributable to depreciation deductions. Under section 4.02(2) of this revenue procedure, C may defer the $30,000 of gain under § 1031. Although C receives $10,000 of cash (boot) in the exchange, C is not required to recognize gain because the boot is taken into account for purposes of § 1031(b) only to the extent the boot exceeds the amount of excluded gain attributable to the relinquished business property. See 4.02(3) of this revenue procedure.

These results are illustrated as follows:
(iv) C’s basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($360,000). C’s basis in the replacement business property is $70,000, which is equal to C’s basis in the relinquished business property ($40,000), increased by the amount of the gain excluded under § 121 ($30,000). See section 4.03 of this revenue procedure.

Example 6. (i) The facts are the same as in Example 3 except that the total fair market value of the replacement properties is $750,000. The fair market value of the replacement residence is $500,000, the fair market value of the replacement business property is $250,000, and C realizes gain of $570,000 on the exchange.

(ii) The gain allocable to the residential portion is $360,000 (2/3 of $750,000 amount realized, or $500,000, minus 2/3 of $210,000 basis, or $140,000). C may exclude gain of $250,000 from gross income under § 121. C must include in income the gain of $110,000 allocable to the residential portion that exceeds the § 121(b) exclusion limitation amount.

(iii) The remaining gain of $210,000 (1/3 of $750,000 amount realized, or $250,000, minus $40,000 adjusted basis) is allocable to the business portion of the house. C may defer the $210,000 of gain, including the $30,000 gain attributable to depreciation, under § 1031.

These results are illustrated as follows:

<table>
<thead>
<tr>
<th></th>
<th>Total property</th>
<th>2/3 residential property</th>
<th>1/3 business property</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount realized</td>
<td>$750,000</td>
<td>$500,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>Basis</td>
<td>$210,000</td>
<td>$140,000</td>
<td>$ 70,000</td>
</tr>
<tr>
<td>Depreciation adjustment</td>
<td>$ 30,000</td>
<td>$ 140,000</td>
<td>$  30,000</td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>$180,000</td>
<td>$140,000</td>
<td>$  40,000</td>
</tr>
<tr>
<td>Realized gain</td>
<td>$570,000</td>
<td>$360,000</td>
<td>$210,000</td>
</tr>
<tr>
<td>Gain excluded under § 121</td>
<td>$250,000</td>
<td>$250,000</td>
<td></td>
</tr>
<tr>
<td>Gain deferred under § 1031</td>
<td>$210,000</td>
<td>$210,000</td>
<td></td>
</tr>
<tr>
<td>Gain recognized</td>
<td>$110,000</td>
<td>$110,000</td>
<td></td>
</tr>
</tbody>
</table>

(iv) C’s basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($500,000). C’s basis in the replacement business property is $40,000, which is equal to C’s basis in the relinquished business property at the time of the exchange.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective January 27, 2005. However, taxpayers may apply this revenue procedure in taxable years for which the period of limitation on refund or credit under § 6511 has not expired.

DRAFTING INFORMATION

The principal author of this revenue procedure is Sara Paige Shepherd of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Ms. Shepherd at (202) 622–4960 (not a toll-free call).
Amendment of Previously Proposed Regulations and Notice of Public Hearing

Statutory Mergers and Consolidations

REG–117969–00

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Amendment of previously proposed regulations and notice of public hearing.

SUMMARY: This document amends previously proposed regulations published in the Federal Register on January 24, 2003 (REG–126485–01, 2003–1 C.B. 542, 68 FR 3477) by cross-reference to temporary regulations. Those regulations define the term "statutory merger or consolidation" as that term is used in section 368(a)(1)(A). This notice of proposed rulemaking affects corporations engaging in mergers and consolidations and their shareholders. It is being issued concurrently with proposed regulations under sections 358, 367, and 884. (See REG–126485–01, 2003–1 C.B. 542, 68 FR 3477). The public hearing (IRS–REG–117969–00). The public hearing functionally, to supplement the reference to state law. Accordingly, the Treasury Department and IRS thought it advisable to define a merger or consolidation functionally, to supplement the reference to state law. Accordingly, the Treasury Department and IRS developed and proposed such a functional definition in 2003. See Notice of Proposed Rulemaking (REG–126485–01, 2003–1 C.B. 542 [68 FR 3477]), cross-referencing temporary regulations (T.D. 9038, 2003–1, C.B. 524 [68 FR 3384]) (January 24, 2003).

Many foreign jurisdictions now have merger or consolidation statutes that operate in material respects like those of the states, i.e., all assets and liabilities move by operation of law. The Treasury Department and IRS believe that transactions effected pursuant to these statutes should be treated as reorganizations if they satisfy the functional criteria applicable to transactions under domestic statutes.

This document proposes a revised definition of a statutory merger or consolidation. The previously proposed definition of a statutory merger required that it be a transaction effected "pursuant to the laws of the United States or a State or the District of Columbia." See REG–126485–01 (2003–1 C.B. 542 [68 FR 3477]). The new proposed definition contained in this document replaces the quoted language with "pursuant to the statute or statutes necessary to effect the merger or consolidation." This proposed change would allow a transaction effected pursuant to the statutes of a foreign jurisdiction or of a United States possession to qualify as a statutory merger or consolidation under section 368(a)(1)(A), provided it otherwise qualifies as a reorganization. The phrase "statute or statutes" is not intended to prevent transactions effected pursuant to legislation from qualifying as mergers or consolidations where such legislation is supplemented by administrative or case law.

This notice of proposed rulemaking also proposes to remove §1.368–2(b)(1)(i) of the previously proposed regulations. That section imposes limitations on the use of disregarded entities in statutory mergers or consolidations when certain entities are not organized under the laws of the United States or a State or the District of Columbia.

Although this document revises the terms of the proposed definition of a statutory merger or consolidation for purposes of section 368, the provisions of the temporary regulations will remain in effect until this proposal is incorporated in temporary or final regulations after notice and comment.
Section 1.368–2(b)(1)(B)(iv). Examples 1 and 2 in the previously proposed regulations each specified that one of the parties to the transaction described in the example “is not treated as owning any assets of an entity that is disregarded as an entity separate from its owner for Federal tax purposes.” The results in those examples would be the same in each case whether or not a party to the transaction held such assets. See §1.368–2(b)(1)(B)(iv), Example 3 in the previously proposed regulations. To avoid any possible implication to the contrary, the Treasury Department and IRS propose removal of the sentence specifying that condition from each example. The Treasury Department and IRS are continuing to study other comments received on the earlier proposed regulations.

A notice of proposed rulemaking proposing amendments to the regulations under sections 358, 367, and 884 (including special rules for determining basis and holding period in certain transactions involving one or more foreign corporations) is being published simultaneously with the publication of this notice of proposed rulemaking. See REG–125628–01 in this issue of the Bulletin.

Proposed Effective Date

These regulations are proposed to apply to transactions occurring after the date final regulations are published in the Federal Register.

Special Analyses

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

Comments and Public Hearing

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

A public hearing has been scheduled for May 19, 2005, beginning at 10 a.m. in the IRS Auditorium (7th Floor), Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the FOR FURTHER INFORMATION CONTACT portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by April 28, 2005. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

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

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

Par. 2. Paragraph (b)(1) of §1.368–2 as proposed on January 24, 2003, at 68 FR 3477, is proposed to be revised to read as follows:

§1.368–2 Definition of terms.

* * * * *

(b)(1)(i) Definitions. The following definitions apply for purposes of this paragraph (b)(1):

(A) Disregarded entity. A disregarded entity is a business entity (as defined in §301.7701–2(a) of this chapter) that is disregarded as an entity separate from its owner for Federal tax purposes. Examples of disregarded entities include a domestic single member limited liability company that does not elect to be classified as a corporation for Federal tax purposes, a corporation (as defined in §301.7701–2(b) of this chapter) that is a qualified REIT subsidiary (within the meaning of section 856(i)(2)), and a corporation that is a qualified subchapter S subsidiary (within the meaning of section 1361(b)(3)(B)).

(B) Combining entity. A combining entity is a business entity that is a corporation (as defined in §301.7701–2(b) of this chapter) that is not a disregarded entity.

(C) Combining unit. A combining unit is composed solely of a combining entity and all disregarded entities, if any, the assets of which are treated as owned by such combining entity for Federal tax purposes.

(ii) Statutory merger or consolidation generally. For purposes of section 368(a)(1)(A), a statutory merger or consolidation is a transaction effected pursuant to the statute or statutes necessary to effect the merger or consolidation, in which transaction, as a result of the operation of such statute or statutes, the following events occur simultaneously at the effective time of the transaction—

(A) All of the assets (other than those distributed in the transaction) and liabilities (except to the extent satisfied or dis-
charged in the transaction) of each member of one or more combining units (each a transferee unit) become the assets and liabilities of one or more members of one other combining unit (the transferor unit); and

(B) The combining entity of each transferee unit ceases its separate legal existence for all purposes; provided, however, that this requirement will be satisfied even if, under applicable law, after the effective time of the transaction, the combining entity of the transferor unit (or its officers, directors, or agents) may act or be acted against, or a member of the transferee unit (or its officers, directors, or agents) may act or be acted against in the name of the combining entity of the transferee unit, provided that such actions relate to assets or obligations of the combining entity of the transferee unit that arose, or relate to activities engaged in by such entity, prior to the effective time of the transaction, and such actions are not inconsistent with the requirements of paragraph (b)(1)(ii)(A) of this section.

(iii) Examples. The following examples illustrate the rules of paragraph (b)(1) of this section. In each of the examples, except as otherwise provided, each of V, Y, and Z is a C corporation. X is a limited liability company. Except as otherwise provided, X is wholly owned by Y and is disregarded as an entity separate from Y for Federal tax purposes. The examples are as follows:

Example 1. Divisive transaction pursuant to a merger statute. (i) Under State W law, Z transfers some of its assets and liabilities to Y, retains the remainder of its assets and liabilities, and remains in existence following the transaction. The transaction qualifies as a merger under State W corporate law.

(ii) The transaction does not satisfy the requirements of paragraph (b)(1)(ii)(A) of this section because all of the assets and liabilities of Z, the combining entity of the transferor unit, do not become the assets and liabilities of Y, the combining entity and sole member of the transferee unit. In addition, the transaction does not satisfy the requirements of paragraph (b)(1)(ii)(B) of this section because the separate legal existence of Z does not cease for all purposes. Accordingly, the transaction does not qualify as a statutory merger or consolidation under section 368(a)(1)(A).

Example 2. Merger of a target corporation into a disregarded entity in exchange for stock of the owner. (i) Under State W law, Z merges into X. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z become the assets and liabilities of X and Z’s separate legal existence ceases for all purposes. In the merger, the Z shareholders exchange their stock of Z for stock of Y.

(ii) The transaction satisfies the requirements of paragraph (b)(1)(ii) of this section because the transaction is effected pursuant to State W law and the following events occur simultaneously at the effective time of the transaction:

1. The combining entity of the transferor unit, X, ceases its separate legal existence for all purposes.

2. The combining entity, X, and sole member of the transferor unit, Z, become the assets and liabilities of Y, the combining entity of the transferee unit, and X, a disregarded entity the assets of which Y is treated as owning for Federal tax purposes.

Example 3. Merger of a target S corporation that owns a QSub into a disregarded entity. (i) The facts are the same as in Example 2, except that Z is an S corporation and owns all of the stock of U, a QSub.

(ii) The deemed formation by Z of U pursuant to §1.1365–5(b)(1) (as a consequence of the termination of U’s QSub election) is disregarded for Federal income tax purposes. The transaction is treated as a transfer of the assets of U to X, followed by X’s transfer of these assets to U in exchange for stock of U. See §1.1365–5(b)(3). Example 9. The transaction will, therefore, satisfy the requirements of paragraph (b)(1)(ii) of this section because the transaction is effected pursuant to State W law and the following events occur simultaneously at the effective time of the transaction:

1. All of the assets and liabilities of Z, the combining entity of the transferee unit, and X, a disregarded entity the assets of which Y is treated as owning for Federal tax purposes, and Z ceases its separate legal existence for all purposes. Moreover, the deemed transfer of the assets of U in exchange for U stock does not cause the transaction to fail to qualify as a statutory merger or consolidation. See section 368(a)(2)(C). Accordingly, the transaction qualifies as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 4. Triangular merger of a target corporation into a disregarded entity. (i) The facts are the same as in Example 2, except that V owns 100 percent of the outstanding stock of Y and, in the merger of Z into X, the Z shareholders exchange their stock of Z for stock of V. In the transaction, Z transfers substantially all of its properties to X.

(ii) The transaction is not prevented from qualifying as a statutory merger or consolidation under section 368(a)(1)(A), provided the requirements of section 368(a)(2)(D) are satisfied. Because the assets of X are treated for Federal tax purposes as the assets of Y, Y will be treated as acquiring substantially all of the properties of Z in the merger for purposes of determining whether the merger satisfies the requirements of section 368(a)(2)(D). As a result, the Z shareholders that receive stock of V will be treated as receiving stock of a corporation that is in control of Y, the combining entity of the transferee unit that is the acquiring corporation for purposes of section 368(a)(2)(D).

Accordingly, the merger will qualify if the transaction satisfies the requirements of section 368(a)(2)(D).

Example 5. Merger of a target corporation into a disregarded entity owned by a partnership. (i) The facts are the same as in Example 2, except that Y is organized as a partnership under the laws of State W and is classified as a partnership for Federal tax purposes.

(ii) The transaction does not satisfy the requirements of paragraph (b)(1)(ii)(A) of this section. All of the assets and liabilities of Z, the combining entity and sole member of the transferor unit, become the assets and liabilities of X and its partners and the assets and liabilities of one or more members of the transferee unit do not become the assets and liabilities of one or more members of a transferee unit because neither X nor Y qualifies as a combining entity. Accordingly, the transaction cannot qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 6. Merger of a disregarded entity into a corporation. (i) Under State W law, X merges into Z. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction:

1. All of the assets and liabilities of X (but not the assets and liabilities of Z other than those of X) become the assets and liabilities of Z and X’s separate legal existence ceases for all purposes.

(ii) The transaction does not satisfy the requirements of paragraph (b)(1)(ii)(A) of this section because all of the assets and liabilities of X do not become the assets and liabilities of one or more members of the transferee unit. The transaction also does not satisfy the requirements of paragraph (b)(1)(ii)(B) of this section because X does not qualify as a combining entity. Accordingly, the transaction cannot qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 7. Merger of a corporation into a disregarded entity in exchange for interests in the disregarded entity. (i) Under State W law, Z merges into X. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction:

1. All of the assets and liabilities of Z become the assets and liabilities of X and Z’s separate legal existence ceases for all purposes.

Example 8. Merger transaction preceded by distribution. (i) Z operates two unrelated businesses, Business P and Business Q, each of which represents 50 percent of the value of the assets of Z. Y desires to acquire and continue operating Business P, but does not want to acquire Business Q. Pursuant to a single plan, Z sells Business Q for cash to parties unrelated to Z and Y in a taxable transaction, and then distributes the proceeds of the sale pro rata to its shareholders. Then, pursuant to State W law, Z merges into Y. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction:

1. All of the assets and liabilities of Z become the assets and liabilities of Y and Z’s separate legal existence ceases for all purposes.

Example 9. Merger of a target corporation into a disregarded entity owned by a partnership. (i) The facts are the same as in Example 2, except that Y is organized as a partnership under the laws of State W and is classified as a partnership for Federal tax purposes.

(ii) The transaction does not satisfy the requirements of paragraph (b)(1)(ii)(A) of this section. All of the assets and liabilities of Z, the combining entity and sole member of the transferor unit, become the assets and liabilities of X and its partners and the assets and liabilities of one or more members of the transferee unit do not become the assets and liabilities of one or more members of a transferee unit because neither X nor Y qualifies as a combining entity. Accordingly, the transaction cannot qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A).
Notice of Proposed Rulemaking

Revision of Income Tax Regulations Under Sections 358, 367, and 884 Dealing With Statutory Mergers or Consolidations Under Section 368(a)(1)(A) Involving One or More Foreign Corporations

REG–125628–01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations amending the income tax regulations under various provisions of the Internal Revenue Code (Code) to account for statutory mergers and consolidations under section 368(a)(1)(A) (including reorganizations described in section 368(a)(2)(D) and (E)) involving one or more foreign corporations. These proposed regulations are issued concurrently with proposed regulations (REG–117969–00) that would amend the definition of a reorganization under section 368(a)(1)(A) to include certain statutory mergers or consolidations effected pursuant to foreign law.

DATES: Written and electronic comments and requests to speak and outlines of topics to be discussed at the public hearing scheduled for May 19, 2005, at 10:00 a.m. must be received by April 28, 2005.

ADDRESS: Send submissions to: CC:PA:LDP:PR (REG–125628–01), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LDP:PR (REG–125628–01), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the IRS Internet site at: www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (IRS and REG–125628–01). The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Robert W. Lorence, Jr., (202) 622–3860; concerning submissions, the hearing, or placement on the building access list to attend the hearing, Guy Traynor, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W-CAR:MP:T:T:S:P, Washington, DC 20224. Comments on the collection of information should be received no later than March 7, 2005. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information can be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in this proposed regulation is in §1.367(a)–3(d)(2)(vi)(B)(ii). This information is required to inform the IRS

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

(Submitted by the Office of the Federal Register on January 4, 2005, 8:45 a.m., and published in the issue of the Federal Register for January 5, 2005, 70 FR 746)
of a domestic corporation that is claiming an exception from the application of section 367(a) and (d) to certain transfers of property to a foreign corporation that is re-transferred by the foreign corporation to a domestic corporation controlled by the foreign corporation. The information is in the form of a statement attached to the domestic corporation’s U.S. income tax return for the year of the transfer certifying that if the foreign corporation disposes of the stock of the domestic controlled corporation with a tax avoidance purpose, the domestic corporation will file an income tax return (or amended return, as the case may be) reporting gain. The collection of information is mandatory. The likely respondents are domestic corporations.

Estimated total annual reporting burden: 50 hours.

Estimated average annual burden hours per respondent: 1 hour.

Estimated number of respondents: 50.

Estimated annual frequency of responses: on occasion.

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

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

Background

Section 368(a)(1)(A) defines a reorganization to include a statutory merger or consolidation (A reorganization). For transactions completed before January 24, 2003, regulations under section 368(a)(1)(A) provided that a reorganization was a merger or consolidation effected pursuant to the corporation law of the United States or a State or Territory or the District of Columbia. See §1.368–2(b)(1), as in effect before January 24, 2003.

On January 24, 2003, the IRS and the Treasury Department issued proposed regulations (REG–126485–01, 2003–1 C.B. 542 [68 FR 3477]) and temporary regulations (T.D. 9038, 2003–1 C.B. 524 [68 FR 3384]), revising the definition of a statutory merger or consolidation. The proposed and temporary regulations define a statutory merger or consolidation in a manner intended to ensure that those transactions are not divisive in nature. Accordingly, the regulations generally require that all the assets and liabilities of the merged corporation (other than assets distributed or liabilities discharged in the transaction) are transferred to the acquiring corporation and that the separate legal identity of the merged corporation ceases to exist in the transaction.

Pursuant to a notice of proposed rulemaking (proposed section 368 regulations) published contemporaneously with this document, the IRS and Treasury are proposing further revisions to the definition of a statutory merger or consolidation to take into account those transactions effected pursuant to foreign law. The proposed section 368 regulations amend the 2003 proposed regulations and provide that an A reorganization may occur, if certain conditions are satisfied, pursuant to the laws of a foreign jurisdiction, including a U.S. possession.

In light of this change, this document contains proposed amendments to the regulations under certain international Code provisions (sections 367, 884, and 6038B) to account for statutory mergers and consolidations involving one or more foreign corporations. Current international tax regulations are premises on an A reorganization being limited to a statutory merger or consolidation involving domestic corporations effected pursuant to domestic law. See, e.g., Rev. Rul. 57–465, 1957–2 C.B. 250. As a result, conforming changes must be made to these international tax regulations to ensure that they apply appropriately to statutory mergers and consolidations effected pursuant to foreign law. The proposed regulations also modify the section 367(a) and (b) regulations to address several other related issues.

Explanation of Provisions

A. Basis and Holding Period Rules

The proposed regulations provide basis and holding period rules for certain transactions involving foreign corporations with section 1248 shareholders in order to preserve relevant section 1248 amounts. A section 1248 shareholder is a U.S. person that satisfies the ownership requirements of section 1248(a) with respect to a foreign corporation. Section 1248(a) applies to a U.S. person that owns stock (directly, indirectly, or constructively) with 10 percent or more of the voting power in the foreign corporation at any time during the 5-year period ending on the sale or exchange of the stock when the foreign corporation was a controlled foreign corporation (CFC). Gain recognized by a section 1248 shareholder on the sale or exchange of stock of the foreign corporation is included in gross income as a dividend to the extent of the earnings and profits of the foreign corporation that are attributable to the stock sold or exchanged and that were accumulated while the stock was held by the U.S. person when the foreign corporation was a CFC (the section 1248 amount).

The IRS and Treasury believe that it is important to preserve section 1248 amounts in certain nonrecognition exchanges of foreign corporation stock. Preservation of section 1248 amounts is a function of the holding period and basis in the stock of the foreign corporation being exchanged. One of the underlying policies of section 367(b) is the preservation of the potential application of section 1248 in connection with certain nonrecognition exchanges. H. Rep. No. 94–658, 94th Cong., 1st Sess., at 242 (Nov. 12, 1975). These proposed regulations provide basis and holding period rules to preserve section 1248 amounts in the context of certain section 354 exchanges and certain triangular reorganizations.

The basis and holding period rules of the proposed regulations also apply to a foreign corporate shareholder of a foreign corporation that is a party to the reorganization, provided that the foreign corporate shareholder has at least one U.S. person that is a section 1248 shareholder with respect to the foreign corporate shareholder and to the foreign corporation. This rule is necessary to preserve application of section 964(e) to the foreign corporate shareholder with respect to lower-tier foreign corporations. Under section 964(e), if a CFC sells or exchanges stock in another foreign corporation, gain recognized on the sale or exchange is included in the income of the CFC as a dividend to the same extent that it would have been included under section 1248(a) if the CFC were a U.S. person. Such dividend income may
be treated as subpart F income that is included in the income of U.S. shareholders of the CFC.

1. Section 354 exchanges

The proposed regulations apply to certain section 354 exchanges involving foreign corporations, including exchanges of multiple blocks of stock. The proposed regulations preserve the bases and holding periods in different blocks of stock in certain foreign target corporations by requiring the exchanging shareholder to establish the particular shares of stock that were received in exchange for shares of a particular block of target stock. If the exchanging shareholder cannot establish the particular shares of target stock that were received for shares of a particular block of stock, then the shareholder must designate which shares of stock were received in exchange for shares of a particular block of stock, provided that the designation is consistent with the terms of the exchange. These tracing methods are used to determine the resulting tax consequences when stock received in a nonrecognition exchange is subsequently sold or otherwise exchanged. If the exchanging shareholder cannot establish, and does not designate, the particular shares received, the shareholder is treated as selling or otherwise exchanging a share received in a nonrecognition exchange for a share that was purchased or acquired at the earliest time.

The IRS and Treasury recently published proposed section 358 regulations (REG–116564–03, 2004–20 I.R.B. 927) that determine the basis of stock or securities received in section 354 exchanges (proposed section 358 regulations). The proposed section 358 regulations generally provide that the basis of each share of stock or security received in an exchange to which section 354, 355, or 356 applies will be the same as the basis of the share of stock or security exchanged therefor. For these purposes, the determination of which share of stock or security is received in exchange for a particular share of stock or security is made in accordance with the terms of the exchange or distribution.

These proposed regulations apply the principles of the proposed section 358 regulations to certain exchanges of stock of a foreign corporation by either a section 1248 shareholder, or a foreign corporate shareholder where at least one U.S. person is a section 1248 shareholder with respect to such foreign corporate shareholder and to the foreign corporation whose shares are exchanged (collectively and individually, section 367(b) shareholder), to ensure the preservation of section 1248 amounts. The proposed regulations also include specific guidance on the shareholder’s holding period in the stock received in the section 354 exchange. The proposed regulations do not, however, apply to distributions described in section 355.

Consistent with the proposed section 358 regulations, the proposed regulations hereunder would not apply to section 351 exchanges or to exchanges to which both section 351 and section 354 (or section 356) apply, if, in addition to stock being received, other property is received or liabilities are assumed. This limitation is intended to prevent a conflict between the rules for determining basis in a section 351 exchange (including the application of section 357(c)) and the rules proposed in this document. The IRS and Treasury are considering approaches for the preservation of section 1248 amounts in section 351 transactions in which liabilities are assumed or other property is received, and comments are requested in this regard.

In addition, the IRS and Treasury are considering developing specific rules for situations in which stock of the foreign acquiring corporation is not issued in the exchange (for example, when the exchanging shareholder owns all the stock of the foreign acquiring corporation). One possible approach may be for each existing share of stock in that corporation to be divided into portions to account for the different basis and holding periods of the stock of the foreign acquiring corporation and the stock of the acquired corporation in order to preserve section 1248 amounts. Comments are requested regarding this approach or possible alternative approaches.

2. Triangular reorganizations

The proposed regulations provide special basis and holding period rules for triangular reorganizations where the merging or surviving corporation is a foreign corporation with a section 367(b) shareholder. These rules apply to reorganizations described in section 368(a)(1)(A) and (a)(2)(D) (forward triangular merger) and to parenthetical section 368(a)(1)(C) reorganizations. In these transactions, the surviving corporation (S) acquires substantially all the assets of the acquired corporation (T), and the T shareholders exchange their T stock for stock of the corporation (P) that is in control (within the meaning of section 368(c)) of S. These rules also apply to reorganizations described in section 368(a)(1)(A) and (a)(2)(E) (reverse triangular merger). In a reverse triangular merger, S, a controlled subsidiary of P, merges into T, the surviving corporation, and the T shareholders exchange their T stock for stock of P.

Under current regulations, in a forward triangular merger or a parenthetical C reorganization, P’s basis in its S stock is adjusted as if P had acquired the T assets directly from T in a section 362(b) exchange and then had transferred the T assets to S in a transaction in which P’s basis in T stock is determined under section 858. See §1.358–6(c)(1) (commonly referred to as the “over-the-top” basis rules). Under current regulations, in a reverse triangular merger, P’s basis in the T stock it receives immediately after the transaction is equal to its basis in its S stock immediately before the transaction adjusted as if T had merged into S in a forward triangular merger and the over-the-top basis rules had applied. See §1.358–6(c)(2). If a reverse triangular merger also qualifies as a section 351 transfer or a section 368(a)(1)(B) reorganization, P can determine its basis in its S stock either by using the over-the-top basis rules as described in the prior sentence or by treating P as if it had acquired the T stock from the former shareholders of T in a transaction in which basis is determined under section 362(b) (carryover stock basis).

The IRS and Treasury are concerned that, in certain exchanges involving foreign corporations, application of the over-the-top basis rules would not properly preserve the section 1248 or 964(e) amounts with respect to the stock of S or T. The proposed regulations provide that, in determining the stock basis of the surviving corporation in certain triangular reorganizations, outside stock basis will be used instead of inside asset basis pursuant to §1.358–6(c). For example, in the case of a forward triangular merger (or a parenthetical C reorganization), where P is a do-
mestic corporation, S is a foreign corporation, and T has a section 1248 shareholder, the basis and holding period in the T stock, not the T assets, are used to determine P’s basis in the S stock. The same rules apply to certain reverse triangular mergers, where S merges into T with T surviving. In that case, P’s basis in the T stock immediately after the transaction would reflect the basis and holding period of the T stock instead of the T assets.

Under this stock basis approach for triangular reorganizations, the proposed regulations provide for a divided basis and holding period in each share of stock in the surviving corporation to reflect the relevant section 1248 amounts in the S stock and T stock. In particular, each share of S stock in a forward triangular merger, and each share of T stock in a reverse triangular merger, where P is a section 367(b) shareholder immediately after the transaction, is divided into portions reflecting the basis and holding period of the S stock and the T stock before the transaction. However, the proposed regulations contain a de minimis exception to this rule. Under this exception, if the value of the S stock immediately before the transaction is de minimis (for example, where S is a corporation formed to facilitate the transaction), then each share of the surviving corporation is not divided; instead, the basis of the S stock is added to the basis of the stock of the surviving corporation held by P. The value of the S stock would be de minimis for this purpose if it is less than 1 percent of the value of the surviving corporation (S or T) immediately after the transaction.

If there are two or more blocks of stock in T or S held by a section 367(b) shareholder immediately after the transaction, then each share of the surviving corporation (S or T) is further divided to account for each block of stock. If two or more blocks of stock are held by one or more shareholders that are not section 367(b) shareholders, then shares in these blocks are aggregated into one divided portion for basis purposes. If none of the S or T shareholders is a section 367(b) shareholder, then the over-the-top basis rules of §1.358–6 apply instead of the rules in these proposed regulations.

The proposed regulations provide special rules when stock of the surviving corporation has a divided basis and holding period. Earnings and profits accumulated prior to the reorganization are attributed to a divided portion of a share of stock based on the block of stock whose basis and holding period the divided portion reflects. Post-reorganization earnings and profits are attributed to each divided share of stock pursuant to section 1248 and the regulations thereunder. The amount of earnings and profits attributed to a divided share of stock pursuant to section 1248 are further attributed to a divided portion of such share of stock based on its fair market value in relation to the other divided portions. Finally, shares of stock are no longer divided into separate portions if section 1248 or 964(e) becomes inapplicable to a subsequent sale or exchange of the stock.

The special basis rules in these proposed regulations apply to all triangular reorganizations where T has at least one section 367(b) shareholder, even if such shareholders own less than a controlling interest in T. The IRS and Treasury are considering whether the current basis rules of §1.358–6 should apply in cases where section 367(b) shareholders do not own a substantial percentage of the stock of T, or whether taxpayers should be permitted to elect to apply the current basis rules under §1.358–6 to determine P’s basis in the stock of the surviving corporation (S or T), provided that all section 367(b) shareholders of T include in income the section 1248 amounts with respect to the stock exchanged. Comments are requested in this regard.

The use of stock basis to determine P’s basis in the surviving corporation also presents administrative concerns when a portion of the stock of T is widely held. In the case of a reorganization described in section 368(a)(1)(B), which presents similar issues, Rev. Proc. 81–70, 1981–2 C.B. 729, provides that statistical sampling techniques, if appropriate, are permitted to determine the basis of stock received by the acquiring corporation. In this regard, the IRS and Treasury believe that it is appropriate to provide comparable treatment for exchanges of securities in this context. Accordingly, Notice 2005–6, 2005–5 I.R.B. 448, published contemporaneously with these proposed regulations, announces that the IRS and Treasury intend to amend §1.367(a)–3(a) to apply the exception from section 367(a) to exchanges of stock or securities except for the fact that money or other property is received in the exchange.

Taxpayers have questioned why the exception to the application of section 367(a) in §1.367(a)–3(a) includes exchanges of stock but not exchanges of securities in section 368(a)(1)(E) reorganizations and certain asset reorganizations. The IRS and Treasury believe that it is appropriate to provide comparable treatment for exchanges of securities in this context. Accordingly, Notice 2005–6, 2005–5 I.R.B. 448, published contemporaneously with these proposed regulations, announces that the IRS and Treasury intend to amend §1.367(a)–3(a) to apply the exception from section 367(a) to exchanges of stock or securities. Notice 2005–6 applies to transfers of securities after January 5, 2005. Taxpayers also may apply the provisions of the notice to transfers of securities occurring on or after July 20, 1998, and on or before January 5, 2005. In applying this notice, however, taxpayers must do so consistently to all transactions within its scope.
The proposed regulations also provide rules concerning the application of section 367(a) to reverse triangular mergers, where stock of P, a corporation that controls the merging corporation S, is treated as transferred (along with any other property of S) to the surviving corporation T in a section 361 transfer. If S is a domestic corporation and T is a foreign corporation, section 367(a) applies to the transfer by S of the P stock to T, unless an exception applies.

The IRS and Treasury believe that, if the stock of P is provided to S pursuant to the plan of reorganization, the section 361 transfer of the P stock from S to T should not be subject to section 367(a), and the proposed regulations so provide. If P does not provide its stock to S pursuant to the plan of reorganization, then the P stock will be treated as property of S and the transfer of such stock will be subject to section 367(a).

The IRS and Treasury intend to amend the regulations under section 6038B to conform with the changes made in these regulations.

C. Concurrent Application of Section 367(a) and (b)

The proposed regulations modify the current application of section 367(a) and (b) to transactions that require the inclusion in income of the all earnings and profits amount under section 367(b). Section 1.367(a)–3(b)(2) provides rules for the concurrent application of section 367(a) and (b) to transfers of stock of a foreign corporation. This may occur, for example, when a U.S. shareholder exchanges stock of a foreign corporation (foreign acquired corporation) for stock of another foreign corporation (foreign acquiring corporation). See §1.367(a)–3(b)(1). It may also occur when an acquiring corporation (foreign or domestic) acquires the assets of a foreign acquired corporation, and the U.S. shareholder exchanges stock of the foreign acquired corporation for stock of the foreign parent of the acquiring corporation in a triangular reorganization. The U.S. person’s exchange of stock of the foreign acquired corporation for stock of either the foreign acquiring corporation or the foreign parent is subject to section 367(a). See §1.367(a)–3(b) and (d). If the exchanging U.S. shareholder owns 5 percent or more (by vote or value) of the stock of the foreign acquiring corporation or the foreign parent immediately after the exchange, the shareholder recognizes gain, if any, under section 367(a), unless the shareholder enters into a gain recognition agreement as provided in §1.367(a)–8. If the exchanging shareholder is not a 5-percent shareholder, then the exchanging shareholder does not recognize gain, if any, on the exchange.

The U.S. shareholder’s exchange described above also may be subject to section 367(b). If the exchanging U.S. shareholder is a section 1248 shareholder of the foreign acquired corporation, and the stock of the foreign acquiring corporation (or its foreign parent corporation) is not stock in a corporation that is a CFC as to which the U.S. shareholder is a section 1248 shareholder immediately after the exchange, then the exchanging shareholder must include in income the all earnings and profits amount with respect to the stock exchanged. See §1.367(b)–4. If, instead, a domestic acquiring corporation acquires the assets of a foreign acquired corporation, and the U.S. shareholder exchanges stock of the foreign acquired corporation for stock of the foreign parent of the acquiring corporation in a triangular reorganization, then the exchanging shareholder must include in income the all earnings and profits amount with respect to the stock of the acquired corporation. See §1.367(b)–3. Unlike the section 1248 amount, the all earnings and profits amount is not limited by the shareholder’s gain inherent in the stock of the foreign acquired corporation.

In cases where section 367(a) and (b) apply concurrently to a transaction, existing §1.367(a)–3(b)(2) provides that section 367(b) will not apply if the transfer is taxable under section 367(a). If the transfer is taxable under section 367(a), the exchanging U.S. shareholder will recognize gain inherent in the exchanged stock (subject to recategorization as dividend income under section 1248). If the transfer is not taxable under section 367(a), because the exchanging U.S. shareholder either is not a 5-percent shareholder or enters into a gain recognition agreement, then section 367(b) applies and the exchange is subject to either §1.367(b)–3 or 1.367(b)–4 at the shareholder level.

Questions with respect to the concurrent application of section 367(a) and (b) have arisen in situations that otherwise would require inclusion of the all earnings and profits amount under §1.367(b)–3. If the all earnings and profits amount is greater than the section 367(a) gain with respect to the stock of the foreign acquired corporation, under current law the exchanging shareholder effectively may elect to be taxed on the lesser amount of gain under section 367(a) simply by failing to file a gain recognition agreement. In that case, section 367(b) would not apply and the shareholder would avoid inclusion in income of the greater all earnings and profits amount.

The ability to elect to recognize the lesser gain inherent in the stock exchanged in such cases is inconsistent with the policies of section 367(b) that apply to inbound transactions, including preventing conversion of tax deferral into tax forgiveness and ensuring that the domestic acquiring corporation’s section 381 carryover basis reflects an after-tax amount. Accordingly, the IRS and Treasury believe that the all earnings and profits amount provisions under §1.367(b)–3 should not operate electively in these cases. The proposed regulations require that, for exchanges subject to §1.367(b)–3 and section 367(a), section 367(b) would apply before section 367(a). In that case, inclusion of the all earnings and profits amount would increase the exchanging shareholder’s stock basis for purposes of computing the shareholder’s gain under section 367(a). Thus, if the all earnings and profits amount exceeds the inherent gain in the exchanged stock, gain is not recognized under section 367(a). If the transaction does not involve inclusion of the all earnings and profits amount (for example, if §1.367(b)–4 applies), the existing ordering rules continue to apply.

D. Parenthetical Section 368(a)(1)(B) Reorganizations

In a parenthetical reorganization under section 368(a)(1)(B), if a U.S. shareholder exchanges stock of an acquired corporation for voting stock of a foreign corporation that controls (within the meaning of section 368(c)) the acquiring corporation, the U.S. shareholder is treated as making an indirect transfer of stock of the acquired corporation to the foreign con-
E. Transfers of Assets Following Certain Asset Reorganizations

If a U.S. shareholder exchanges stock or securities of an acquired corporation for stock or securities of a foreign acquiring corporation in a reorganization described in section 368(a)(1)(C), and the foreign acquiring corporation transfers all or part of the assets or stock acquired in the transaction are transferred to a corporation controlled by the acquiring corporation, that is subject to the §1.367(a)–3(b) stock transfer rules. If the acquired corporation is domestic, the U.S. shareholder is treated as transferring stock of a domestic corporation to the foreign acquiring corporation in a transaction that is subject to §1.367(a)–3(c).

On August 16, 2004, the IRS and Treasury issued proposed regulations under §1.368–2(k) that permit assets or stock acquired in any reorganization under section 368(a)(1) to be transferred to a corporation controlled by the acquiring corporation without disqualifying the reorganization. Prior to these proposed regulations, the IRS and Treasury issued Rev. Rul. 2002–85, 2002–2 C.B. 986, which extended this treatment to section 368(a)(1)(D) reorganizations. Notice 2002–77, 2002–2 C.B. 997, issued contemporaneously with Rev. Rul. 2002–85, provided that §1.367(a)–3(d)(1)(v) would be amended to treat transactions described in Rev. Rul. 2002–85 as indirect stock transfers, if the transfer of assets by the acquiring corporation to its controlled subsidiary occurred pursuant to the plan of reorganization.

The effect of the proposed regulations under §1.368–2(k) is to permit transfers of assets or stock to a controlled subsidiary in reorganizations not specifically identified or mentioned in section 368(a)(2)(C) (section 368(a)(1)(D) and (F) reorganizations). The proposed regulations amend the indirect stock transfer rules to conform to the changes in the section 368 regulations. As a result, the proposed regulations provide that the transfer of assets to a controlled subsidiary subsequent to an asset reorganization under section 368(a)(1) would constitute an indirect transfer of stock, provided the transfer of assets by the foreign acquiring corporation to its controlled subsidiary occurs as part of the same transaction.

F. Indirect Transfers Involving a Change in Domestic or Foreign Status of Acquired Corporation

As indicated above, under existing §1.367(a)–3(d)(1)(v), a U.S. shareholder of an acquired corporation is treated as transferring the stock of the acquired corporation to the foreign acquiring corporation to the extent of the assets transferred to the controlled subsidiary. §1.367(a)–3(d)(1)(v). Section 368(a)(2)(C) provides that a transaction otherwise qualifying as a reorganization under section 368(a)(1)(A), (B), (C), and (G) will not be disqualified because all or part of the stock of the acquired corporation, the foreign acquiring corporation disposes of the foreign acquiring corporation, or the controlling corporation disposes of the stock of the acquired corporation, within 5 years of the initial transfer. See §1.367(a)–3(d)(2)(ii).

The proposed regulations revise the indirect stock transfer rules to include triangular section 368(a)(1)(B) reorganizations in which a U.S. shareholder exchanges stock of the acquired corporation for voting stock of a domestic corporation that controls a foreign acquiring corporation. In such a case, the gain recognition agreement filed with respect to the transfer may be triggered (and gain on the initial transfer of stock will be recognized) if the foreign controlling corporation disposes of the stock of the acquiring corporation, or the acquiring corporation disposes of the stock of the acquired corporation, within 5 years of the initial transfer. See §1.367(a)–3(d)(2)(ii).

The proposed regulations revise the indirect stock transfer rules to include triangular section 368(a)(1)(B) reorganizations in which a U.S. shareholder exchanges stock of the acquired corporation for voting stock of a domestic corporation that controls a foreign acquiring corporation. In such a case, the gain recognition agreement filed with respect to the transfer may be triggered (and gain on the initial transfer of stock will be recognized) if the foreign controlling corporation disposes of the stock of the acquiring corporation, or the acquiring corporation disposes of the stock of the acquired corporation, within 5 years of the initial transfer. See §1.367(a)–3(d)(2)(ii).

The proposed regulations revise the indirect stock transfer rules to include triangular section 368(a)(1)(B) reorganizations in which a U.S. shareholder exchanges stock of the acquired corporation for voting stock of a domestic corporation that controls a foreign acquiring corporation. In such a case, the gain recognition agreement filed with respect to the transfer may be triggered (and gain on the initial transfer of stock will be recognized) if the foreign controlling corporation disposes of the stock of the acquiring corporation, or the acquiring corporation disposes of the stock of the acquired corporation, within 5 years of the initial transfer. See §1.367(a)–3(d)(2)(ii).
scribed in section 351, provided the domestic transferee’s basis in the assets is no greater than the basis that the domestic acquired corporation had in such assets. The initial asset transfer to the foreign corporation is not subject to section 367(a) in such cases because the assets re-transferred to the domestic corporation remain subject to U.S. corporate tax.

The IRS and Treasury are concerned that asset reorganizations subject to this coordination rule may be used to facilitate corporate inversion transactions. An inversion generally involves a U.S. multinational corporation reincorporating outside the United States for tax purposes (either as a foreign corporation or as a subsidiary of a new foreign corporation). The IRS and Treasury also are concerned that the coordination rule might be used to facilitate divisive transactions. The proposed regulations address both of these concerns by modifying the scope of the coordination rule.

The revised coordination rule operates as follows. Section 367(a) and (d) generally apply to the transfer of assets to a foreign corporation even if the foreign corporation transfers all or part of the assets received to a controlled domestic corporation. This general rule, however, is subject to two exceptions which do not require income recognition under section 367(a) and (d) on the transfer of assets to the foreign corporation to the extent that assets are re-transferred to the domestic controlled corporation.

The first exception applies if the domestic acquired corporation is controlled (within the meaning of section 368(c)) by 5 or fewer domestic corporations, appropriate basis adjustments as provided in section 367(a)(5) are made to the stock of the foreign acquiring corporation, and any other conditions provided in regulations under section 367(a)(5) are satisfied. Although there currently are no regulations under section 367(a)(5), this exception will incorporate any conditions or limitations in future regulations once published.

In cases where the first exception does not apply, the second exception applies if the following two conditions are satisfied: (1) the indirect transfer of stock of the domestic acquired corporation satisfies the requirements of §1.367(a)-3(c)(1)(i), (ii), and (iv), and (c)(6); and (2) the domestic acquired corporation attaches a statement (described below) to its tax return for the taxable year of the transfer.

The statement that the domestic acquired corporation files must certify that, if the foreign acquiring corporation disposes of any stock of the domestic controlled corporation with a principal purpose of avoiding U.S. tax that would have been imposed on the domestic acquired corporation had it disposed of the re-transferred assets, the domestic acquired corporation will amend its return for the year of the initial transaction and recognize gain (described below). The disposition of stock is presumed to have a principal purpose of tax avoidance if the disposition occurs within 2 years of the transfer. The presumption may be rebutted, however, if the domestic acquired corporation (or the foreign acquiring corporation on its behalf) demonstrates to the satisfaction of the Commissioner that the transaction did not have a principal purpose of tax avoidance.

If the domestic acquired corporation recognizes gain pursuant to the statement, it is treated as if, immediately prior to the exchange, it had transferred the re-transferred assets, including any intangible assets, directly to a domestic corporation in exchange for stock of the corporation in a transaction that is treated as a section 351 exchange, and immediately sold the stock to an unrelated party at fair market value in a sale in which it recognizes gain, if any, but not loss. For purposes of this rule, the deemed transfer to a domestic corporation is treated as a section 351 exchange regardless of whether all the requirements for nonrecognition under section 351 are otherwise satisfied. Treating the domestic acquired corporation as recognizing gain on the disposition of stock, rather than assets, is intended to approximate the consequences that would have resulted had the domestic acquired corporation transferred the assets to a corporation and sold the stock received in such transfer prior to the outbound reorganization.

In addition, this treatment is consistent with other provisions that address divisive transactions. See, e.g., section 355(e) and §1.367(e)(2)(b)(2)(iii).

The basis that the foreign acquiring corporation has in the stock of the domestic controlled corporation is increased by the amount of gain recognized by the domestic acquired corporation under these rules immediately prior to its disposition; however, the basis of the re-transferred assets held by the domestic controlled corporation will not be increased by such gain. Finally, the anti-abuse provision under §1.367(d)-1T(g)(6) will not apply to intangible property included in the re-transferred assets.

H. Application of Section 367(b)
Regulations to Certain Triangular Reorganizations

Section 367(b) applies to exchanges under sections 332, 351, 354, 355, 356, and 361 (except to the extent described in section 367(a)(1)) in which the status of a foreign corporation as a corporation for tax purposes is necessary for application of the relevant nonrecognition provisions. Except as provided in regulations, under section 367(b) a foreign corporation that is a party to such an exchange is considered to be a corporation for tax purposes, and therefore the parties involved in the transaction are eligible for nonrecognition treatment.

Section 1.367(b)-4 applies to acquisitions by a foreign corporation (the foreign acquiring corporation) of the stock or assets of another foreign corporation (the foreign acquired corporation) in certain nonrecognition exchanges (a section 367(b) exchange). Consistent with section 1248, §1.367(b)-4(b)(1)(i) addresses exchanges by a section 1248 shareholder (or, in certain cases, a CFC shareholder that has a section 1248 shareholder), and generally requires such a shareholder to include in income its section 1248 amount as a result of a section 367(b) exchange, if immediately after the exchange (i) the stock received in the exchange is not stock in a corporation that is a controlled foreign corporation as to which the section 1248 shareholder described above is a section 1248 shareholder, or (ii) the foreign acquiring corporation or the foreign acquired corporation (if any, such as in a transaction described in section 368(a)(1)(B) or 351), is not a controlled foreign corporation as to which the section 1248 shareholder described above is a section 1248 shareholder.

Therefore, in a triangular reorganization (such as a triangular reorganization described in section 368(a)(1)(C)) that is within the scope of §1.367(b)-4, a section 367(b) shareholder must include in income
the section 1248 amount if, for example, it receives stock of a domestic corporation in exchange for its stock in a controlled foreign corporation. This is the case because, immediately after the exchange, the section 367(b) shareholder does not hold stock in a corporation that is a controlled foreign corporation as to which such shareholder is a section 367(b) shareholder.

Pursuant to the basis rules contained in this proposed regulation under §1.367(b)–13, the section 1248 amount with respect to the stock of the foreign acquired corporation that is exchanged can be properly preserved in the stock of a foreign corporation owned by a domestic corporation when the section 367(b) shareholder receives stock of the domestic corporation in a triangular reorganization. Consequently, the proposed regulations provide that a section 367(b) shareholder receiving stock of a domestic corporation in a triangular reorganization is not required to include in income the section 1248 amount under §1.367(b)–4(b)(1)(i), provided that the domestic corporation, immediately after the exchange, is a section 1248 shareholder of the surviving corporation (or in the case of a parenthetical section 368(a)(1)(B) reorganization, of the acquired corporation) that is itself a controlled foreign corporation.

I. Application of Section 367(b) Regulations to Certain Outbound Reorganizations

If a domestic corporation is a section 1248 shareholder with respect to a foreign corporation and transfers the stock in such foreign corporation to another foreign corporation in a section 361 transfer, the domestic corporation must include in income the section 1248 amount, if any, with respect to the stock of the transferred foreign corporation. See section 1248(f)(1) and §1.367(b)–4(b)(2)(ii), Example 4.

Taxpayers have commented that this rule may result in income inclusions in some cases where the section 1248 amount could be preserved, such that a current inclusion may not be necessary or appropriate. The IRS and Treasury are considering the application of section 367(a)(5) and section 1248(f)(1) to such transactions, in conjunction with §1.367(b)–13 of these regulations, to preserve section 1248 amounts, and comments are requested in this regard. The IRS and Treasury also are considering, and request comments, on situations in which there are multiple shareholders (including minority shareholders) of the domestic corporation; multiple assets (including appreciated and depreciated assets being transferred as part of the section 361 transfer); and liabilities being assumed in connection with the transaction.

J. Nonrecognition Transactions under the FIRPTA and PFIC Provisions

Section 897(a) generally treats gain or loss from the disposition of a U.S. real property interest by a nonresident alien individual or a foreign corporation as gain or loss that is effectively connected with the conduct of a trade or business within the United States. Sections 897(d) and (e) provide rules that apply section 897 in the context of distributions and nonrecognition exchanges of U.S. real property interests. Temporary regulations were issued under sections 897(d) and (e) providing guidance on the application of section 897 to certain corporate transactions involving U.S. real property interests. See §1.897–5T, 1.897–6T, and Notice 89–85, 1989–2 C.B. 403. These rules do not specifically address A reorganizations because such regulations were based on A reorganizations being limited to statutory mergers between domestic corporations. The IRS and Treasury intend to revise these regulations to reflect A reorganizations and welcome comments on revisions that are necessary to apply these regulations to A reorganizations, as well as comments on other issues under the regulations.

Section 1291(f) provides authority to issue regulations concerning the exchange of stock in a passive foreign investment company (PFIC) in a nonrecognition transaction. Proposed regulations were published in the Federal Register (57 FR 11047) on April 1, 1992, providing rules for the disposition of PFIC stock by U.S. shareholders in nonrecognition exchanges. See §1.1291–6 of the proposed regulations. The application of these proposed regulations is based on A reorganizations being limited to statutory mergers between domestic corporations. The IRS and Treasury intend to revise these proposed regulations to reflect A reorganizations and welcome comments on revisions that are necessary in this regard, as well as comments on other issues under these regulations.

Proposed Effective Date

Except as otherwise specified, these regulations are proposed to apply to transactions occurring after the date these regulations are published as final regulations in the Federal Register.

Special Analyses

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

Comments and Public Hearing

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

A public hearing has been scheduled for May 19, 2005, beginning at 10:00 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more
than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the FOR FURTHER INFORMATION CONTACT portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by April 28, 2005. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

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

* * * * *

Proposed Amendments to the Regulations

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

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18. In paragraph (d)(3), newly designated Example 6A, paragraph (i), the first and last sentences are revised.

19. In paragraph (d)(3), newly designated Example 6B and Example 9 are revised.

20. In paragraph (d)(3), for each of the newly designated examples listed in the first column, replace the language in the second column with the language in the third column:

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<td>Example 12</td>
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<tr>
<td>Example 13A, paragraph (i) and paragraph (ii), first sentence</td>
<td>Example 10</td>
<td>Example 13</td>
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<tr>
<td>Example 14A, paragraph (i)</td>
<td>Example 11</td>
<td>Example 14</td>
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22. In paragraph (e)(1), remove the first sentence and add two sentences in its place.

The revisions and additions are as follows:

§1.367(a)–3 Treatment of transfers of stock or securities to foreign corporations.

(a) ** * * * ** However, if, in an exchange described in section 354 or 356, a U.S. person exchanges stock of a foreign corporation in a reorganization described in section 368(a)(1)(E), or a U.S. person exchanges stock of a domestic or foreign corporation for stock of a foreign corporation pursuant to an asset reorganization that is not treated as an indirect stock transfer under section (d) of this section, such section 354 or 356 exchange is not a transfer to a foreign corporation subject to section 367(a). See paragraph (d)(3), Example 16, of this section. For purposes of this section, an asset reorganization is defined as a reorganization described in section 368(a)(1) involving a transfer of assets under section 361. If, in a transfer described in section 361, a domestic merging corporation transfers stock of a controlling corporation to a foreign surviving corporation in a reorganization described in sections 368(a)(1)(A) and (a)(2)(E), such section 361 transfer is not subject to section 367(a) if the stock of the controlling corporation is provided to the merging corporation by the controlling corporation pursuant to the plan of reorganization; a section 361 transfer of other property, including stock of the controlling corporation not provided by the controlling corporation pursuant to the plan of reorganization, by the domestic merging corporation to the foreign surviving corporation pursuant to such a reorganization is subject to section 367(a). For special basis and holding period rules involving foreign corporations that are parties to certain reorganizations under section 368(a)(1), see §1.367(b)–13, * * *

(i) ** * In general. ** A transfer of foreign stock or securities described in section 367(a) and the regulations thereunder as well as in section 367(b) and the regulations thereunder shall be subject concurrently to sections 367(a) and (b) and the regulations thereunder, except as provided in paragraph (b)(2)(i)(A) or (B) of this section. See paragraph (d)(3), Example 11, of this section.

(A) If a foreign corporation transfers assets to a domestic corporation in a transaction to which §1.367(b)–3(a) and (b) and the indirect stock transfer rules of paragraph (d) of this section apply, then the section 367(b) rules shall apply prior to the section 367(a) rules. See paragraph (d)(3), Example 15, of this section. This paragraph (b)(2)(i)(A) applies only to transactions occurring after the date these regulations are published as final regulations in the Federal Register.

(B) Except as provided in paragraph (b)(2)(i)(A) of this section, section 367(b) and the regulations thereunder shall not apply if the foreign corporation is not treated...
as a corporation under section 367(a)(1). See paragraph (d)(3), Example 14, of this section.

* * * * *

(c) * * *

(5) * * *

(vi) Transferee foreign corporation. Except as provided in paragraph (d)(1)(iii)(B) of this section, the transferee foreign corporation shall be the foreign corporation that issues stock or securities to the U.S. person in the exchange.

* * * * *

(d) * * *

(1) * * * For examples of the concurrent application of the indirect stock transfer rules under section 367(a) and the rules of section 367(b), see paragraph (d)(3), Examples 14 and 15 of this section. For purposes of this paragraph (d), if a corporation acquiring assets in a reorganization described in section 368(a)(1) transfers all or a portion of such assets to a corporation controlled (within the meaning of section 368(c)) by the acquiring corporation as part of the same transaction, the subsequent transfer of assets to the controlled corporation will be referred to as a controlled asset transfer. See section 368(a)(2)(C).

(i) * * * See paragraph (d)(3), Example 1 of this section for an example of a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) involving domestic acquired and acquiring corporations, and see paragraph (d)(3), Example 10 of this section for an example involving a domestic acquired corporation and a foreign acquiring corporation.

(ii) * * * See paragraph (d)(3), Example 2 of this section for an example of a reorganization described in sections 368(a)(1)(A) and (a)(2)(E) involving domestic acquired and acquiring corporations, and see paragraph (d)(3), Example 11 of this section for an example involving a domestic acquired corporation and a foreign acquiring corporation.

(iii) Triangular reorganizations described in section 368(a)(1)(B)—(A) A U.S. person exchanges stock of the acquired corporation for voting stock of a foreign corporation that is in control (as defined in section 368(c)) of the acquiring corporation in a reorganization described in section 368(a)(1)(B). See paragraph (d)(3), Example 5 of this section.

(B) A U.S. person exchanges stock of the acquired corporation for voting stock of a domestic corporation that is in control (as defined in section 368(c)) of a foreign acquiring corporation in a reorganization described in section 368(a)(1)(B).

(1) For purposes of paragraphs (b) and (c) of this section, the foreign acquiring corporation is considered to be the transferee foreign corporation even though the U.S. transferor receives stock of the domestic controlling corporation in the exchange.

(2) If stock of a foreign acquired corporation is exchanged for the voting stock of a domestic corporation in control of a foreign acquiring corporation, then the exchange will be subject to the rules of paragraph (b) of this section. If the exchanging shareholder is a section 1248 shareholder with respect to the foreign acquired corporation, the indirect transfer will be subject to sections 367(a) and (b) concurrently. For the application of section 367(b) to the exchange, see §§1.367(b)–4 and 1.367(b)–13(c).

(3) If stock of a domestic acquired corporation is exchanged for the voting stock of a domestic corporation in control of a foreign acquiring corporation, then the exchange will be subject to the rules of paragraph (c) of this section.

(4) For purposes of applying the gain recognition agreement provisions of paragraph (d)(2) of this section and §1.367(a)–8, the domestic controlling corporation will be treated as the transferee foreign corporation. Thus, a disposition of foreign acquiring corporation stock by the domestic controlling corporation, or a disposition of acquired corporation stock by the foreign acquiring corporation, will trigger the gain recognition agreement. See paragraph (d)(3), Example 5A of this section.

(5) This paragraph (d)(1)(iii)(B) applies only to transactions occurring after the date these regulations are published as final regulations in the Federal Register.

* * * * *

(v) Transfers of assets to subsidiaries in certain section 368(a)(1) reorganizations. A U.S. person exchanges stock or securities of a corporation (the acquired corporation) for stock or securities of a foreign acquiring corporation in an asset reorganization (other than a triangular section 368(a)(1)(C) reorganization described in paragraph (d)(1)(iv) of this section or a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) or (a)(2)(E) described in paragraphs (d)(1)(i) or (ii) of this section) that is followed by a controlled asset transfer. In the case of a transaction described in this paragraph (d)(1)(v) in which some but not all of the assets of the acquired corporation are transferred in a controlled asset transfer, the transaction shall be considered to be an indirect transfer of stock or securities subject to this paragraph (d) only to the extent of the assets so transferred. The remaining assets shall be treated as having been transferred in an asset transfer rather than an indirect stock transfer, and such asset transfer shall be subject to the other provisions of section 367, including sections 367(a)(1), (3), and (5), and (d) if the acquired corporation is a domestic corporation. See paragraph (d)(3), Examples 6A and 6B of this section.

* * * * *

(2) * * *

(i) Transferee foreign corporation. Except as provided in paragraph (d)(1)(iii)(B) of this section, the transferee foreign corporation shall be the foreign corporation that issues stock or securities to the U.S. person in the exchange.

(ii) Transferred corporation. The transferred corporation shall be the acquiring corporation, except as provided in this paragraph (d)(2)(ii). In the case of a triangular section 368(a)(1)(B) reorganization described in paragraph (d)(1)(iii) of this section, the transferred corporation shall be the acquired corporation. In the case of an indirect stock transfer described in paragraph (d)(1)(i), (ii), or (iv) of this section followed by a controlled asset transfer, or an indirect stock transfer described in paragraph (d)(1)(v) of this section, the transferred corporation shall be the controlled corporation to which the assets are transferred. In the case of successive section 351 transfers described in paragraph (d)(1)(vi) of this section, the transferred corporation shall be the corporation to which the assets are transferred in the final section 351 transfer. The transferred property shall be the stock or securities of the transferred corporation, as appropriate under the circumstances.
(C) In the case of an asset reorganization followed by a controlled asset transfer, as described in paragraph (d)(1)(v) of this section, the assets of the acquired corporation that are transferred to the corporation controlled by the acquiring corporation are followed by a controlled asset transfer, or a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) followed by a controlled asset transfer, the assets of the acquired corporation including those transferred to the corporation controlled by the acquiring corporation; and

(ii) The domestic acquired corporation is controlled (within the meaning of section 368(c)) by 5 or fewer domestic corporations, appropriate basis adjustments as provided in section 367(a)(5) are made to the stock of the foreign acquiring corporation, and any other conditions as provided in regulations under section 367(a)(5) are satisfied. For purposes of determining whether the domestic acquired corporation is controlled by 5 or fewer domestic corporations, all members of the same affiliated group within the meaning of section 1504 shall be treated as 1 corporation.

(ii) The requirements of paragraphs (c)(1)(i), (ii), and (iv), and (c)(6) of this section are satisfied with respect to the indirect transfer of stock in the domestic acquired corporation, and the domestic acquired corporation attaches a statement described in paragraph (d)(2)(vi)(C) of this section to its U.S. income tax return for the taxable year of the transfer.

(2) Sections 367(a) and (d) shall not apply to transfers described in paragraph (d)(1)(vi) of this section where a U.S. person transfers assets to a foreign corporation in a section 351 exchange, to the extent that such assets are transferred by such foreign corporation to a domestic corporation in another section 351 exchange, but only if the domestic transferee’s basis in the assets is no greater than the basis that the U.S. transferor had in such assets.

(ii) The domestic acquired corporation shall be treated as if, immediately prior to the transfer, it transferred the re-transferred assets, including any intangible assets, directly to a domestic corporation in exchange for stock of such domestic corporation that is treated as a section 351 exchange, and immediately sold such stock to an unrelated party for its fair market value in a sale in which it shall recognize gain, if any (but not loss). Any gain recognized by the domestic acquired corporation pursuant to this paragraph (d)(2)(vi)(E) will increase the basis of the domestic controlled corporation immediately before the transaction described in paragraph (d)(2)(vi)(D) of this section, but will not increase the basis of the re-transferred assets held by the domestic controlled corporation. Section 1.367(d)-1T(g)(6) shall not apply with respect to any intangible...
property included in the re-transferred assets described in the preceding sentence.

(2) If additional tax is required to be paid as a result of a transaction described in paragraph (d)(2)(vi) of this section, then interest must be paid on that amount at rates determined under section 6621 with respect to the period between the date prescribed for filing the domestic acquired corporation’s income tax return for the year of the transfer and the date on which the additional tax for that year is paid.

(F) Examples. For illustrations of the rules in paragraph (d)(2)(vi) of this section, see paragraph (d)(3), Examples 6B, 6C, 6D, 9, and 13A of this section.

(G) Effective dates. Paragraph (d)(2)(vi) of this section applies only to transactions occurring after the date these regulations are published as final regulations in the Federal Register. See §1.367(a)–3(d)(2)(vi), as contained in 26 CFR Part 1 revised as of April 1, 2004, for transactions occurring on or after July 20, 1998, until the date these regulations are published as final regulations in the Federal Register.

(3) * * * * * Example 2. Section 368(a)(1)(A)/(a)(2)(E) reorganization—(i) Facts. The facts are the same as in Example 1, except that Nenco merges into W and Nenco receives stock of W which it distributes to F in a reorganization described in sections 368(a)(1)(A) and (a)(2)(E). Pursuant to the reorganization, A receives 40 percent of the stock of F in an exchange described in section 354.

(ii) Result. The consequences of the transfer are similar to those described in Example 1. Pursuant to paragraph (d)(1)(ii) of this section, the reorganization is subject to the indirect stock transfer rules. F is treated as the transferee foreign corporation, and W is treated as the transferred corporation. Provided that the requirements of paragraph (c)(1) of this section are satisfied, including the requirement that A enter into a five-year gain recognition agreement as described in §1.367(a)–8, A’s exchange of W stock for F stock under section 354 will not be subject to section 367(a)(1).

* * * * * Example 5A. Triangular section 368(a)(1)(B) reorganization—(i) Facts. The facts are the same as in Example 5, except that F is a domestic corporation and S is a foreign corporation.

(ii) Result. U’s exchange of Y stock for stock of F, a domestic corporation in control of S, the foreign acquiring corporation, is treated as an indirect transfer of Y stock to a foreign corporation under paragraph (d)(1)(iii) of this section. U’s exchange of Y stock for F stock will not be subject to section 367(a)(1) provided that all of the requirements of paragraph (c)(1) are satisfied, including the requirement that U enter in a five-year gain recognition agreement. In satisfying the 50 percent or less ownership require-ments of paragraph (c)(1)(i) and (ii) of this section, U’s indirect ownership of S stock (through its direct ownership of F stock) will determine whether the requirement of paragraph (c)(1)(i) is satisfied and will be taken into account in determining whether the requirement of paragraph (c)(1)(ii) is satisfied. See paragraph (c)(4)(iv). For purposes of applying the gain recognition agreement provisions of paragraph (d)(2) of this section and §1.367(a)–8, F is treated as the transferee foreign corporation. The gain recognition agreement would be triggered if F sold all or a portion of the stock of S, or if S sold all or a portion of the stock of Y.

* * * * * Example 6A. Section 368(a)(1)(C) reorganization followed by a controlled asset transfer—(i) Facts. The facts are the same as in Example 6, except that the transaction is structured as a section 368(a)(1)(C) reorganization, followed by a controlled asset transfer, and R is a foreign corporation. * * * F then contributes Businesses B and C to R in a controlled asset transfer.

* * * * * Example 6B. Section 368(a)(1)(C) reorganization followed by a controlled asset transfer to a domestic controlled corporation—(i) Facts. The facts are the same as in Example 6A, except that R is a domestic corporation.

(ii) Result. As in Example 6A, the outbound transfer of the Business A assets to F is not affected by the rules of this paragraph (d) and is subject to the general rules under section 367. However, the Business A assets qualify for the section 367(a)(3) active trade or business exception. The Business B and C assets are part of an indirect stock transfer under this paragraph (d) but must first be tested under sections 367(a) and (d). The Business B assets qualify for the active trade or business exception under section 367(a)(3); the Business C assets do not. However, pursuant to paragraph (d)(2)(vi)(B) of this section, the Business C assets are not subject to section 367(a)(1) or (d) provided that the basis of the Business C assets in the hands of R is no greater than the basis of the assets in the hands of Z, and appropriate basis adjustments are made pursuant to section 367(a)(5) to the stock of F held by V. (In this case, no adjustments are required, pursuant to section 358, V takes a basis of $30 in the stock of F, which is equal to V’s proportionate share of the basis of the assets of Z ($30 transferred to F).) V also is deemed to make an indirect transfer of stock under the rules of paragraph (d). To preserve non-recognition treatment under section 367(a), V must enter into a 5-year gain recognition agreement in the amount of $50, the amount of the appreciation in the Business B and C assets, as the transfer of such assets by Z was not taxable under section 367(a)(1) and constituted an indirect stock transfer.

Example 6C. Section 368(a)(1)(C) reorganization followed by a controlled asset transfer to a domestic controlled corporation—(i) Facts. The facts are the same as in Example 6B, except that Z is owned by individuals, none of whom qualify as five-percent target shareholders with respect to Z within the meaning of paragraph (c)(5)(iii) of this section. The following additional facts are present. No U.S. persons that are either officers or directors of Z own any stock of F immediately after the transfer. F is engaged in an active trade or business outside the United States that satisfies the test set forth in paragraph (c)(3) of this section.

(ii) Result. The transfer of the Business A assets is not affected by the rules of this paragraph (d). However, the transfer of such assets is subject to gain recognition under section 367(a)(1), because the section 367(a)(3) active trade or business exception is inapplicable pursuant to section 367(a)(5). The Business B and C assets are part of an indirect stock transfer under this paragraph (d) but must first be tested under sections 367(a) and (d). The transfer of the Business B assets (which otherwise would satisfy the section 367(a)(3) active trade or business exception) generally is subject to section 367(a)(1) pursuant to section 367(a)(5). The transfer of the Business C assets generally is subject to sections 367(a)(1) and (d).

However, pursuant to paragraph (d)(2)(vi)(B) of this section, the transfer of the Business B and C assets is not subject to sections 367(a)(1) and (d), provided the basis of the Business B and C assets in the hands of R is no greater than the basis in the hands of Z and certain other requirements are satisfied. Since Z is not controlled within the meaning of section 368(c) by 5 or fewer domestic corporations, the indirect transfer of Z stock must satisfy the requirements of paragraphs (c)(1)(i), (ii), and (iv), and (c)(6) of this section, and Z must attach a statement described in paragraph (d)(2)(vi)(C) of this section to its U.S. income tax return for the taxable year of the transfer. In general, the statement must contain a certification that, if F disposes of the stock of R (in a recognition or nonrecognition transaction) and a principal purpose of the transfer is the avoidance of U.S. tax that would have been imposed on Z on the disposition of the Business B and C assets transferred to R, then Z (or F on behalf of Z) will file a return (or amended return as the case may be) recognizing gain ($50), as if, immediately prior to the reorganization, Z transferred the Business B and C assets to a domestic corporation in exchange for stock in a transaction treated as a section 351 exchange and immediately sold such stock to an unrelated party for its fair market value. A transaction is deemed to have a principal purpose of U.S. tax avoidance if F disposes of R stock within two years of the transfer, unless Z (or F on behalf of Z) can rebut the presumption to the satisfaction of the Commissioner. See paragraph (d)(2)(vi)(D) of this section.

With respect to the indirect transfer of Z stock, the requirements of paragraphs (c)(1)(i), (ii), and (iv) of this section are satisfied. Thus, assuming Z attaches the statement described in paragraph (d)(2)(vi)(C) of this section to its U.S. income tax return and satisfies the reporting requirements of (c)(6) of this section, the transfer of Business B and C assets is not subject to section 367(a) or (d).

Example 6D. Section 368(a)(1)(C) reorganization followed by a controlled asset transfer to a domestic controlled corporation—(i) Facts. The facts are the same as in Example 6C, except that Z shareholders receive 60 percent of the F stock in exchange for their Z stock in the reorganization.

(ii) Result. The requirement of paragraph (c)(1)(i) of this section is not satisfied because the Z shareholders that are U.S. persons do not receive 50 percent or less of the total voting power and the total value of the stock of F in the transaction. Accordingly, Z shareholders that are U.S. persons are subject to section 367(a)(1) on their exchange of Z stock for F stock pursuant to the reorganization.
For the same reason, the conditions of paragraph (d)(2)(vi)(B)(f)(iii) of this section are not met. Accordingly, the transfer of Business B and C assets is subject to sections 367(a)(1) and (d), even though such assets are re-transferred to R, a domestic corporation. As in Example 6C, the transfer of Business A assets, which is not affected by the rules of paragraph (d) of this section, is subject to gain recognition under sections 367(a)(1) and (5).

Example 9. Concurrent application with a controlled asset transfer—(i) Facts. The facts are the same as in Example 8, except that R transfers the Business A assets to M, a wholly owned domestic subsidiary of R, in a controlled asset transfer. In addition, V’s basis in its Z stock is $90.

(ii) Result. Pursuant to paragraph (d)(2)(vi)(B) of this section, sections 367(a) and (d) do not apply to Z’s transfer of the Business A assets to R, because such assets are re-transferred to M, a domestic corporation, provided that the basis of the Business A assets in the hands of M is no greater than the basis of the assets in the hands of Z, and certain other requirements are satisfied. Because Z is controlled (within the meaning of section 367(c)(4)) by a domestic corporation, appropriate basis adjustments must be made pursuant to section 367(a)(5) to the stock of F held by V. (In this case, no adjustments are required because, pursuant to section 358, V takes a basis of $90 in the stock of F, which is less than V’s proportionate share of the basis in the assets of Z ($100 transferred to R).) Section 367(a)(1) does not apply to Z’s transfer of its Business B assets to R (which are not re-transferred to M) because such assets qualify for an exception to gain recognition under section 367(a)(3). With respect to the indirect transfer of Z stock, such transfer is not subject to gain recognition under section 367(a)(1) if the requirements of paragraph (c) of this section are satisfied, including the requirement that V enter into a 5-year gain recognition agreement and comply with the requirements of §1.367(a)-8 with respect to the gain ($100) realized on the Z stock. Under paragraphs (d)(2)(i) and (ii) of this section, the transferee foreign corporation is F and the transferred corporation is R. Pursuant to paragraph (d)(2)(iv) of this section, a disposition by F of the stock of R, or a disposition by R of the stock of M, will trigger the gain recognition agreement. To determine whether an asset disposition constitutes a deemed disposition of the transferred corporation’s stock under the rules of §1.367(a)-8(c)(3)(i), both the Business A assets in M and the Business B assets in R must be considered.

Example 10. Concurrent application in section 368(a)(1)(A)/(a)(2)(D) reorganization—(i) Facts. The facts are the same as in Example 8, except that R acquires all of the assets of Z in a reorganization described in sections 368(a)(1)(A) and (a)(2)(D). Pursuant to the reorganization, V receives 30 percent of the stock of F in a section 354 exchange.

(ii) Result. The consequences of the transaction are similar to those in Example 8. The assets of Business A and B that are transferred to R must be tested under section 367(a) prior to the consideration of the indirect stock transfer rules of this paragraph (d). The Business B assets qualify for the active trade or business exception under section 367(a)(3). Because the Business A assets do not qualify for the exception, Z must recognize $40 of gain under section 367(a) on the transfer of Business A assets to R. Because V and Z file a consolidated return, V’s basis in the stock of Z is increased from $100 to $140 as a result of Z’s $40 gain. V’s indirect transfer of Z stock will be taxable under section 367(a) unless V enters into a gain recognition agreement in the amount of $60 ($200 value of Z stock, less $140 adjusted basis) and the other requirements of paragraph (c)(1) of this section are satisfied.

Example 11. Section 368(a)(1)(A)/(a)(2)(E) reorganization—(i) Facts. F, a foreign corporation, owns all the stock of D, a domestic corporation. V, a domestic corporation, owns all the stock of Z, a foreign corporation. V has a basis of $100 in the stock of Z which has a fair market value of $200. D is an operating corporation with assets valued at $100 with a basis of $60. In a reorganization described in sections 368(a)(1)(A) and (a)(2)(E), D merges into Z, and V exchanges its Z stock for 55 percent of the outstanding F stock.

(ii) Result. Under paragraph (d)(1)(ii) of this section, V is treated as making an indirect transfer of Z stock to F. V’s exchange of Z stock for F stock will be taxable under section 367(a) (and section 1248 will be applicable) if V fails to enter into a 5-year gain recognition agreement in accordance with the requirements of §1.367(a)-8. Under paragraph (d)(1)(iii) of this section, if V enters into a gain recognition agreement, the exchange will be subject to the provisions of section 367(b) and the regulations thereunder as well as section 367(a). Under §1.367(b)-4(b) of this chapter, however, no income inclusion is required because both F and Z are controlled foreign corporations with respect to which V is a section 1248 shareholder immediately after the exchange. Under paragraphs (d)(2)(i) and (ii) of this section, the transferee foreign corporation is F, and the transferred corporation is Z (the acquiring corporation). If F disposes (within the meaning of §1.367(a)-8(e)) of all (or a portion) of Z stock within the 5-year term of the agreement (and V has not made a valid election under §1.367(a)-8(b)(1)(viii)), V is required to file an amended return for the year of the transfer and include in income, with interest, the gain realized but not recognized on the initial section 354 exchange. To determine whether Z (the transferred corporation) disposes of substantially all of its assets, the assets of Z immediately prior to the transaction are taken into account, pursuant to paragraph (d)(2)(v)(B) of this section. Because D is owned by F, a foreign corporation, section 367(a)(5) precludes any assets of D from qualifying for nonrecognition under section 367(a)(3). Thus, D recognizes $40 of gain on the transfer of its assets to Z under section 367(a)(1).

Example 15. Concurrent application of indirect stock transfer rules and section 367(b)—(i) Facts. F, a foreign corporation, owns all of the stock of Newco, a domestic corporation. P, a domestic corporation, owns all of the stock of FC, a foreign corporation. P’s basis in the stock of FC is $50 and the value of FC stock is $100. The all earnings and profits amount with respect to the FC stock held by P is $60. See §1.367(b)-2(d). In a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) (and paragraph (d)(1)(i) of this section), Newco acquires all of the properties of FC, and P exchanges its stock in FC for 20 percent of the stock in F. (ii) Result. Because a domestic corporation, Newco, acquires the assets of a foreign corporation, FC, in an asset reorganization to which §1.367(b)-3(a) and (b) and the indirect stock rules of paragraph (d) of this section apply, the section 367(b) rules apply before the section 367(a) rules apply. See §1.367(a)-3(b)(2)(ii)(A). Under the rules of section 367(b), P must include in income the all earnings and profits amount of $60 with respect to its FC stock. See §1.367(b)-3. Although P’s exchange of FC stock for F stock under section 354 is an indirect stock transfer, no gain is recognized under section 367(a), because P’s basis in the FC stock is increased by the amount ($60) included in income under the rules of section 367(b). See §1.367(b)-2(e)(3)(ii). Alternatively, if P’s all earnings and profits amount were $30, then the amount of the income inclusion and basis adjustment under the rules of section 367(b) would be $30, and the amount of gain subject to section 367(a)(1) would be $20 unless P entered into a 5-year gain recognition agreement in accordance with §1.367(a)-8.

Par. 5. Section 1.367(a)-8 is amended as follows:

1. In paragraphs (c)(2) and (d), remove the words “district director” and add “Director of Field Operations” in their place.

2. In paragraph (e)(1)(i), a sentence is added after the first sentence.

The addition reads as follows:

§1.367(a)-8 Gain recognition agreement requirements.

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

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

(i) It also includes an indirect disposition of the stock of the transferred corporation as described in §1.367(a)-3(d)(2)(iv). * * * * * * * * *
Par. 6. In §1.367(b)–1(a), remove the third and fourth sentences and add a sentence in their place to read as follows:

§1.367(b)–1 Other transfers.

(a) * * * For rules coordinating the concurrent application of sections 367(a) and (b), including the extent to which section 367(b) does not apply if the foreign corporation is not treated as a corporation under section 367(a), see §1.367(a)–3(b)(2)(i).

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Par. 7. In §1.367(b)–3(b)(3)(ii), revise paragraph (i) of Example 5 to read as follows:

§1.367(b)–3 Repatriation of foreign corporate assets in certain nonrecognition transactions.

* * * * *

(b) * * *

(3) * * *

(ii) Exception. In the case of a triangular reorganization described in section 368(a)(1)(B) or (C), or a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) or (E), an exchange is not described in paragraph (b)(1)(i) of this section if the stock received in the exchange is stock of a domestic corporation and, immediately after the exchange, such domestic corporation is a section 1248 shareholder of the acquired corporation (in the case of a triangular section 368(a)(1)(B) reorganization) or the surviving corporation (in the case of a reorganization described in sections 368(a)(1)(D) or (E)) involving a foreign corporation.

* * * * * *

Par. 8. Section 1.367(b)–4 is amended as follows.

1. Paragraph (a) is revised.

2. Redesignate paragraph (b)(1)(ii) as paragraph (b)(1)(iii), and add new paragraph (b)(1)(ii).

3. In newly designated paragraph (b)(1)(iii), after Example 3, add Examples 3A and 3B.

The revisions and additions read as follows:

§1.367(b)–4 Acquisition of foreign corporate stock or assets by a foreign corporation in certain nonrecognition transactions.

(a) Scope. This section applies to an acquisition by a foreign corporation (the foreign acquiring corporation) of the stock or assets of a foreign corporation (the foreign acquired corporation) in an exchange described in section 351 or a reorganization described in section 368(a)(1). In the case of a reorganization described in sections 368(a)(1)(A) and (a)(2)(E), this section applies if stock of the foreign surviving corporation is exchanged for stock of a foreign corporation in control of the merging corporation; in such a case, the foreign surviving corporation is treated as a foreign acquired corporation for purposes of this section. A foreign corporation that undergoes a reorganization described in section 368(a)(1)(E) is treated as both the foreign acquired corporation and foreign acquiring corporation for purposes of this section. See §1.367(a)–3(b)(2) for transactions subject to the concurrent application of this section and section 367(a).

(b) * * *

(1) * * *

(ii) Exception. In the case of a triangular reorganization described in section 368(a)(1)(B) or (C), or a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) or (E), an exchange is not described in paragraph (b)(1)(i) of this section if the stock received in the exchange is stock of a domestic corporation and, immediately after the exchange, such domestic corporation is a section 1248 shareholder of the acquired corporation (in the case of a triangular section 368(a)(1)(B) reorganization) or the surviving corporation (in the case of a reorganization described in sections 368(a)(1)(D) or (E)) involving a foreign corporation.

* * * * * *

Par. 9. In §1.367(b)–6, paragraph (a)(1), add a sentence to the end to read as follows:

§1.367(b)–6 Effective dates and coordination rules.

(a) * * *

(1) * * *

The rules of §§1.367(b)–3 and 1.367(b)–4, as they apply to reorganizations described in section 368(a)(1)(A) (including reorganizations described in section 368(a)(2)(D) or (E)) involving a foreign acquiring or foreign acquired corporation, apply only to transfers occurring after the date these regulations are published as final regulations in the Federal Register.

* * * * * *

Par. 10. Section 1.367(b)–13 is added to read as follows:
§1.367(b)–13 Special rules for determining basis and holding period.

(a) Scope and definitions—(1) Scope. This section provides special basis and holding period rules for certain transactions involving the acquisition of property by a foreign acquiring corporation in nontax recognition exchanges. Special rules apply to determine the basis and holding period of stock of a foreign corporation received by certain shareholders in a section 354 or 356 exchange. In addition, special rules apply to determine the basis and holding period of stock of certain foreign surviving corporations held by a controlling corporation whose stock is issued in an exchange under section 354 or 356 in a triangular reorganization. This section applies to transactions that are subject to section 367(b) as well as section 367(a), including transactions concurrently subject to sections 367(a) and (b).

(2) Definitions. For purposes of this section, the following definitions apply:

(i) A foreign acquired corporation is a foreign corporation whose stock or assets are acquired by a foreign corporation in a reorganization described in section 368(a)(1). In a reverse triangular merger, where T is a foreign corporation, T is treated as a foreign acquired corporation. A foreign corporation that undergoes a reorganization described in section 368(a)(1)(E) is treated as a foreign acquired corporation.

(ii) A block of stock has the meaning provided in §1.1248–2(b).

(iii) A triangular reorganization is a reorganization described in §1.358–6(b)(2)(i), (ii), or (iii) (but not a reorganization described in §1.358–6(b)(2)(iv)). A triangular C reorganization, a forward triangular merger, and a reverse triangular merger each is a reorganization described in §1.358–6(b)(2)(i), (ii), or (iii), respectively. For purposes of triangular reorganizations—

(A) P is a corporation that is a party to a reorganization that is in control (within the meaning of section 368(c)) of another party to the reorganization and whose stock is transferred pursuant to the reorganization;

(B) S is a corporation that is a party to the reorganization and that is controlled by P; and

(C) T is a corporation that is another party to the reorganization.

(b) Determination of basis and holding period for exchanges of foreign stock—(1) Application. Except as provided in paragraph (b)(4) of this section, this paragraph (b) applies to a shareholder that exchanges stock of a foreign acquired corporation in an exchange under section 354 or 356 for stock of a controlled foreign corporation, if—

(i) Immediately before the exchange each such shareholder is a section 1248 shareholder with respect to the foreign acquired corporation, or such shareholder is a foreign corporation and a United States person is a section 1248 shareholder with respect to both such foreign corporation and the foreign acquired corporation; and

(ii) The exchange is not described in §1.367(b)–4(b)(1)(i), (2)(i), or (3).

(2) Basis and holding period rules—(i) If a shareholder surrenders a share of stock in an exchange under the terms of section 354 or 356, the basis and holding period of each share of stock received in the exchange shall be the same as the basis and holding period of the allocable portion of the share or shares of stock exchanged therefor, as adjusted under §1.358–1 (such that the section 1248 amount of each share of stock exchanged is preserved in the share or shares of stock received). If more than one share of stock is received in exchange for one share of stock, the basis of the share of stock surrendered shall be allocated to the shares of stock received in the exchange in proportion to the fair market value of the shares of stock received. If one share of stock is received in respect of more than one share of stock or a fraction of a share of stock is received, the basis of the shares of stock surrendered must be allocated to the share of stock received, or a fraction thereof received, in a manner that reflects, to the greatest extent possible, that a share of stock is received in respect of shares of stock acquired on the same date and at the same price. The provisions of this paragraph may be applied, to the extent possible, on the basis of blocks of stock.

(ii) If a shareholder that purchased or acquired shares of stock in a corporation on different dates or at different prices exchanges such shares of stock under the terms of section 354 or 356, and the shareholder is not able to identify which particular share or shares of stock (or portion of a share of stock) is received in exchange for a particular share or shares of stock, the shareholder may designate which share or shares of stock is received in exchange for a particular share or shares of stock, provided that such designation is consistent with the terms of the exchange or distribution. The designation must be made on or before the first date on which the basis of a share of stock received is relevant. The basis of a share received, for example, is relevant when such share is sold or otherwise transferred. The designation will be binding for purposes of determining the Federal tax consequences of any sale or transfer of a share received. If the shareholder fails to make a designation, then the shareholder will not be able to identify which share is sold or transferred for purposes of determining the basis of property sold or transferred under section 1012 and §1.1012–1(c) and, instead, will be treated as selling or transferring the share received in respect of the earliest share purchased or acquired. See paragraph (e), Example 1 of this section for an illustration of this paragraph (b).

(c) Application of section to triangular reorganizations. In the case of a triangular reorganization, this paragraph (b) applies only to the exchange of T stock for P stock by T shareholders. See paragraph (c) of this section to determine the basis and holding period of stock of the surviving corporation (S or T) held by P immediately after a triangular reorganization.

(d) Holders not able to identify which particular share or shares of stock is received in exchange. If a shareholder is not able to identify which particular share or shares of stock is received in exchange for a particular share or shares of stock, the shareholder may designate which share or shares of stock is received in exchange for a particular share or shares of stock, provided that such designation is consistent with the terms of the exchange or distribution. The designation must be made on or before the first date on which the basis of a share of stock received is relevant. The basis of a share received, for example, is relevant when such share is sold or otherwise transferred. The designation will be binding for purposes of determining the Federal tax consequences of any sale or transfer of a share received. If the shareholder fails to make a designation, then the shareholder will not be able to identify which share is sold or transferred for purposes of determining the basis of property sold or transferred under section 1012 and §1.1012–1(c) and, instead, will be treated as selling or transferring the share received in respect of the earliest share purchased or acquired. See paragraph (e), Example 1 of this section for an illustration of this paragraph (b).

(3) In the case of a triangular reorganization, this paragraph (b) applies only to the exchange of T stock for P stock by T shareholders. See paragraph (c) of this section to determine the basis and holding period of stock of the surviving corporation (S or T) held by P immediately after a triangular reorganization.

(4) Paragraphs (b)(1) through (3) of this section shall not apply to determine the basis of a share of stock received by a shareholder in an exchange described in both section 351 and section 354 or 356, if, in connection with the exchange, the shareholder exchanges property for stock in an exchange to which neither section 354 nor 356 applies or liabilities of the shareholder are assumed.

(e) Determination of basis and holding period for triangular reorganizations—(1) Application. In the case of a triangular reorganization, this paragraph (c) applies, if—

(i) In the case of a reverse triangular merger—

(A) Immediately before the transaction, either P is a section 1248 shareholder with respect to S, or P is a foreign corporation and a United States person is a sec-
tion 1248 shareholder with respect to both P and S; and

(B) P’s exchange of S stock is not described in §1.367(b)–3(a) and (b) or in §1.367(b)–4(b)(1)(i), (2)(i), or (3); or

(ii)(A) Immediately before the transaction, a shareholder of T is either a section 1248 shareholder with respect to T or a foreign corporation and a United States person is a section 1248 shareholder with respect to both such foreign corporation and T; and

(B) With respect to at least one of the exchanging shareholders described in paragraph (c)(1)(ii)(A) of this section, the exchange of T stock is not described in §1.367(b)–3(a) and (b) or in §1.367(b)–4(b)(1)(i), (2)(i), or (3).

(2) Basis and holding period rules. In the case of a triangular reorganization described in this paragraph (c), each share of stock of the surviving corporation (S or T) held by P must be divided into portions attributable to the S stock and the T stock immediately before the exchange. See paragraph (e) of this section, Examples 2 through 5 for illustrations of this rule.

(i) Portions attributable to S stock—(A) In the case of a forward triangular merger or a triangular C reorganization, the basis and holding period of the portion of each share of surviving corporation stock attributable to the S stock is the basis and holding period of such share of stock immediately before the exchange.

(B) In the case of a reverse triangular merger, the basis and holding period of the portion of each share of surviving corporation stock attributable to the S stock is described in paragraph (c)(1)(ii)(A) of this section with respect to S, and P exchanges two or more blocks of S stock pursuant to the transaction, then each share of the surviving corporation (T) stock attributable to the S stock must be further divided into separate portions to account for the separate blocks of stock in S.

(C) If the value of S stock immediately before the triangular reorganization is less than one percent of the value of the surviving corporation stock immediately after the triangular reorganization, then P may determine its basis in the surviving corporation stock by applying the rules of paragraph (c)(2)(ii) of this section to determine the basis and holding period of the surviving corporation stock attributable to the T stock, and then increasing the basis of each share of surviving corporation stock by the proportionate amount of P’s aggregate basis in the S stock immediately before the exchange (without dividing the stock of the surviving corporation into separate portions attributable to the S stock).

(ii) Portions attributable to T stock—(A) If any exchanging shareholder of T stock is described in paragraph (c)(1)(ii) of this section, the basis and holding period of the portion of each share of stock in the surviving corporation attributable to the T stock is the basis and holding period immediately before the exchange of a proportionate amount of the T stock to which such portion relates. If any exchanging shareholder of T stock is described in paragraph (c)(1)(ii) of this section, and such shareholder exchanges two or more blocks of T stock pursuant to the transaction, then each share of surviving corporation stock attributable to the T stock must be further divided into separate portions to account for the separate blocks of T stock.

(B) If no exchanging shareholder of T stock is described in paragraph (c)(1)(ii) of this section, the rules of §1.358–6(c) apply to determine the basis of the portion of each share of the surviving corporation attributable to T immediately before the exchange.

(d) Special rules applicable to divided shares of stock—(1) In general—(i) Shares of stock in different blocks can be aggregated into one divided portion for basis purposes, if such shares immediately before the exchange are owned by one or more shareholders that are—

(A) Neither section 1248 shareholders with respect to the corporation nor foreign corporate shareholders; or

(B) Foreign corporate shareholders, provided that no United States persons are section 1248 shareholders with respect to both such foreign corporate shareholders and the corporation.

(ii) For purposes of determining the amount of gain realized on the sale or exchange of stock that has a divided portion pursuant to paragraph (c) of this section, any amount realized on such sale or exchange will be allocated to each divided portion of the stock based on the relative fair market value of the stock to which the portion is attributable at the time the portions were created.

(iii) Shares of stock will no longer be required to be divided if section 1248 or section 964(e) would not apply to a disposition or exchange of such stock.

(2) Pre-exchange earnings and profits. All earnings and profits (or deficits) accumulated by a foreign corporation before the reorganization and attributable to a share (or block) of stock for purposes of section 1248 are attributable to the divided portion of stock with the basis and holding period of that share (or block). See §1.367(b)–4(d).

(3) Post-exchange earnings and profits. Any earnings and profits (or deficits) accumulated by the surviving corporation subsequent to the reorganization are attributable to each divided share of stock pursuant to section 1248 and the regulations thereunder. The amount of earnings and profits (or deficits) attributable to a divided share of stock is further attributed to the divided portions of such share of stock based on the relative fair market value of each divided portion of stock.

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

Example 1. (i) Facts. US1 is a domestic corporation that owns all of the stock of FT, a foreign corporation with 100 shares of stock outstanding. Each share of FT stock is valued at $10x. Because US1 acquired the stock of FT at two different dates, US1 owns two blocks of FT stock for purposes of section 1248. The first block consists of 60 shares. The shares in the first block have a basis of $300x ($5x per share), a holding period of 10 years, and $240x ($4x per share) of earnings and profits attributable to the shares for purposes of section 1248. The second block consists of 40 shares. The shares in the second block have a basis of $600x ($15x per share), a holding period of 2 years, and $80x ($2x per share) of earnings and profits attributable to the shares for purposes of section 1248. US2, a domestic corporation, owns all of the stock of FP, a foreign corporation, which owns all of the stock of FS, a foreign corporation. FT merges into FS with FT surviving in a reorganization described in section 368(a)(1)(A). Pursuant to the reorganization, US1 receives 50 shares of FS stock with a value of $1,000x for its FT stock in an exchange that qualifies for nonrecognition under section 354.

(ii) Basis and holding period determination—(A) US1 is a section 1248 shareholder of FT immediately before the exchange and exchanges its FT stock for stock of a controlled foreign corporation (FS) as to which US1 is a section 1248 shareholder immediately after the exchange. US1 is not required to include income under §1.367(b)–4(b) with respect to the exchange. Accordingly, the basis and holding period of the FS stock received by US1 is determined pursuant to paragraph (b) of this section.
(B) Pursuant to paragraph (b) of this section, 30 shares of the FS stock received by US1 in the reorganization (valued at $20x per share and exchanged for US1’s first block of 60 shares of FT stock) have a basis of $300x ($10x per share), a holding period of 10 years, and $240x of earnings and profits ($8x per share) attributable to such shares for purposes of section 1248. In addition, 20 shares of the FS stock (valued at $20 per share and exchanged for US1’s second block of 40 shares of FT stock) have a basis of $600x ($30x per share), a holding period of 2 years, and $80x of earnings and profits ($4x per share) attributable to such shares for purposes of section 1248. (iii) Subsequent Disposition. Assume, subsequent to the exchange, US1 disposes of 20 shares of FS stock. On or before the date of the disposition when the basis of the FS shares received by US1 becomes relevant, US1 can designate the 20 shares from the first block, the second block, or from any combination of shares in both blocks.

Example 2. (i) Facts. The facts are the same as in Example 1, except that US1 receives 50 shares of FP stock (instead of FS stock) with a value of $1,000x in exchange for its FS stock. Accordingly, the merger of FT into FS qualifies as a forward triangular merger, and immediately after the exchange US1 is a section 1248 shareholder with respect to FP and FS. Additionally, prior to the transaction, FP owned two blocks of FS stock. Each block consisted of 10 shares with a value of $200x ($20x per share). The shares in the first block had a basis of $50x ($5x per share), a holding period of 10 years, and $50x ($5x per share) of earnings and profits attributable to such shares for purposes of section 1248. The shares in the second block had a basis of $100x ($10x per share), a holding period of 5 years, and $20x ($2x per share) of earnings and profits attributable to such shares for purposes of section 1248. (ii) Basis and holding period determination. (A) The basis and holding period of the FP shares received by US1 in the exchange are determined pursuant to paragraph (b) of this section and are identical to the results in Example 1. (B)(1) US1 is a section 1248 shareholder of FT immediately before the transaction. Moreover, US1 is not required to include income under §1.358–6(b)(2) or §1.358–6(b)–4(b) as described in paragraph (c)(2) of this section. Accordingly, the basis and holding period of the FS stock held by FP immediately after the triangular reorganization is determined pursuant to paragraph (c) of this section. (2) Pursuant to paragraph (c) of this section, each share of FS stock is divided into portions attributable to the basis and holding period of the FS stock held by FP immediately before the exchange (the FS portion) and the FT stock held by US1 immediately before the exchange (the FT portion). The basis and holding period of the FS portion is the basis and holding period of the FS stock held by FP immediately before the exchange. Thus, each share of FS stock in the first block has a portion with a basis of $5x, a value of $20x, a holding period of 10 years, and $5x of earnings and profits attributable to such portion for purposes of section 1248. Each share of FS stock in the second block has a portion with a basis of $10x, a value of $20x, a holding period of 5 years, and $2x of earnings and profits attributable to such portion for purposes of section 1248. (j) Because the exchanging shareholder of FT stock (US1) is a section 1248 shareholder, the holding period and basis of the FT portion is the holding period and the proportionate amount of the basis of the FS stock immediately before the exchange to which such portion relates. Further, because US1 exchanged two blocks of FT stock, the FT portion must be divided into two separate portions attributable to the two blocks of FT stock. Thus, each share of FS stock will have a second portion with a basis of $15x ($300x basis / 20 shares), a value of $30x ($600x value / 20 shares), a holding period of 10 years, and $12x of earnings and profits ($240x / 20 shares) attributable to such portion for purposes of section 1248. Each share of FS stock will have a third portion with a basis of $30x ($600x basis / 20 shares), a value of $20x ($400x value / 20 shares), a holding period of 2 years, and $4x of earnings and profits ($80x / 20 shares) attributable to such portion for purposes of section 1248. (iii) Assume, immediately after the transaction, FP disposes of a share of FS stock from the first block. When FP disposes of any share of its FS stock, it is treated as disposing of each divided portion of such share. With respect to the first portion (attributable to the FT stock), FP recognizes a gain of $15x ($200x value - $5x basis), $5x of which is treated as a dividend under section 1248. With respect to the second portion (attributable to the first block of FT stock), FP recognizes a gain of $15x ($30x value - $15x basis), $12x of which is treated as a dividend under section 1248. With respect to the third portion (attributable to the second block of FT stock), FP recognizes a capital loss of $10x ($20x value - $30x basis). (iv) Assume further, immediately after the transaction, FP also disposes of a share of stock from the second block of FS stock. With respect to the first portion (attributable to the FS stock), FP recognizes a gain of $10x ($20x value - $10x basis), $2x of which is treated as a dividend under section 1248. With respect to the second portion (attributable to the first block of FT stock), FP recognizes a gain of $15x ($30x value - $15x basis), $12x of which is treated as a dividend under section 1248. With respect to the third portion (attributable to the second block of FT stock), FP recognizes a capital loss of $10x ($20x value - $30x basis).

Example 2A. (i) Facts. The facts are the same as in Example 2, except that FS merges into FT with FT surviving in a reverse triangular merger. Pursuant to the merger, US1 receives FP stock with a value of $1,000x in exchange for its FS stock, and FP receives 10 shares of FT stock with a value of $1,400x in exchange for its FS stock. Immediately after the exchange, US1 is a section 1248 shareholder with respect to FP and FT. (ii) Basis and holding period determination—(A) Because USP is a section 1248 shareholder of FS immediately before the transaction, the basis and holding period of the FS stock held by USP immediately after the triangular reorganization is determined pursuant to paragraph (c) of this section. (B) Pursuant to paragraph (c) of this section, each share of FS stock is divided into portions attributable to the basis and holding period of the FS stock held by USP immediately before the exchange (the FS portion) and the basis of FT’s net assets (the FT portion) immediately before the exchange. The basis of FT’s net assets (and not FT stock) is used to determine the FT portion because FT does not have a section 1248 shareholder immediately before the transaction. As a result, the rules of §1.358–6(c) apply to determine the basis of the FT portion of each share of FS stock. The basis and holding period of the FS portion is the basis and holding period of the FS stock held by USP immediately before the exchange. Thus, each share of FS stock has a portion with a basis of $5x, a value of $10x, and a holding period of 10 years. The basis of the FT portion is the basis of the FT assets to which such portion relates. Thus, each share of FS stock has a second portion with a basis of $5x ($50x basis in FT’s assets / 10 shares) and a value of $10x ($100x value of FT’s assets / 10 shares). All of FS’ earnings and profits prior to the transaction ($70x) is attributed solely to the FS portion in each share of FS stock.
stock. The FS portion of each share of FS stock has earnings and profits of $7x ($70x / 10 shares) attributable to such portion for purposes of section 1248. As a result of each share of stock being divided into portions, the basis of the FS stock is not averaged with the basis of the FT assets to increase the section 1248 amount with respect to the stock of the surviving corporation (FS).

Example 4. (i) Facts. US, a domestic corporation, owns all of the stock of FT, a foreign corporation. The FT stock held by US constitutes a single block of stock with a value of $1,000x, a basis of $600x, and holding period of 5 years. USP, a domestic corporation, forms FS, a foreign corporation, pursuant to the plan of reorganization and capitalizes it with $10x of cash. FS merges into FT with FT surviving in a reverse triangular merger and a reorganization described in section 368(a)(1)(B). Pursuant to the reorganization, US receives USP stock with a value of $1,010x in exchange for its FS stock, and USP receives 10 shares of FT stock with a value of $1,010x in exchange for its FS stock. (ii) Basis and holding period determination. (A) US and USP are section 1248 shareholders of FT and FS, respectively, immediately before the transaction. Neither US nor USP is required to include income under §1.367(b)–4(b) or 1.367(b)–4(b) as described in paragraph (c)(2) of this section. The basis and holding period of the FT stock held by USP is determined pursuant to paragraph (c) of this section. (B) Pursuant to paragraph (c) of this section, because the exchanging shareholder of FT stock (US) is a section 1248 shareholder of FT, each share of the surviving corporation (FT) has a proportionate amount of the basis and holding period of the FT stock immediately before the exchange to which such share relates. Thus, the portion of each share of FT stock attributable to the FT stock has a basis of $60x ($600x basis / 10 shares), a value of $100x ($1,000x value / 10 shares), and a holding period of 5 years. Because the value of FS stock immediately before the triangular reorganization ($10x) is less than one percent of the value of the surviving corporation (FT) immediately after the triangular reorganization ($1,010x), USP may determine its basis in the stock of the surviving corporation (FT) by increasing the basis of each share of FT stock by the proportionate amount of USP’s aggregate basis in the FS stock immediately before the exchange (without dividing each share of FT stock into separate portions to account for FS and FT). If USP so elects, USP’s basis in each share of FT stock is increased by $1x ($10x basis in FS stock / 10 shares). As a result, each share of FT stock has a basis of $61x, a value of $101x, and a holding period of 5 years.

Example 5. (i) Facts. US, a domestic corporation, owns all of the stock of FT, a foreign corporation. The FT stock held by US constitutes one block of stock with a basis of $170x, a value of $200x, a holding period of 5 years, and $10x of earnings and profits attributable to such stock for purposes of section 1248. FP, a foreign corporation, owns all the stock of FS, a foreign corporation. FS has 10 shares of stock outstanding. No United States person is a section 1248 shareholder with respect to FP or FS. The FS stock held by FP has a value of $100x and a basis of $50x ($5x per share). FT merges into FS with FS surviving in a forward triangular merger. Pursuant to the merger, US receives FP stock with a value of $200x for its FT stock in an exchange that qualifies for non-recognition under section 354. FP is a controlled foreign corporation and US is a section 1248 shareholder with respect to FP and FS immediately after the exchange. (ii) Basis and holding period determination. (A) Because US is a section 1248 shareholder of FT immediately before the transaction, and US is not required to include income under §§1.367(b)–3(b) and 1.367(b)–4(b) as described in paragraph (c)(2) of this section, the basis and holding period of the FS stock held by FP immediately after the triangular reorganization is determined pursuant to paragraph (c) of this section. (B) Pursuant to paragraph (c) of this section, each share of FS stock is divided into portions attributable to the basis and holding period of the FS stock held by FP immediately before the exchange (the FS portion) and the FT stock held by US immediately before the exchange (the FT portion). The basis and holding period of the FS portion is the basis and holding period of the FS stock held by FP immediately before the exchange. Thus, each share of FS stock has a portion with a basis of $5x and a value of $10x. Because the exchanging shareholder of FT stock (US) is a section 1248 shareholder of FT, the basis and holding period of the FT portion is the proportionate amount of the basis and the holding period of the FT stock immediately before the exchange to which such portion relates. Thus, each share of FS stock will have a second portion with a basis of $17x ($170x basis / 10 shares), a value of $20x ($200x value / 10 shares), a holding period of 5 years, and $1x of earnings and profits ($10x earnings and profits / 10 shares) attributable to such portion for purposes of section 1248. (iii) Subsequent disposition. (A) Several years after the merger, FP disposes of all of its FS stock in a transaction governed by section 964(e). At the time of the disposition, FS stock has decreased in value to $210x (a post-merger reduction in value of $90x), and FS has incurred a post-merger deficit in earnings and profits of $30x. (B) Pursuant to paragraph (d)(1)(ii) of this section, for purposes of determining the amount of gain realized on the sale or exchange of stock that has a divided portion, any amount realized on such sale or exchange is allocated to each divided portion of the stock based on the relative fair market value of the stock to which the portion is attributable at the time the portions were created. Immediately before the merger, the value of the FS stock in relation to the value of both the FS stock and the FT stock was one-third ($100x / ($100x plus $200x)). Likewise, immediately before the merger, the value of the FT stock in relation to the value of both the FT stock and the FS stock was two-thirds ($200x / $100x plus $200x). Accordingly, one-third of the $210x amount realized is allocated to the FS portion of each share and two-thirds to the FT portion of each share. Thus, the amount realized allocated to the FS portion of each share is $7x (one-third of $210x divided by 10 shares). The amount realized allocated to the FT portion of each share is $14x (two-thirds of $210x divided by 10 shares). (C) Pursuant to paragraph (d)(3) of this section, any earnings and profits (or deficits) accumulated by the surviving corporation subsequent to the reorganization are attributed to the divided portions of shares of stock based on the relative fair market value of each divided portion of stock. Accordingly, one-third of the post-merger earnings and profits deficit of $30x is allocated to the FS portion of each share and two-thirds to the FT portion of each share. Thus, the deficit in earnings and profits allocated to the FS portion of each share is $1x (one-third of $30x divided by 10 shares). The deficit in earnings and profits allocated to the FT portion of each share is $2x (two-thirds of $30x divided by 10 shares). (D) When FP disposes of its FS stock, FP is treated as disposing of each divided portion of a share of stock. With respect to the FS portion of each share of stock, FP recognizes a gain of $2x ($7x value - $5x basis), which is not recharacterized as a dividend because a deficit in earnings and profits of $1x is attributable to such portion for purposes of section 1248. With respect to the FT portion of each share of stock, FP recognizes a loss of $5x ($14x value - $17x basis).

(e) Effective date. This section applies to exchanges occurring after the date these regulations are published as final regulations in the Federal Register.

Par. 11. Section 1.884–2 is amended as follows:
1. Paragraphs (c)(3) through (c)(6) (i)(A) are revised.
2. Paragraphs (c)(6)(i)(B), (C), and (D) are added.
3. Paragraphs (c)(6)(ii) through (f) are revised.
4. Paragraph (g) is amended by adding a sentence at the end.

The revisions and additions read as follows:

§1.884–2 Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary.

* * * * *

(c)(3) through (c)(6)(i)(A) [Reserved]. For further guidance, see §1.884–2T(c)(3) through (c)(6)(i)(A).

(c)(6)(i)(B) Shareholders of the transferee (or of the transferee’s parent in the case of a triangular reorganization described in section 368(a)(1)(C) or a reorganization described in sections 368(a)(1)(A) and 368(a)(2)(D) or (E)) who in the aggregate owned more than 25 percent of the value of the stock of the transferee at any time within the 12-month period preceding the close of the year in which the section 381(a) transaction occurs sell, exchange or otherwise dispose of their stock or securities in the transferee at any time during a period of three years
from the close of the taxable year in which the section 381(a) transaction occurs.

(c)(6)(i)(C) In the case of a triangular reorganization described in section 368(a)(1)(C) or a reorganization described in sections 368(a)(1)(A) and 368(a)(2)(D) or (E), the transferee’s parent sells, exchanges, or otherwise disposes of its stock or securities in the transferee at any time during a period of three years from the close of the taxable year in which the section 381(a) transaction occurs.

(c)(6)(i)(D) A corporation related to any such shareholder or the shareholder itself if it is a corporation (subsequent to an event described in paragraph (c)(6)(i)(A) or (B) of this section) or the transferee’s parent (subsequent to an event described in paragraph (c)(6)(i)(C) of this section), uses, directly or indirectly, the proceeds or property received in such sale, exchange or disposition, or property attributable thereto, in the conduct of a trade or business in the United States at any time during a period of three years from the date of sale in the case of a disposition of stock in the transferor, or from the close of the taxable year in which the section 381(a) transaction occurs.

Par. 12. In §1.884–2T, paragraphs (c)(6)(i)(B), (C), and (D) are revised to read as follows:

§1.884–2T Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary (Temporary).

* * * * *

(c) * * *

(6) * * *

(i) * * *

(B), (C), and (D) [Reserved]. For further guidance, see §1.884–2T(c)(6)(ii) through (f).

(g) * * * Paragraphs (c)(6)(i)(B), (C), and (D), are applicable for tax years beginning after December 31, 1986, except that such paragraphs are applicable to transactions occurring after the date these regulations are published as final regulations in the Federal Register in the case of reorganizations described in sections 368(a)(1)(A) and 368(a)(2)(D) or (E).

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

(Amended by Regulations 26 CFR Part 1884, المؤلف 14, 2005, 18-45 a.m. and published in the issue of the Federal Register for January 5, 2005, 70 F.R. 749)

Archer MSAs
Announcement 2005–12

PURPOSE

Sections 220(i) and (j) of the Internal Revenue Code provide that if the number of Archer Medical Savings Account (Archer MSA) returns filed for 2003 is 60,832 and that the number of Archer MSA returns projected to be filed for 2004 is 56,492 (after reduction in each case for statutorily specified exclusions, such as the exclusion for previously uninsured taxpayers). Consequently, February 1, 2005, is not a “cut-off” date and 2004 is not a “cut-off” year for the Archer MSA pilot project.

BACKGROUND

The Health Insurance Portability and Accountability Act of 1996 added section 220 to the Code to permit eligible individuals to establish Archer MSAs under a pilot project effective January 1, 1997. The pilot project, as amended by The Working Families Tax Relief Act of 2004 (WFTRA) § 322, has a scheduled “cut-off” year of 2005, but may have an earlier “cut-off” year if the number of individuals who have established Archer MSAs exceeds certain numerical limitations. Trustees’ reports for Archer MSAs established from January 1, 2004, through June 30, 2004, were due no later than January 3, 2005. IRS is required to publish a determination of whether 2004 is a “cut-off” year no later than February 1, 2005. See sections 220(i) and (j) as amended by WFTRA; Ann. 2004–82, 2004–45 I.R.B. 834.

If a year is a “cut-off” year, section 220(i)(1) generally provides that no individual will be eligible for a deduction or exclusion for Archer MSA contributions for any taxable year beginning after the “cut-off” year unless the individual (A) was an active Archer MSA participant for any taxable year ending on or before the close of the “cut-off” year, or (B) first became an active Archer MSA participant for a taxable year ending after the “cut-off” year by reason of coverage under a high deductible health plan of an Archer MSA-participating employer.

Section 220(j)(2)(A) provides that the numerical limitation for 2004 is exceeded if the number of Archer MSA returns filed on or before April 15, 2004, for taxable years ending with or within the 2003 calendar year, plus the Secretary’s estimate of the number of Archer MSA returns for those taxable years which will be filed after April 15, 2004, exceeds 750,000.

February 14, 2005 555 2005–7 I.R.B.
For this purpose, section 220(j)(2)(A) provides that a tax return is an Archer MSA return for a taxable year if any exclusion is claimed under section 106(b) or any deduction is claimed under section 220 for that taxable year. Section 220(j)(2)(B) provides, as an alternative test, that the numerical limitation for 2004 is also exceeded if the sum of 90 percent of the Archer MSA returns for 2003 plus the product of 2.5 and the number of Archer MSAs for taxable years beginning in 2004 that are established during the portion of 2004 preceding July 1 (based on reports by Archer MSA trustees and custodians), exceeds 750,000.

Under section 220(j)(3), in determining whether any calendar year is a “cut-off” year, the Archer MSA of any previously uninsured individual is not taken into account. In addition, section 220(j)(4)(D) specifies that, to the extent practical, all Archer MSAs established by an individual are aggregated and two married individuals opening separate Archer MSAs are to be treated as having a single Archer MSA for purposes of determining the number of Archer MSAs.

A total of 66,015 tax returns reporting an excludable or deductible contribution to an Archer MSA for the 2003 taxable year were filed by April 15, 2004. Of this total, 15,513 taxpayers were reported as being previously uninsured. It has been estimated that an additional 13,220 tax returns reporting Archer MSA contributions for the 2003 taxable year have been or will be filed after April 15, 2004, including 2,890 taxpayers who were previously uninsured. Accordingly, it has been determined that there were 79,235 (66,015 plus 13,220) Archer MSA returns for 2003. Of this total, 18,403 (15,513 plus 2,890) were for taxpayers reported as being previously uninsured. As a result, 60,832 (79,235 minus 18,403) Archer MSA returns count toward the applicable statutory limitation for 2004 Archer MSA returns of 750,000.

Based on the Forms 8851 filed on or before January 3, 2005, by Archer MSA trustees and custodians, it has been determined that 4,062 taxpayers who did not have Archer MSA contributions for 2003 established Archer MSAs for 2004 during the portion of 2004 preceding July 1. Of this total, 3,362 taxpayers were reported by trustees and custodians as previously uninsured, and therefore are not taken into account in determining whether 2004 is a “cut-off” year. In addition, 3 taxpayers were reported by trustees and custodians as excludable from the count because his or her spouse also established an Archer MSA. Accordingly, the applicable number of Archer MSAs established from January 1, 2004, through June 30, 2004, is 697 (4,062 minus 3,362 plus 3). The alternative limitation for 2004 (90 percent of the applicable number of Archer MSA returns for 2003 plus the product of 2.5 and the number of applicable Archer MSAs established from January 1, 2004, through June 30, 2004) is 56,492 (90 percent of 60,832 plus 2.5 multiplied by 697), which is less than the statutory limit of 750,000. Thus, 2004 is not a “cut-off” year for the Archer MSA pilot project by reason of either the 2004 Archer MSA returns test of section 220(j)(2)(A) or the alternative test of section 220(j)(2)(B) of the Code.

Questions regarding this announcement may be directed to Elizabeth Purcell in the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) at (202) 622–6080 (not a toll-free number).
Definition of Terms

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

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

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

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

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

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

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

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

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

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

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

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
Ex—Executor.
F—Fiduciary.
FC—Foreign Country.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
FR—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.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
T.F.E.—Transferee.
TFR—Transferor.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
X—Corporation.
Y—Corporation.
Z—Corporation.
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