

## **HIGHLIGHTS OF THIS ISSUE**

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

### **INCOME TAX**

#### **Rev. Rul. 2007-51, page 573.**

**Limitations on setoff under sections 6402 and 6411.** This ruling holds that the Service may credit an overpayment against unassessed internal revenue tax liabilities that have been determined in a statutory notice of deficiency sent to the taxpayer. It further holds that under section 6411(b) of the Code, the Service may credit a decrease in tax resulting from a tentative carryback adjustment against unassessed liabilities determined in a statutory notice of deficiency. Rev. Rul. 54-378 clarified.

#### **Rev. Rul. 2007-52, page 575.**

**Definition of a liability under section 6402(a) and 6411(b).** This ruling holds that the Service has the right under section 6402 of the Code to credit an overpayment against internal revenue liabilities for which no assessment has been made, or statutory notice of deficiency issued, when the liabilities are identified in a proof of claim filing in a bankruptcy case. Similarly, the ruling holds that the Service has the right under section 6411(b) to credit a decrease in tax resulting from a tentative carryback adjustment against internal revenue tax liabilities for which no assessment has been made, or statutory notice of deficiency issued, when the liabilities are identified in a proof of claim filed in a bankruptcy case.

#### **Rev. Rul. 2007-53, page 577.**

**Revocation of Rev. Rul.; tentative allowance.** The IRS has determined that Rev. Rul. 78-369 is inconsistent with the regulations under section 6411 of the Code. Rev. Rul. 78-369 revoked.

#### **Rev. Rul. 2007-58, page 562.**

**Qualified pension or retirement plan.** This ruling supplements Rev. Rul. 94-62, 1994-2 C.B. 164, by expanding the list of entities that are treated as “qualified pension or retirement plans” within the meaning of regulations section 1.817-5(f)(3)(iii). Rev. Rul. 94-62 supplemented.

#### **Rev. Rul. 2007-59, page 582.**

**Bankruptcy effects of disaster and combat zone relief.** This ruling provides that the postponement of the time to file a return under section 7508 or 7508A of the Code does not change the date that the return is last due, including extensions, and therefore does not change the priority and dischargeability of the tax for bankruptcy purposes.

#### **T.D. 9355, page 577.**

#### **REG-118886-06, page 591.**

Final, temporary, and proposed regulations under section 6411 of the Code clarify that, after being computed under the terms of regulations sections 1.6411-2 and 1.6411-2T, a tentative carryback adjustment may be reduced under sections 1.6411-3 and 1.6411-3T by unassessed amounts under certain circumstances. The regulations provide technical revisions that remove all references to IRS district director and service center director, as those positions no longer exist within the IRS.

(Continued on the next page)

Announcements of Disbarments and Suspensions begin on page 596.  
Finding Lists begin on page ii.

**REG-118719-07, page 593.**

Proposed regulations under section 817 of the Code concern the diversification requirements of section 817(h). The regulations would expand the list of holders whose beneficial interests in an investment company, partnership, or trust do not prevent a segregated asset account from looking through to the assets of the investment company, partnership, or trust, to satisfy the requirements of section 817(h). The regulations also would remove the sentence in regulations section 1.817-5(a)(2) that provides that the payment required to remedy an inadvertent diversification failure must be based on the tax that would have been owed by the policyholders if they were treated as receiving the income on the contract.

**Rev. Proc. 2007-58, page 585.**

This procedure provides the domestic asset/liability percentages and domestic investment yields needed by foreign life insurance companies and foreign property and liability insurance companies to compute their minimum effectively connected net investment income under section 842(b) of the Code for taxable years beginning after December 31, 2005.

**ESTATE TAX****T.D. 9348, page 563.**

Final regulations under section 2642 of the Code provide guidance regarding the qualified severance of a trust for generation-skipping transfer (GST) tax purposes under section 2642(a)(3), which was added to the Code by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

**REG-128843-05, page 587.**

Proposed regulations under section 2642 of the Code provide guidance regarding the generation-skipping transfer (GST) tax consequences of the severance of trusts in a manner that is effective under state law, but that does not meet the requirements of a qualified severance under section 2642(a)(3). The regulations also provide guidance regarding the GST tax consequences of a qualified severance of a trust with an inclusion ratio between zero and one into more than two resulting trusts. The regulations also provide special funding rules applicable to the non *pro rata* division of certain assets between or among resulting trusts.

**EXCISE TAX****T.D. 9346, page 570.**

Final regulations under section 4081 of the Code relate to the entry of taxable fuel into the United States. The regulations affect enterers of taxable fuel, certain other importers of record, and certain sureties.

**ADMINISTRATIVE****Rev. Rul. 2007-59, page 582.****Bankruptcy effects of disaster and combat zone relief.**

This ruling provides that the postponement of the time to file a return under section 7508 or 7508A of the Code does not change the date that the return is last due, including extensions, and therefore does not change the priority and dischargeability of the tax for bankruptcy purposes.

**Notice 2007-74, page 585.****Bankruptcy effects of disaster relief for Hurricane Katrina victims who file section 6081 extensions.**

This notice clarifies Notice 2006-56, 2006-28 I.R.B. 58, by explaining that even if an affected taxpayer requested an extension of time to file a return under section 6081 during the section 7508A postponement period, the due date of the return, including extensions, would be the original due date plus six months. The postponement under section 7508A does not change the priority and dischargeability of tax for bankruptcy purposes, regardless of when the extension of time under section 6081 is requested. Rev. Rul. 2007-59 amplified. Notice 2006-56 clarified.

# The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by

applying the tax law with integrity and fairness to all.

## Introduction

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

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

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

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations,

court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

### **Part I.—1986 Code.**

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

### **Part II.—Treaties and Tax Legislation.**

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

### **Part III.—Administrative, Procedural, and Miscellaneous.**

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

### **Part IV.—Items of General Interest.**

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

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

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

## Section 408A.—Roth IRAs

26 CFR 1.408A-1: Roth IRAs in general.

26 CFR 1.408(q)-1: Deemed IRAs in qualified employer plans.

Rev. Rul. 2007-58 expands the list of entities that are treated as “qualified pension or retirement plans” within the meaning of section 1.817-5(f)(3)(iii). See Rev. Rul. 2007-58, page 562.

## Section 415.—Limitations on Benefits and Contributions Under Qualified Plans

Rev. Rul. 2007-58 expands the list of entities that are treated as “qualified pension or retirement plans” within the meaning of section 1.817-5(f)(3)(iii). See Rev. Rul. 2007-58, page 562.

## Section 457.—Deferred Compensation Plans of State and Local Governments and Tax-Exempt Organizations

Rev. Rul. 2007-58 expands the list of entities that are treated as “qualified pension or retirement plans” within the meaning of section 1.817-5(f)(3)(iii). See Rev. Rul. 2007-58, page 562.

## Section 817.—Treatment of Variable Contracts

26 CFR 1.817-5: Diversification requirements for variable annuity, endowment, and life insurance contracts.

(Also §§ 408(p), 408(q), 408A, 415(m), 457(f).)

**Qualified pension or retirement plan.** This ruling supplements Rev. Rul. 94-62, 1994-2 C.B. 164, by expanding the list of entities that are treated as “qualified pension or retirement plans” within the meaning of regulations section 1.817-5(f)(3)(iii). Rev. Rul. 94-62 supplemented.

## Rev. Rul. 2007-58

This revenue ruling supplements Rev. Rul. 94-62, 1994-2 C.B. 164, by listing additional arrangements that each qualify as a “qualified pension or retirement plan” for purposes of § 1.817-5(f)(3)(iii) of the Income Tax Regulations.

## BACKGROUND

Under section 817(h) of the Internal Revenue Code, a segregated asset account upon which a variable annuity or life insurance contract is based must be adequately diversified in order for the variable contract to be treated as an annuity under § 72 or as a life insurance contract under § 7702. Section 817(h)(4) and § 1.817-5(f) provide that in certain cases diversification may be satisfied under a “look-through” rule. If the look-through rule applies with respect to a beneficial interest in a regulated investment company, for example, the diversification requirements are applied by taking into account the assets held by the regulated investment company. One of the requirements for applying the look-through rule under § 1.817-5(f)(2)(i) is that all of the beneficial interests in a regulated investment company, partnership or trust be held by one or more insurance companies. For purposes of determining whether this requirement is satisfied, § 1.817-5(f)(3)(iii) provides that beneficial interests held by the trustee of a qualified pension or retirement plan are disregarded.

Rev. Rul. 94-62 provides that, solely for purposes of § 1.817-5(f)(3)(iii), the term “qualified pension or retirement plan” includes the following arrangements:

1. A plan described in § 401(a) that includes a trust exempt from tax under § 501(a);
2. An annuity plan described in § 403(a);
3. An annuity contract described in § 403(b), including a custodial account described in § 403(b)(7);
4. An individual retirement account described in § 408(a);
5. An individual retirement annuity described in § 408(b);
6. A governmental plan within the meaning of § 414(d) or an eligible deferred compensation plan within the meaning of § 457(b);
7. A simplified employee pension of an employer that satisfies the requirements of § 408(k);
8. A plan described in § 501(c)(18);

9. Any other trust, plan, account, contract, or annuity that the Internal Revenue Service has determined in a letter ruling to be within the scope of § 1.817-5(f)(3)(iii).

Whether an arrangement is described in § 1.817-5(f)(3)(iii) is based on the meaning and purpose of §§ 817 and 818. Since the issuance of Rev. Rul. 94-62, the Service has determined that certain additional arrangements may be treated as “qualified pension or retirement plans” for purposes of § 1.817-5(f)(3)(iii).

## HOLDING

In addition to the nine arrangements identified in Rev. Rul. 94-62 and solely for purposes of § 1.817-5(f)(3)(iii), the term “qualified pension or retirement plan” includes the following five arrangements: a simple retirement account described in § 408(p); a deemed IRA described in § 408(q); a Roth IRA described in § 408A; a § 415(m) plan that is also a “governmental plan” within the meaning of § 414(d); and a § 457(f) plan that has as its sponsor either (i) a charitable organization described in § 818(a)(4), or (ii) a governmental organization described in § 818(a)(4), whose employees are described in § 403(b)(1)(A)(ii). Accordingly, the list of arrangements that are treated as “qualified pension or retirement plans” within the meaning of § 1.817-5(f)(3)(iii) is supplemented to read as follows:

1. A plan described in § 401(a) that includes a trust exempt from tax under § 501(a);
2. An annuity plan described in § 403(a);
3. An annuity contract described in § 403(b), including a custodial account described in § 403(b)(7);
4. An individual retirement account described in § 408(a);
5. An individual retirement annuity described in § 408(b);
6. A governmental plan within the meaning of § 414(d) or an eligible deferred compensation plan within the meaning of § 457(b);

7. A simplified employee pension of an employer that satisfies the requirements of § 408(k);

8. A plan described in § 501(c)(18);

9. A simple retirement account described in § 408(p);

10. A deemed IRA described in § 408(q);

11. A Roth IRA described in § 408A;

12. A § 415(m) plan that is also a “governmental plan” within the meaning of § 414(d);

13. A § 457(f) plan that has as its sponsor either (i) a charitable organization described in § 818(a)(4), or (ii) a governmental organization described in § 818(a)(4), whose employees are described in § 403(b)(1)(A)(ii); and

14. Any other trust, plan, account, contract, or annuity that the Internal Revenue Service has determined in a letter ruling to be within the scope of § 1.817-5(f)(3)(iii).

#### EFFECT ON OTHER REVENUE RULING(S)

Rev. Rul. 94-62 is *supplemented*.

#### DRAFTING INFORMATION

The principal author of this revenue ruling is Melissa S. Luxner of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling, contact Melissa S. Luxner at (202) 622-3970 (not a toll-free call).

## Section 2642.—Inclusion Ratio

26 CFR 26.2642-6: *Qualified severance.*

### T.D. 9348

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

### Qualified Severance of a Trust for Generation-Skipping Transfer (GST) Tax Purposes

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations providing guidance regarding the qualified severance of a trust for generation-skipping transfer (GST) tax purposes under section 2642(a)(3) of the Internal Revenue Code (Code), which was added to the Code by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). The regulations will affect trusts that are subject to the GST tax.

DATES: *Effective Date:* The regulations are effective August 2, 2007.

*Applicability Date:* For dates of applicability, see §26.2642-6(k)(1) and §26.2642-6(k)(2).

FOR FURTHER INFORMATION CONTACT: Mayer R. Samuels, (202) 622-3090 (not a toll-free number).

#### SUPPLEMENTARY INFORMATION:

##### Paperwork Reduction Act

The collection of information contained in these final regulations has been previously reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1902.

The collection of information in these final regulations is in §26.2642-6(e). This information is requested by the IRS to identify whether a trust is exempt from the GST tax. This information is required to determine whether the amount of tax has been calculated correctly. The respondents are trustees of trusts that are being severed.

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

The estimated average annual burden per respondent / recordkeeper is .5 hours per respondent. Comments concerning the accuracy of this burden estimate should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224 and the **Office of Management**

**and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this 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 2642(a)(3) was added to the Internal Revenue Code by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Public Law 107-16 (115 Stat. 38 (2001)). Under section 2642(a)(3), if a trust is divided into two or more trusts in a “qualified severance,” the resulting trusts will be recognized as separate trusts for GST tax purposes. In many cases, a qualified severance of a trust will facilitate the most efficient and effective use of the transferor’s GST tax exemption. The GST tax exemption is each person’s lifetime exemption that may be allocated to a generation-skipping transfer. If the transfer is made in trust, allocation of the donor’s GST tax exemption reduces the trust’s inclusion ratio, which in turn determines the amount of GST tax imposed on any generation-skipping transfer made with regard to the trust.

On August 24, 2004, the IRS published in the **Federal Register** a notice of proposed rulemaking (REG-145987-03, 2004-2 C.B. 519 [69 FR 51967]), providing rules under section 2642(a)(3) regarding the qualified severance of a trust for GST tax purposes. The IRS received written and oral comments responding to the notice of proposed rulemaking. No public hearing was requested or held. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision, and the corresponding proposed regulations are removed. The comments and revisions to the proposed regulations are discussed below. In addition, additional proposed regulations (REG-128843-05) are being issued contemporaneously with these final regulations in order to respond to certain comments that the Treasury Department and the IRS believe merit further consideration in proposed regulations.

## Summary of Comments

The proposed regulations take the position that the severance rules contained in §26.2654-1(b) of the regulations were superseded by the enactment of section 2642(a)(3), and therefore that §26.2654-1(b) is no longer effective. However, many commentators noted that sections 2654(b) and 2642(a)(3) address different situations, and they suggested that section 2642(a)(3) was intended to supplement, rather than to replace, section 2654(b), and to thereby provide more flexibility in severing trusts for GST tax purposes. The commentators noted that section 2642(a)(3) qualified severances are effective prospectively from the date of severance and thus, that section only addresses severances that typically would occur after an irrevocable trust (whether *inter vivos* or testamentary) has been in existence for a period of time. In contrast, §26.2654-1(b) addresses only severances of testamentary trusts and revocable *inter vivos* trusts included in the transferor's gross estate, and a severance satisfying §26.2654-1(b) is effective retroactively to the date of death. Section 26.2654-1(b) provides for the recognition of severances of separate shares of such trusts, and of discretionary severances that, although not provided for in the governing instrument, are necessary to fully utilize available tax benefits (for example, the reverse qualified terminable interest property election under section 2652(a)(3)). To fulfill the purpose of these severances (generally, efficient utilization and allocation of the decedent's GST exemption), the severance must be effective retroactive to the date of death. Thus, section 2642(a)(3) and §26.2654-1(b) address different circumstances.

In response to these comments, the final regulations do not supersede §26.2654-1(b). Rather, §26.2654-1(b) is retained, but, as explained hereafter, is proposed to be amended as described in a notice of proposed rulemaking issued contemporaneously with these final regulations. Subject to those proposed changes, §26.2654-1(b) will continue to provide rules for mandatory and discretionary severances of trusts includible in the transferor's gross estate, effective retroactively to the transferor's date of death. The final regulations under §26.2642-6 generally

provide rules for the qualified severance of a trust (whether or not includible in the transferor's gross estate) if the severance will be effective only prospectively from the date of severance.

One commentator requested that the regulations provide that separate trusts, created as the result of a mandated division of a single trust that is effective under state law, be recognized prospectively as separate trusts for certain GST tax purposes, even if the severance does not satisfy the requirements of a qualified severance. This comment will be addressed in the proposed regulations under section 2642, issued contemporaneously with these final regulations.

One commentator requested that the regulations provide additional flexibility in severing a trust that has an inclusion ratio between zero and one. Specifically, the commentator requested that the final regulations permit the qualified severance of a trust into one or more separate resulting trusts, as long as one or more of the resulting trusts, in the aggregate, would receive a fractional share of the total value of the original trust's assets that equals the applicable fraction of the original trust. In such a qualified severance, the resulting trust or trusts receiving this fractional share would each have an inclusion ratio of zero, and each of the other resulting trusts would have an inclusion ratio of one. This comment will be addressed in the proposed regulations under section 2642, issued contemporaneously with these final regulations.

In response to comments, the final regulations continue to require that, in notifying the IRS of the severance of a trust, the words "Qualified Severance" should appear at the top of Form 706-GS(T), "*Generation-Skipping Transfer Tax Return For Terminations*," but the use of red ink for that purpose is not required.

One commentator questioned the requirement in the proposed regulations that any non-*pro rata* funding of trusts resulting from a qualified severance must be based on the value of the trust assets as of the date of funding. The commentator pointed out that, in many cases, the funding of trusts resulting from a qualified severance will take place over a period of time, rather than on one specific date. Accordingly, under the final regulations, the non-*pro rata* funding of trusts result-

ing from a qualified severance must be achieved by applying the appropriate fraction or percentage to the total value of the trust assets as of the "date of severance." The term "date of severance" is defined as the date selected for determining the value of the trust assets (whether selected on a discretionary basis or by a court order), provided that funding is commenced immediately and occurs within a reasonable time before or after the selected date of severance. For this purpose, a reasonable time may differ depending upon the type of asset involved, but in no event may be more than 90 days.

Several commentators requested that the regulations address the severance of a trust that was irrevocable on September 25, 1985, but with respect to which an addition was made to the trust after September 25, 1985. For purposes of determining the inclusion ratio with respect to such a trust, §26.2601-1(b)(1)(iv)(A) provides that the trust is deemed to consist of two portions, one portion not subject to GST tax (the non-chapter 13 portion) with an inclusion ratio of zero, and one portion subject to GST tax (the chapter 13 portion) with an inclusion ratio determined under section 2642. In response to these comments, the final regulations provide guidance regarding a qualified severance of the chapter 13 portion of these trusts.

The proposed regulations include a mandatory reporting requirement, without which a severance would not constitute a qualified severance. One commentator noted that, in some situations, it may be advantageous to sever a trust but to avoid qualification under section 2642(a)(3) as a qualified severance. The Treasury Department and the IRS believe that the qualified severance rules were not intended to be optional; that is, able to be employed or avoided depending upon the tax consequences of a particular severance. Therefore, under the final regulations, the reporting provisions do not constitute a requirement for qualified severance status, but each severance should be reported to ensure that the provisions of Chapter 13 of the Code may be properly applied with regard to the trusts.

One commentator noted that §1.1001-1(h)(1) of the proposed regulations provides favorable income tax treatment only with respect to a qualified severance. The commentator re-

questioned that the regulations also address the income tax treatment of all other trust modifications and severances. The commentator noted that the failure to address, for example, the income tax consequences of severances that are not qualified severances for GST tax purposes implies that such severances are taxable events for income tax purposes. In response to these comments, the category of severances to which §1.1001-1(h)(1) will apply has been broadened. No inference should be drawn with respect to the income tax consequences under section 1001 of any severance that is not described in §1.1001-1(h)(1).

Commentators noted that some qualified severances may result in a taxable termination or taxable distribution, for example, if after the severance, one of the resulting trusts is a skip person. The final regulations clarify that, if the qualified severance itself results in a GST taxable event, the taxable event is treated as occurring immediately after the severance. As a result, if the resulting trust that is a skip person is also the trust that has a zero inclusion ratio after the severance, then no GST tax will result from the taxable event that is deemed to occur after the severance. An example was added illustrating this rule.

Finally, in response to comments, an example has been added addressing the qualified severance rules in the case of a trust where the beneficiary is granted a contingent testamentary general power of appointment that is dependent upon the trust's inclusion ratio.

### Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the collection of information imposed by this regulation is not significant as reflected in the estimated burden of information collection for, which is 0.5 hours per respondent, and

that few trustees are likely to be small entities. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on their impact on small business.

### Drafting Information

The principal author of these final regulations is Mayer R. Samuels, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. Other personnel from the IRS and the Treasury Department participated in their development.

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### Adoption of Amendments to the Regulations

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

#### PART 1—INCOME TAXES

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

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

Par. 2. In §1.1001-1, paragraph (h) is added to read as follows:

#### §1.1001-1 Computation of gain or loss.

\* \* \* \* \*

(h) *Severances of trusts*—(1) *In general*. The severance of a trust (including without limitation a severance that meets the requirements of §26.2642-6 or of §26.2654-1(b) of this chapter) is not an exchange of property for other property differing materially either in kind or in extent if—

(i) An applicable state statute or the governing instrument authorizes or directs the trustee to sever the trust; and

(ii) Any non-*pro rata* funding of the separate trusts resulting from the severance (including non-*pro rata* funding as described in §26.2642-6(d)(4) or §26.2654-1(b)(1)(ii)(C) of this chapter), whether mandatory or in the discretion of the trustee, is authorized by an applicable state statute or the governing instrument.

(2) *Effective/applicability date*. This paragraph (h) applies to severances occurring on or after August 2, 2007. Taxpayers may apply this paragraph (h) to severances occurring on or after August 24, 2004, and before August 2, 2007.

#### PART 26—GENERATION-SKIPPING TRANSFER TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1986

Par. 3. The authority citation for part 26 is amended by adding an entry in numerical order to read, in part, as follows:

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

Section 26.2642-6 also issued under 26 U.S.C. 2642. \* \* \*

Par. 4. In §26.2600-1, the table of contents is amended by adding entries for §§26.2642-6 and 26.2654-1 to read as follows:

#### §26.2600-1 Table of contents.

\* \* \* \* \*

#### §26.2642-6 Qualified severance.

- (a) In general.
- (b) Qualified severance defined.
- (c) Effective date of qualified severance.
- (d) Requirements for a qualified severance.
- (e) Reporting a qualified severance.
- (f) Time for making a qualified severance.

(g) Trusts that were irrevocable on September 25, 1985.

- (1) In general.
- (2) Trusts in receipt of a post-September 25, 1985, addition.
- (h) [Reserved]
- (i) [Reserved]
- (j) Examples.
- (k) Effective date.
- (1) In general.
- (2) Transition rule.

\* \* \* \* \*

#### §26.2654-1 Certain trusts treated as separate trusts.

\* \* \* \* \*

- (c) Cross reference.

\* \* \* \* \*

Par. 5. Section 26.2642-6 is added to read as follows:

*§26.2642-6 Qualified severance.*

(a) *In general.* If a trust is divided in a qualified severance into two or more trusts, the separate trusts resulting from the severance will be treated as separate trusts for generation-skipping transfer (GST) tax purposes and the inclusion ratio of each new resulting trust may differ from the inclusion ratio of the original trust. Because the post-severance resulting trusts are treated as separate trusts for GST tax purposes, certain actions with respect to one resulting trust will generally have no GST tax impact with respect to the other resulting trust(s). For example, GST exemption allocated to one resulting trust will not impact on the inclusion ratio of the other resulting trust(s); a GST tax election made with respect to one resulting trust will not apply to the other resulting trust(s); the occurrence of a taxable distribution or termination with regard to a particular resulting trust will not have any GST tax impact on any other trust resulting from that severance. In general, the rules in this section are applicable only for purposes of the GST tax and are not applicable in determining, for example, whether the resulting trusts may file separate income tax returns or whether the severance may result in a gift subject to gift tax, may cause any trust to be included in the gross estate of a beneficiary, or may result in a realization of gain for purposes of section 1001. See §1.1001-1(h) of this chapter for rules relating to whether a qualified severance will constitute an exchange of property for other property differing materially either in kind or in extent.

(b) *Qualified severance defined.* A qualified severance is a division of a trust (other than a division described in §26.2654-1(b)) into two or more separate trusts that meets each of the requirements in paragraph (d) of this section.

(c) *Effective date of qualified severance.* A qualified severance is applicable as of the date of the severance, as defined in §26.2642-6(d)(3), and the resulting trusts are treated as separate trusts for GST tax purposes as of that date.

(d) *Requirements for a qualified severance.* For purposes of this section, a quali-

fied severance must satisfy each of the following requirements:

(1) The single trust is severed pursuant to the terms of the governing instrument, or pursuant to applicable local law.

(2) The severance is effective under local law.

(3) The date of severance is either the date selected by the trustee as of which the trust assets are to be valued in order to determine the funding of the resulting trusts, or the court-imposed date of funding in the case of an order of the local court with jurisdiction over the trust ordering the trustee to fund the resulting trusts on or as of a specific date. For a date to satisfy the definition in the preceding sentence, however, the funding must be commenced immediately upon, and funding must occur within a reasonable time (but in no event more than 90 days) after, the selected valuation date.

(4) The single trust (original trust) is severed on a fractional basis, such that each new trust (resulting trust) is funded with a fraction or percentage of the original trust, and the sum of those fractions or percentages is one or one hundred percent, respectively. For this purpose, the fraction or percentage may be determined by means of a formula (for example, that fraction of the trust the numerator of which is equal to the transferor's unused GST tax exemption, and the denominator of which is the fair market value of the original trust's assets on the date of severance). The severance of a trust based on a pecuniary amount does not satisfy this requirement. For example, the severance of a trust is not a qualified severance if the trust is divided into two trusts, with one trust to be funded with \$1,500,000 and the other trust to be funded with the balance of the original trust's assets. With respect to the particular assets to be distributed to each resulting trust, each resulting trust may be funded with the appropriate fraction or percentage (*pro rata* portion) of each asset held by the original trust. Alternatively, the assets may be divided among the resulting trusts on a non-*pro rata* basis, based on the fair market value of the assets on the date of severance. However, if funded on a non-*pro rata* basis, each resulting trust must be funded by applying the appropriate fraction or percentage to the total fair market value of the trust assets as of the date of severance.

(5) The terms of the resulting trusts must provide, in the aggregate, for the same succession of interests of beneficiaries as are provided in the original trust. This requirement is satisfied if the beneficiaries of the separate resulting trusts and the interests of the beneficiaries with respect to the separate trusts, when the separate trusts are viewed collectively, are the same as the beneficiaries and their respective beneficial interests with respect to the original trust before severance. With respect to trusts from which discretionary distributions may be made to any one or more beneficiaries on a non-*pro rata* basis, this requirement is satisfied if—

(i) The terms of each of the resulting trusts are the same as the terms of the original trust (even though each permissible distributee of the original trust is not a beneficiary of all of the resulting trusts);

(ii) Each beneficiary's interest in the resulting trusts (collectively) equals the beneficiary's interest in the original trust, determined by the terms of the trust instrument or, if none, on a per-capita basis. For example, in the case of the severance of a discretionary trust established for the benefit of A, B, and C and their descendants with the remainder to be divided equally among those three families, this requirement is satisfied if the trust is divided into three separate trusts of equal value with one trust established for the benefit of A and A's descendants, one trust for the benefit of B and B's descendants, and one trust for the benefit of C and C's descendants;

(iii) The severance does not shift a beneficial interest in the trust to any beneficiary in a lower generation (as determined under section 2651) than the person or persons who held the beneficial interest in the original trust; and

(iv) The severance does not extend the time for the vesting of any beneficial interest in the trust beyond the period provided for in (or applicable to) the original trust.

(6) In the case of a qualified severance of a trust with an inclusion ratio as defined in §26.2642-1 of either one or zero, each trust resulting from the severance will have an inclusion ratio equal to the inclusion ratio of the original trust.

(7) In the case of a qualified severance occurring after GST tax exemption has been allocated to the trust (whether by an affirmative allocation, a deemed allocation, or an automatic allocation pursuant

to the rules contained in section 2632), if the trust has an inclusion ratio as defined in §26.2642-1 that is greater than zero and less than one, then the trust must be severed initially into two trusts. One resulting trust must receive that fractional share of the total value of the original trust as of the date of severance that is equal to the applicable fraction, as defined in §26.2642-1(b) and (c), used to determine the inclusion ratio of the original trust immediately before the severance. The other resulting trust must receive that fractional share of the total value of the original trust as of the date of severance that is equal to the excess of one over the fractional share described in the preceding sentence. The trust receiving the fractional share equal to the applicable fraction shall have an inclusion ratio of zero, and the other trust shall have an inclusion ratio of one. If the applicable fraction with respect to the original trust is .50, then, with respect to the two equal trusts resulting from the severance, the Trustee may designate which of the resulting trusts will have an inclusion ratio of zero and which will have an inclusion ratio of one. Each separate trust resulting from the severance then may be further divided in accordance with the rules of this section. See paragraph (j), *Example 7* of this section.

(e) *Reporting a qualified severance*—(1) *In general.* A qualified severance is reported by filing Form 706-GS(T), “*Generation-Skipping Transfer Tax Return For Terminations*,” (or such other form as may be provided from time to time by the Internal Revenue Service (IRS) for the purpose of reporting a qualified severance). Unless otherwise provided in the applicable form or instructions, the IRS requests that the filer write “*Qualified Severance*” at the top of the form and attach a Notice of Qualified Severance (Notice). The return and attached Notice should be filed by April 15th of the year immediately following the year during which the severance occurred or by the last day of the period covered by an extension of time, if an extension of time is granted, to file such form.

(2) *Information concerning the original trust.* The Notice should provide, with respect to the original trust that was severed—

- (i) The name of the transferor;
- (ii) The name and date of creation of the original trust;

(iii) The tax identification number of the original trust; and

(iv) The inclusion ratio before the severance.

(3) *Information concerning each new trust.* The Notice should provide, with respect to each of the resulting trusts created by the severance—

(i) The name and tax identification number of the trust;

(ii) The date of severance (within the meaning of paragraph (c) of this section);

(iii) The fraction of the total assets of the original trust received by the resulting trust;

(iv) Other details explaining the basis for the funding of the resulting trust (a fraction of the total fair market value of the assets on the date of severance, or a fraction of each asset); and

(v) The inclusion ratio.

(f) *Time for making a qualified severance.* (1) A qualified severance of a trust may occur at any time prior to the termination of the trust. Thus, provided that the separate resulting trusts continue in existence after the severance, a qualified severance may occur either before or after—

(i) GST tax exemption has been allocated to the trust;

(ii) A taxable event has occurred with respect to the trust; or

(iii) An addition has been made to the trust.

(2) Because a qualified severance is effective as of the date of severance, a qualified severance has no effect on a taxable termination as defined in section 2612(a) or a taxable distribution as defined in section 2612(b) that occurred prior to the date of severance. A qualified severance shall be deemed to occur before a taxable termination or a taxable distribution that occurs by reason of the qualified severance. See paragraph (j) *Example 8* of this section.

(g) *Trusts that were irrevocable on September 25, 1985*—(1) *In general.* See §26.2601-1(b)(4) for rules regarding severances and other actions with respect to trusts that were irrevocable on September 25, 1985.

(2) *Trusts in receipt of a post-September 25, 1985, addition.* A trust described in §26.2601-1(b)(1)(iv)(A) that is deemed for GST tax purposes to consist of one separate share not subject to GST tax (the non-chapter 13 portion) with an inclusion ratio of zero, and one separate share subject

to GST tax (the chapter 13 portion) with an inclusion ratio determined under section 2642, may be severed into two trusts in accordance with §26.2654-1(a)(3). One resulting trust will hold the non-chapter 13 portion of the original trust (the non-chapter 13 trust) and will not be subject to GST tax, and the other resulting trust will hold the chapter 13 portion of the original trust (the chapter 13 trust) and will have the same inclusion ratio as the chapter 13 portion immediately prior to the severance. The chapter 13 trust may be further divided in a qualified severance in accordance with the rules of this section. The non-chapter 13 trust may be further divided in accordance with the rules of §26.2601-1(b)(4).

(h) [Reserved].

(i) [Reserved].

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

*Example 1. Succession of interests.* T dies in 2006. T’s will establishes a testamentary trust (Trust) providing that income is to be paid to T’s sister, S, for her life. On S’s death, one-half of the corpus is to be paid to T’s child, C (or to C’s estate if C fails to survive S), and one-half of the corpus is to be paid to T’s grandchild, GC (or to GC’s estate if GC fails to survive S). On the Form 706, “*United States Estate (and Generation-Skipping Transfer) Tax Return*,” filed for T’s estate, T’s executor allocates all of T’s available GST tax exemption to other transfers and trusts, such that Trust’s inclusion ratio is 1. Subsequent to filing the Form 706 in 2007 and in accordance with applicable state law, the trustee divides Trust into two separate trusts, Trust 1 and Trust 2, with each trust receiving 50 percent of the value of the assets of the original trust as of the date of severance. Trust 1 provides that trust income is to be paid to S for life with remainder to C or C’s estate, and Trust 2 provides that trust income is to be paid to S for life with remainder to GC or GC’s estate. Because Trust 1 and Trust 2 provide for the same succession of interests in the aggregate as provided in the original trust, the severance constitutes a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied.

*Example 2. Succession of interests in discretionary trust.* In 2006, T establishes Trust, an irrevocable trust providing that income may be paid from time to time in such amounts as the trustee deems advisable to any one or more members of the group consisting of T’s children (A and B) and their respective descendants. In addition, the trustee may distribute corpus to any trust beneficiary in such amounts as the trustee deems advisable. On the death of the last to die of A and B, the trust is to terminate and the corpus is to be distributed in two equal shares, one share to the then-living descendants of each child, per stirpes. T elects, under section 2632(c)(5), to not have the automatic allocation rules contained in section 2632(c) apply with respect to T’s transfers to Trust, and T does not otherwise allocate GST tax exemption with respect to Trust. As a result, Trust has an inclusion ratio of one. In 2008,

the trustee of Trust, pursuant to applicable state law, divides Trust into two equal but separate trusts, Trust 1 and Trust 2, each of which has terms identical to the terms of Trust except for the identity of the beneficiaries. Trust 1 and Trust 2 each has an inclusion ratio of one. Trust 1 provides that income is to be paid in such amounts as the trustee deems advisable to A and A's descendants. In addition, the trustee may distribute corpus to any trust beneficiary in such amounts as the trustee deems advisable. On the death of A, Trust 1 is to terminate and the corpus is to be distributed to the then-living descendants of A, per stirpes, but, if A dies with no living descendants, the principal will be added to Trust 2. Trust 2 contains identical provisions, except that B and B's descendants are the trust beneficiaries and, if B dies with no living descendants, the principal will be added to Trust 1. Trust 1 and Trust 2 in the aggregate provide for the same beneficiaries and the same succession of interests as provided in Trust, and the severance does not shift any beneficial interest to a beneficiary who occupies a lower generation than the person or persons who held the beneficial interest in Trust. Accordingly, the severance constitutes a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied.

*Example 3. Severance based on actuarial value of beneficial interests.* In 2004, T establishes Trust, an irrevocable trust providing that income is to be paid to T's child C during C's lifetime. Upon C's death, Trust is to terminate and the assets of Trust are to be paid to GC, C's child, if living, or, if GC is not then living, to GC's estate. T properly elects, under section 2632(c)(5), to not have the automatic allocation rules contained in section 2632(c) apply with respect to T's transfers to Trust, and T does not otherwise allocate GST tax exemption with respect to Trust. Thus, Trust has an inclusion ratio of one. In 2008, the trustee of Trust, pursuant to applicable state law, divides Trust into two separate trusts, Trust 1 for the benefit of C (and on C's death to C's estate), and Trust 2 for the benefit of GC (and on GC's death to GC's estate). The document severing Trust directs that Trust 1 is to be funded with an amount equal to the actuarial value of C's interest in Trust prior to the severance, determined under section 7520 of the Internal Revenue Code. Similarly, Trust 2 is to be funded with an amount equal to the actuarial value of GC's interest in Trust prior to the severance, determined under section 7520. Trust 1 and Trust 2 do not provide for the same succession of interests as provided under the terms of the original trust. Therefore, the severance is not a qualified severance.

*Example 4. Severance of a trust with a 50% inclusion ratio.* On September 1, 2006, T transfers \$100,000 to a trust for the benefit of T's grandchild, GC. On a timely filed Form 709, "United States Gift (and Generation-Skipping Transfer) Tax Return," reporting the transfer, T allocates all of T's remaining GST tax exemption (\$50,000) to the trust. As a result of the allocation, the applicable fraction with respect to the trust is .50 [\$50,000 (the amount of GST tax exemption allocated to the trust) divided by \$100,000 (the value of the property transferred to the trust)]. The inclusion ratio with respect to the trust is .50 [1 - .50]. In 2007, pursuant to authority granted under applicable state law, the trustee severs the trust into two trusts, Trust 1 and Trust 2, each of which is identical to the original trust and each of which receives

a 50 percent fractional share of the total value of the original trust, valued as of the date of severance. Because the applicable fraction with respect to the original trust is .50 and the trust is severed into two equal trusts, the trustee may designate which resulting trust has an inclusion ratio of one, and which resulting trust has an inclusion ratio of zero. Accordingly, in the Notice of Qualified Severance reporting the severance, the trustee designates Trust 1 as having an inclusion ratio of zero, and Trust 2 as having an inclusion ratio of one. The severance constitutes a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied.

*Example 5. Funding of severed trusts on a non-pro rata basis.* T's will establishes a testamentary trust (Trust) for the benefit of T's descendants, to be funded with T's stock in Corporation A and Corporation B, both publicly traded stocks. T dies on May 1, 2004, at which time the Corporation A stock included in T's gross estate has a fair market value of \$100,000 and the stock of Corporation B included in T's gross estate has a fair market value of \$200,000. On a timely filed Form 706, T's executor allocates all of T's remaining GST tax exemption (\$270,000) to Trust. As a result of the allocation, the applicable fraction with respect to Trust is .90 [\$270,000 (the amount of GST tax exemption allocated to the trust) divided by \$300,000 (the value of the property transferred to the trust)]. The inclusion ratio with respect to Trust is .10 [1 - .90]. On August 1, 2008, in accordance with applicable local law, the trustee executes a document severing Trust into two trusts, Trust 1 and Trust 2, each of which is identical to Trust. The instrument designates August 3, 2008, as the date of severance (within the meaning of paragraph (d)(3) of this section). The terms of the instrument severing Trust provide that Trust 1 is to be funded on a non-pro rata basis with assets having a fair market value on the date of severance equal to 90% of the value of Trust's assets on that date, and Trust 2 is to be funded with assets having a fair market value on the date of severance equal to 10% of the value of Trust's assets on that date. On August 3, 2008, the value of the Trust assets totals \$500,000, consisting of Corporation A stock worth \$450,000 and Corporation B stock worth \$50,000. On August 4, 2008, the trustee takes all action necessary to transfer all of the Corporation A stock to Trust 1 and to transfer all of the Corporation B stock to Trust 2. On August 6, 2008, the stock transfers are completed and the stock is received by the appropriate resulting trust. Accordingly, Trust 1 is funded with assets having a value equal to 90% of the value of Trust as of the date of severance, August 3, 2008, and Trust 2 is funded with assets having a value equal to 10% of the value of Trust as of the date of severance. Therefore, the severance constitutes a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied. Trust 1 will have an inclusion ratio of zero and Trust 2 will have an inclusion ratio of one.

*Example 6.* [Reserved].

*Example 7. Statutory qualified severance.* T dies on October 1, 2004. T's will establishes a testamentary trust (Trust) to be funded with \$1,000,000. Trust income is to be paid to T's child, S, for S's life. The trustee may also distribute trust corpus from time to time, in equal or unequal shares, for the benefit of any one or more members of the group consisting of S and T's three grandchildren (GC1, GC2, and GC3).

On S's death, Trust is to terminate and the assets are to be divided equally among GC1, GC2, and GC3 (or their respective then-living descendants, per stirpes). On a timely filed Form 706, T's executor allocates all of T's remaining GST tax exemption (\$300,000) to Trust. As a result of the allocation, the applicable fraction with respect to the trust is .30 [\$300,000 (the amount of GST tax exemption allocated to the trust) divided by \$1,000,000 (the value of the property transferred to the trust)]. The inclusion ratio with respect to the trust is .70 [1 - .30]. On June 1, 2007, the trustee determines that it is in the best interest of the beneficiaries to sever Trust to provide a separate trust for each of T's three grandchildren and their respective families. The trustee severs Trust into two trusts, Trust 1 and Trust 2, each with terms and beneficiaries identical to Trust and thus each providing that trust income is to be paid to S for life, trust principal may be distributed for the benefit of any or all members of the group consisting of S and T's grandchildren, and, on S's death, the trust is to terminate and the assets are to be divided equally among GC1, GC2, and GC3 (or their respective then-living descendants, per stirpes). The instrument severing Trust provides that Trust 1 is to receive 30% of Trust's assets and Trust 2 is to receive 70% of Trust's assets. Further, each such trust is to be funded with a *pro rata* portion of each asset held in Trust. The trustee then severs Trust 1 into three equal trusts, Trust GC1, Trust GC2, and Trust GC3. Each trust is named for a grandchild of T and provides that trust income is to be paid to S for life, trust principal may be distributed for the benefit of S and T's grandchild for whom the trust is named, and, on S's death, the trust is to terminate and the trust proceeds distributed to the respective grandchild for whom the trust is named. If that grandchild has predeceased the termination date, the trust proceeds are to be distributed to that grandchild's then-living descendants, per stirpes, or, if none, then equally to the other two trusts resulting from the severance of Trust 1. Each such resulting trust is to be funded with a *pro rata* portion of each Trust 1 asset. The trustee also severs Trust 2 in a similar manner, into Trust GC1(2), Trust GC2(2), and Trust GC3(2). The severance of Trust into Trust 1 and Trust 2, the severance of Trust 1 into Trust GC1, Trust GC2, Trust GC3, and the severance of Trust 2 into Trust GC1(2), Trust GC2(2) and Trust GC3(2), constitute qualified severances, provided that all other requirements of section 2642(a)(3) and this section are satisfied with respect to each severance. Trust GC1, Trust GC2, Trust GC3 will each have an inclusion ratio of zero and Trust GC1(2), Trust GC2(2), and Trust GC3(2) will each have an inclusion ratio of one.

*Example 8. Qualified severance deemed to preclude a taxable termination.* In 2004, T establishes an *inter vivos* irrevocable trust (Trust) for a term of 10 years providing that Trust income is to be paid annually in equal shares to T's child C and T's grandchild GC (the child of another then-living child of T). If either C or GC dies prior to the expiration of the 10-year term, the deceased beneficiary's share of Trust's income is to be paid to that beneficiary's then-living descendants, per stirpes, for the balance of the trust term. At the expiration of the 10-year trust term, the corpus is to be distributed equally to C and GC; if either C or GC is not then living, then such decedent's share is to be distributed instead to such decedent's then-living descendants, per stirpes. T allocates T's

GST tax exemption to Trust such that Trust's applicable fraction is .50 and Trust's inclusion ratio is .50 [1-.50]. In 2006, pursuant to applicable state law, the trustee severs the trust into two equal trusts, Trust 1 and Trust 2. The instrument severing Trust provides that Trust 1 is to receive 50% of the Trust assets, and Trust 2 is to receive 50% of Trust's assets. Both resulting trusts are identical to Trust, except that each has different beneficiaries: C and C's descendants are designated as the beneficiaries of Trust 1, and GC and GC's descendants are designated as the beneficiaries of Trust 2. The severance constitutes a qualified severance, provided all other requirements of section 2642(a)(3) and this section are satisfied. Because the applicable fraction with respect to Trust is .50 and Trust was severed into two equal trusts, the trustee may designate which resulting trust has an inclusion ratio of one, and which has an inclusion ratio of zero. Accordingly, in the Notice of Qualified Severance reporting the severance, the trustee designates Trust 1 as having an inclusion ratio of one, and Trust 2 as having an inclusion ratio of zero. Because Trust 2 is a skip person under section 2613, the severance of Trust resulting in the distribution of 50% of Trust's corpus to Trust 2 would constitute a taxable termination or distribution (as described in section 2612(a)) of that 50% of Trust for GST tax purposes, but for the rule that a qualified severance is deemed to precede a taxable termination that is caused by the qualified severance. Thus, no GST tax will be due with regard to the creation and funding of Trust 2 because the inclusion ratio of Trust 2 is zero.

*Example 9.* [Reserved].

*Example 10. Beneficiary's interest dependent on inclusion ratio.* On August 8, 2006, T transfers \$1,000,000 to Trust and timely allocates \$400,000 of T's remaining GST tax exemption to Trust. As a result of the allocation, the applicable fraction with respect to Trust is .40 [\$400,000 divided by \$1,000,000] and Trust's inclusion ratio is .60 [1 - .40]. Trust provides that all income of Trust will be paid annually to C, T's child, for life. On C's death, the corpus is to pass in accordance with C's exercise of a testamentary limited power to appoint the corpus of Trust to C's lineal descendants. However, Trust provides that if, at the time of C's death, Trust's inclusion ratio is greater than zero, then C may also appoint that fraction of the trust corpus equal to the inclusion ratio to the creditors of C's estate. On May 3, 2008, pursuant to authority granted under applicable state law, the trustee severs Trust into two trusts. Trust 1 is funded with 40% of Trust's assets, and Trust 2 is funded with 60% of Trust's assets in accordance with the requirements of this section. Both Trust 1 and Trust 2 provide that all income of Trust will be paid annually to C during C's life. On C's death, Trust 1 corpus is to pass in accordance with C's exercise of a testamentary limited power to appoint the corpus to C's lineal descendants. Trust 2 is to pass in accordance with C's exercise of a testamentary power to appoint the corpus of Trust to C's lineal descendants and to the creditors of C's estate. The severance constitutes a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied. No additional contribution or allocation of GST tax exemption is made to either Trust 1 or Trust 2 prior to C's death. Accordingly, the inclusion ratio with respect to Trust 1 is zero. The inclusion ratio

with respect to Trust 2 is one until C's death, at which time C will become the transferor of Trust 2 for GST tax purposes. (Some or all of C's GST tax exemption may be allocated to Trust 2 upon C's death.)

*Example 11. Date of severance.* Trust is an irrevocable trust that has both skip person and non-skip person beneficiaries. Trust holds two parcels of real estate, Property A and Property B, stock in Company X, a publicly traded company, and cash. On June 16, 2008, the local court with jurisdiction over Trust issues an order, pursuant to the trustee's petition authorized under state law, severing Trust into two resulting trusts of equal value, Trust 1 and Trust 2. The court order directs that Property A will be distributed to Trust 1 and Property B will be distributed to Trust 2, and that an appropriate amount of stock and cash will be distributed to each trust such that the total value of property distributed to each trust as of the date of severance will be equal. The court order does not mandate a particular date of funding. Trustee receives notice of the court order on June 24, and selects July 16, 2008, as the date of severance. On June 26, 2008, Trustee commences the process of transferring title to Property A and Property B to the appropriate resulting trust(s), which process is completed on July 8, 2008. Also on June 26, the Trustee hires a professional appraiser to value Property A and Property B as of the date of severance and receives the appraisal report on Friday, October 3, 2008. On Monday, October 6, 2008, Trustee commences the process of transferring to Trust 1 and Trust 2 the appropriate amount of Company X stock valued as of July 16, 2008, and that transfer (as well as the transfer of Trust's cash) is completed by October 9, 2008. Under the facts presented, the funding of Trust 1 and Trust 2 occurred within 90 days of the date of severance selected by the trustee, and within a reasonable time after the date of severance taking into account the nature of the assets involved and the need to obtain an appraisal. Accordingly, the date of severance for purposes of this section is July 16, 2008, the resulting trusts are to be funded based on the value of the original trust assets as of that date, and the severance is a qualified severance assuming that all other requirements of section 2642(a)(3) and this section are met. (However, if Trust had contained only marketable securities and cash, then in order to satisfy the reasonable time requirement, the stock transfer would have to have been commenced, and generally completed, immediately after the date of severance, and the cash distribution would have to have been made at the same time.)

(k) *Effective date*—(1) *In general.* This section applies to severances occurring on or after August 2, 2007.

(2) *Transition rule.* In the case of a qualified severance occurring after December 31, 2000, and before August 2, 2007, taxpayers may rely on any reasonable interpretation of section 2642(a)(3) as long as reasonable notice concerning the qualified severance and identification of the trusts involved has been given to the IRS. For this purpose, the proposed regulations (69 FR 51967) are treated as a reasonable interpretation of the statute. For purposes of the reporting provisions

of §26.2642-6(e), notice to the IRS should be mailed by the due date of the gift tax return (including extensions granted) for gifts made during the year in which the severance occurred. If no gift tax return is filed, notice to the IRS should be mailed by April 15th of the year immediately following the year during which the severance occurred. For severances occurring between December 31, 2000, and January 1, 2007, notification should be mailed to the IRS as soon as reasonably practicable after August 2, 2007, if sufficient notice has not already been given.

Par. 6. Section 26.2654-1 is amended by adding paragraphs (b)(4) *Example 3* and (c) to read as follows:

*§26.2654-1 Certain trusts treated as separate trusts.*

\* \* \* \* \*

(b) \* \* \* \* \*

(4) *Examples.* \* \* \* \*

*Example 3. Formula severance.* T's will establishes a testamentary marital trust (Trust) that meets the requirements of qualified terminable interest property (QTIP) if an election under section 2056(b)(7) is made. Trust provides that all trust income is to be paid to T's spouse for life. On the spouse's death, the trust corpus is to be held in further trust for the benefit of T's then-living descendants. On T's date of death in January of 2004, T's unused GST tax exemption is \$1,200,000, and T's will includes \$200,000 of bequests to T's grandchildren. Prior to the due date for filing the Form 706, "United States Estate (and Generation-Skipping Transfer) Tax Return," for T's estate, T's executor, pursuant to applicable state law, divides Trust into two separate trusts, Trust 1 and Trust 2. Trust 1 is to be funded with that fraction of the Trust assets, the numerator of which is \$1,000,000, and the denominator of which is the value of the Trust assets as finally determined for federal estate tax purposes. Trust 2 is to be funded with that fraction of the Trust assets, the numerator of which is the excess of the Trust assets over \$1,000,000, and the denominator of which is the value of the Trust assets as finally determined for federal estate tax purposes. On the Form 706 filed for the estate, T's executor makes a QTIP election under section 2056(b)(7) with respect to Trust 1 and Trust 2 and a "reverse" QTIP election under section 2652(a)(3) with respect to Trust 1. Further, T's executor allocates \$200,000 of T's available GST tax exemption to the bequests to T's grandchildren, and the balance of T's exemption (\$1,000,000) to Trust 1. If the requirements of paragraph (b) of this section are otherwise satisfied, Trust 1 and Trust 2 are recognized as separate trusts for GST tax purposes. Accordingly, the "reverse" QTIP election and allocation of GST tax exemption with respect to Trust 1 are recognized and effective for generation-skipping transfer tax purposes.

(c) *Cross reference.* For rules applicable to the qualified severance of trusts

(whether or not includible in the transferor's gross estate), see §26.2642-6.

**PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT**

Par. 8. In §602.101, paragraph (b) is amended by adding entries in numerical order to the table to read as follows:

Par. 7. The authority citation for part 602 continues to read as follows:  
Authority: 26 U.S.C. 7805.

§602.101 OMB Control numbers.

\* \* \* \* \*  
(b) \* \* \*

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.1001-1 * * * * *	1545-1902
26.2642-6 * * * * *	1545-1902
26.2654-1 * * * * *	1545-1902

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

Approved July 24, 2007.

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

(Filed by the Office of the Federal Register on August 1, 2007, 8:45 a.m., and published in the issue of the Federal Register for August 2, 2007, 72 F.R. 42291)

fuel, other importers of record, and certain sureties.

**DATES: Effective Date:** These regulations are effective July 27, 2007.

**Applicability Dates:** For dates of applicability, see §§48.4081-1(f) and 48.4081-3(j).

**FOR FURTHER INFORMATION CONTACT:** Celia Gabrysh at (202) 622-3130 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:**

**Paperwork Reduction Act**

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1897. The collection of information in these final regulations is in §48.4081-3(c)(2)(iii) and (iv). This collection of information allows certain importers of record and sureties to avoid liability for the tax on the entry of taxable fuel into the United States.

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.

The estimated annual burden per respondent and/or recordkeeper varies from 15 minutes to 2.25 hours, depending on in-

dividual circumstances, with an estimated average of 1.25 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224, and the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

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

**Background**

This document amends the Manufacturers and Retailers Excise Tax Regulations (26 CFR part 48) to provide rules relating to the tax that section 4081 of the Internal Revenue Code (Code) imposes on the entry of taxable fuel into the United States. On July 30, 2004, a temporary regulation (T.D. 9145, 2004-2 C.B. 464 [69 FR 45587]) relating to this topic was published in the **Federal Register**. A notice of proposed rulemaking (REG-120616-03, 2004-2 C.B. 474 [69 FR 45631]) cross-referencing the temporary regulations was published in the **Federal Register** on the same day. Written

**Section 4081.—Imposition of Tax**

26 CFR 48.4081-1: Taxable fuel; definitions.

**T.D. 9346**

**DEPARTMENT OF THE TREASURY  
Internal Revenue Service  
26 CFR Parts 48 and 602**

**Entry of Taxable Fuel**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final regulations and removal of temporary regulations.

**SUMMARY:** This document contains final regulations relating to the tax on the entry of taxable fuel into the United States. The final regulations affect enterers of taxable

and electronic comments were received and a public hearing was held on January 12, 2005. After considering the written comments and the comments made at the public hearing, the proposed regulations are adopted as revised by this Treasury decision, and the corresponding temporary regulations are removed.

*The temporary and proposed regulations.* Effective September 28, 2004, the temporary regulations provide that the importer of record (under Customs law) of taxable fuel is jointly and severally liable with the enterer for the tax imposed on the entry of taxable fuel if the importer of record is not the enterer (that is, the importer of record is a customs broker engaged by the enterer) and the enterer is not a taxable fuel registrant. Under the law in effect before September 28, 2004, an importer of record's Customs bond could have been charged for any unpaid tax imposed on the entry of fuel imported under the bond. The preamble of the temporary regulations stated, however, that the IRS would not charge the Customs bond for the tax imposed on an entry of fuel occurring before September 28, 2004. In addition, the temporary regulations provide that the Customs bond posted with respect to the importation of fuel will not be charged for the tax imposed on an entry of fuel occurring after September 27, 2004, if the enterer is a taxable fuel registrant or the surety believes, based on the enterer's certification, that the enterer is a taxable fuel registrant.

*Public comments.* One commentator that represents an association of road builders supported the proposed and temporary regulations, calling them one of a series of important initiatives necessary to combat fuel tax evasion and finance the Highway Trust Fund.

Several commentators that represent tribal interests in the state of New York opposed the regulations. They maintained that the regulations will cause fuel prices to increase at service stations located on tribal reservations. These higher fuel prices will reduce sales and result in the loss of several hundred tribal jobs. In addition, a reduction in sales at these stations would cause a decrease in receipts from the tribal tax on fuel sold on the reservations. This tax funds general tribal

government services, including police, health, and welfare programs.

Many of these commentators also suggested that the Treasury Department and the IRS failed to comply with section 5 of Executive Order 13175 (65 FR 6724) and Executive Order 12866 (58 FR 51735), which generally requires each Federal agency to consult with tribal officials before the promulgation of any regulation that "has tribal implications" or that "imposes substantial direct compliance costs on Indian tribal governments."

*The final regulations.* This Treasury decision adopts the proposed rules as final regulations without substantive change. Because the cross-reference notice of proposed rulemaking referred to the text of temporary rules, the Treasury decision includes the nonsubstantive, clerical changes needed to incorporate the temporary rule text into the final regulations.

The rules in these regulations address the nonpayment of tax on fuel that is entered into the United States. An enterer's failure to pay this tax not only gives it a competitive price advantage over its compliant competitors, but it also deprives the United States Treasury of revenue intended for the Highway Trust Fund. The final regulations do not impose a new tax burden on enterers of taxable fuel. Instead, the regulations simply provide the IRS with an additional enforcement tool to collect the tax that is owed under existing law and give an additional incentive for enterers to be registered.

The imposition of tax on the entry of fuel sold on reservations results not from these regulations but from the statute, which does not provide an exemption from the tax for fuel sold on reservations. The only effect of these regulations is to improve the ability of the IRS to apply the tax consistently and fairly with respect to all taxpayers subject to the tax, without regard to whether or not the fuel is ultimately sold on tribal reservations.

The Treasury Department and IRS determined that these regulations are not subject to Executive Order 13175 (65 FR 67249) which obligates an agency to consult with tribal officials when developing "policies that have tribal implications." This executive order defines "policies that have tribal implications," in part, as regulations that have substantial direct effects

on one or more Indian tribes. The regulations do not have tribal implications, as specified in Executive Order 13175, because they do not significantly or uniquely affect the communities of Indian tribal governments, nor do they impose direct compliance costs on them. Any economic effect of the fuel tax on tribal economies is a consequence of the statutory imposition of the tax, not the manner in which the regulations operate to implement the statute. Thus, Executive Order 13175 does not apply to the final or temporary regulations.

## Special Analyses

It has been determined that these regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that any burden on taxpayers is minimal. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these final regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on the impact of the regulations on small business.

## Drafting Information

The principal author of these regulations is Celia Gabrysh, Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS, the Treasury Department, and the Bureau of Customs and Border Protection, Department of Homeland Security, participated in their development.

\* \* \* \* \*

## Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 48 and 602 are amended as follows:

PART 48—MANUFACTURERS AND RETAILERS EXCISE TAXES

Paragraph 1. The authority citation for part 48 continues to read, in part, as follows:

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

Par. 2. Section 48.4081-1 is amended as follows:

1. Paragraph (b) is amended by revising the definition of *Enterer*.

2. The first sentence of paragraph (f)(2) is revised.

The revisions read as follows:

§48.4081-1 *Taxable fuel; definitions.*

\* \* \* \* \*

(b) \* \* \*

*Enterer* generally means the importer of record (under customs law) with respect to the taxable fuel, except that—

(1) If the importer of record is a customs broker engaged by the owner of the taxable fuel, the person for whom the broker is acting is the enterer; and

(2) If there is no importer of record for taxable fuel entered into the United States, the owner of the taxable fuel at the time it is brought into the United States is the enterer.

\* \* \* \* \*

(f) \* \* \*

(2) In paragraph (b) of this section the definition of *aviation gasoline* and the third sentence in the definition of *terminal* are applicable after January 1, 1998, the definition of *kerosene, excluded liquid*, and *taxable fuel* are applicable after June 30, 1998, and the definition of *enterer* is applicable to entries of taxable fuel after September 27, 2004. \* \* \*

§48.4081-1T [Removed]

Par. 3. Section 48.4081-1T is removed.

Par. 4. Section 48.4081-3 is amended by revising paragraphs (c)(2)(ii) through (iv), and (j) to read as follows:

§48.4081-3 *Taxable fuel; taxable events other than removal at the terminal rack.*

\* \* \* \* \*

(c) \* \* \*

(2) \* \* \*

(ii) *Joint and several liability of the importer of record.* The importer of record with respect to the taxable fuel is jointly and severally liable with the enterer for the tax imposed under paragraph (c)(1) of this section if—

(A) The importer of record is not the enterer of the taxable fuel; and

(B) The enterer is not a taxable fuel registrant.

(iii) *Conditions for avoidance of liability.* The importer of record is not liable for the tax under paragraph (c)(2)(ii) of this section if, at the time of the entry, the importer of record—

(A) Has an unexpired notification certificate (as described in §48.4081-5) from the enterer; and

(B) Has no reason to believe that any information in the notification certificate is false.

(iv) *Customs bond.* The Customs bond posted with respect to the importation of the fuel will not be charged for the tax imposed on the entry of the fuel if the enterer is a taxable fuel registrant. A Customs bond will not be charged for the tax imposed on the entry of the fuel covered by the bond, if at the time of entry, the surety—

(A) Has an unexpired notification certificate (as described in §48.4081-5) from the enterer; and

(B) Has no reason to believe that any information in the notification certificate is false.

\* \* \* \* \*

(j) *Effective/applicability date:* This section is applicable January 1, 1994, except that paragraphs (c)(2)(ii) through (iv) of this section are applicable to entries of taxable fuel after September 27, 2004.

§48.4081-3T [Removed]

Par. 5. Section 48.4081-3T is removed.

§48.4081-5 [Amended]

Par. 6. Section 48.4081-5 is amended by revising paragraph (a) to read as follows:

(a) *Overview.* This section sets forth requirements for the notification certificate under §§48.4081-2(c)(2)(ii), 48.4081-3(c)(2)(iii) and (iv), 48.4081-3(d)(2)(iii), 48.4081-3(e)(2)(iii), 48.4081-3(f)(2)(ii), and 48.4081-4(c) to notify another person of the taxable fuel registrant's registration status.

\* \* \* \* \*

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 7. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 8. In §602.101, paragraph (b) is amended by removing the entry for §48.4081-3T, and revising the entry for §48.4081-3 in the table to read as follows:

§602.101 *OMB Control numbers.*

\* \* \* \* \*

(b) \* \* \*

CFR part or section where identified and described	Current OMB control No.
* * * * *	
48.4081-3 .....	1545-1270
	1545-1418
	1545-1897
* * * * *	

Kevin M. Brown,  
Deputy Commissioner for  
Services and Enforcement.

Approved July 16, 2007.

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

(Filed by the Office of the Federal Register on July 26, 2007, 8:45 a.m., and published in the issue of the Federal Register for July 27, 2007, 72 F.R. 41222)

## Section 6402.—Authority to Make Credits or Refunds

26 CFR 301.6402-1: Authority to make credits or refunds.

(Also: Section 6411; 1.6411-3.)

**Limitations on setoff under sections 6402 and 6411.** This ruling holds that the Service may credit an overpayment against unassessed internal revenue tax liabilities that have been determined in a statutory notice of deficiency sent to the taxpayer. It further holds that under section 6411(b) of the Code, the Service may credit a decrease in tax resulting from a tentative carryback adjustment against unassessed liabilities determined in a statutory notice of deficiency. Rev. Rul. 54-378 clarified.

## Rev. Rul. 2007-51

### ISSUES

(1) Does section 6402(a) of the Code allow the Service to credit an overpayment against unassessed internal revenue tax liabilities determined in a notice of deficiency?

(2) Does section 6411(b) of the Code allow the Service to credit a decrease in tax resulting from a tentative carryback adjustment against unassessed internal revenue tax liabilities determined in a notice of deficiency?

### SCOPE

This revenue ruling only applies to internal revenue tax liabilities that are subject to the deficiency procedures of Subchapter B of Chapter 63 of the Code. This revenue ruling does not address the question of the Service's crediting rights prior to issuing a notice of deficiency, in the context of a termination assessment under section 6851 or otherwise. This revenue

ruling also does not address the Service's crediting rights when a taxpayer is in bankruptcy (or other insolvency) proceedings. See Rev. Rul. 2007-52 (this Bulletin) for the Service's crediting rights when a taxpayer is in bankruptcy.

### FACTS

*Situation 1.* On March 15, 2005, a corporate taxpayer filed its income tax return for the tax year ending December 31, 2004, claiming a refund of \$500,000. On April 15, 2005, the Service sent a notice of deficiency to the taxpayer for tax year 2003 in the amount of \$1,000,000. As of April 15, 2005, the Service had not refunded the \$500,000 overpayment for tax year 2004 or assessed the \$1,000,000 deficiency for tax year 2003.

*Situation 2.* On March 15, 2005, a corporate taxpayer filed a Form 1139, *Corporation Application for Tentative Refund*, carrying back a net operating loss from tax year 2004 to tax year 2002. The carryback generated a \$250,000 decrease in tax for tax year 2002. On April 15, 2005, the Service sent a notice of deficiency to the taxpayer for tax year 2003 in the amount of \$1,000,000. As of April 15, 2005, the Service had not assessed the \$1,000,000 deficiency for tax year 2003 or tentatively refunded the \$250,000 decrease in tax for tax year 2002.

### LAW

#### *Authority to Make Credits or Refunds*

Section 6402(a) provides that within the applicable period of limitations the Secretary may credit the amount of any overpayment, including interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made the overpayment. The Secretary shall refund any balance to the person who made the overpayment, subject to further credit against amounts specified in sections 6402(c), (d), and (e). Regulations under section 6402(a) similarly provide that credit may be made against "any outstanding liability." See section 301.6402-1 of the Regulations on Procedure and Administration.

### *Tentative Carryback and Refund Adjustments*

Section 6411(a) provides that a taxpayer may file an application for tentative carryback adjustment of the tax for the prior taxable year affected by a net operating loss carryback, a business credit carryback, or a capital loss carryback from any taxable year. The application shall be made on Form 1139 or, in the case of taxpayers other than corporations, on Form 1045, and shall set forth in detail the information required by sections 6411(a)(1) through (a)(6) and by section 1.6411-1 of the Income Tax Regulations.

Section 6411(b) provides, in general, that within a period of 90 days from the date of filing the application for tentative carryback adjustment, the Secretary shall make a limited examination of the application to discover omissions and errors of computation, and shall determine the amount of the decrease in tax attributable to the carryback. See also section 1.6411-3(b) of the Income Tax Regulations.

Pursuant to section 6411(b) and section 1.6411-3(d), the decrease in tax attributable to the carryback shall, in the following order:

1. be applied under section 1.6411-3(d)(1) against any unpaid amount of the tax with respect to which such decrease was determined (*i.e.*, unpaid tax for the carryback year);
2. be credited under section 1.6411-3(d)(2) against any unsatisfied amount of any tax for the taxable year immediately preceding the taxable year of the net operating loss carryback, business credit carryback, or capital loss carryback, the time for payment of which was extended under section 6164; and
3. be credited under section 1.6411-3(d)(3) against any tax or installment thereof "then due" from the taxpayer, and, if not so credited, be refunded to the taxpayer.

### ANALYSIS

#### *Authority to Make Credits*

Section 6402 permits the Service to credit overpayments against "any liability in respect of an internal revenue tax on

the part of the person who made the overpayment.” Neither section 6402 nor the associated regulations specify when “any liability” arises for purposes of determining when the Service may credit an overpayment. It is, however, well-established that the Internal Revenue Code imposes income tax liability based on an annual accounting period. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 363 (1931) (tax liability is based on the net result of all transactions occurring during a fixed accounting period); *Edelson v. Commissioner*, 829 F.2d 828, 834 (9th Cir. 1987) (“[T]ax liabilities, though unassessed, are deemed obligations due and owing at the close of the taxable year.”). Moreover, the accrual of an income tax liability is not dependent on the Service sending a notice of deficiency. Nor is the accrual of a tax liability dependent on the Service making an assessment. *Goldston v. United States*, 104 F.3d 1198, 1199–1200 (10<sup>th</sup> Cir. 1997) (tax liability arises from statutory duty to pay tax, not assessment of liability); *United States v. Latham*, 754 F.2d 747, 750 (7<sup>th</sup> Cir. 1985) (assessment is an administrative determination that is not a prerequisite to tax liability.)

For purposes of the crediting provisions of section 6402(a), an internal revenue tax liability for a tax year will arise no later than the date on which the Service sends a notice of deficiency to the taxpayer pursuant to section 6212 that identifies the nature and amount of the tax liability. Although there are circumstances in which an internal revenue tax liability may be a “liability in respect of an internal revenue tax” within the meaning of section 6402(a) prior to the issuance of a notice of deficiency they are outside the scope of this revenue ruling.

Section 6411(b) permits, after application to other unpaid amounts, the decrease in tax attributable to a carryback to be credited against “any tax . . . then due from the taxpayer.” See also section 1.6411–3(d)(3) of the Income Tax Regulations. Neither section 6411(b) nor the regulations thereunder specify when a tax liability is “then due” for purposes of determining when the Service can credit a carryback adjustment. Case law analyzing the phrase “then due” in the context of predecessor statutes to section 6402, while consistent with this revenue ruling, does not aid in the interpretation of the phrase because these cases

involve inconsistent treatment of overpayment and underpayment interest, and the statutory scheme relating to the accrual of interest has since changed. See *McCarl v. United States*, 42 F.2d 346 (D.C. Cir. 1930); *Standard Oil Co. v. United States*, 5 F. Supp. 976, 988 (Ct. Cl. 1934).

Section 6151(a) prescribes the time for when a payment of tax is due. The statute provides that a person required to file a return shall, without assessment or notice or demand from the Secretary, pay the tax at the time fixed for filing the return (determined without regard to extensions). It follows that, in the context of a deficiency, an internal revenue tax liability is “then due” for purposes of section 6411 no later than the date on which the Service issues a notice of deficiency to the taxpayer identifying a tax liability that is past due. Circumstances in which an internal revenue tax liability may, in the context of a deficiency, be “then due” within the meaning of section 6411(b) prior to issuance of a notice of deficiency are outside the scope of this revenue ruling.

Although sections 6402(a) and 6411(b) do not require a deficiency determination or assessment as a prerequisite to the Service crediting an overpayment or a carryback adjustment to a tax liability, the Service generally does not make such credits until the tax liability is determined with specificity. When the Service issues a notice of deficiency, it has determined the tax liability with specificity. Liabilities set forth in a notice of deficiency generally are presumed to be correct at the time the notice of deficiency is sent. See *Helvering v. Taylor*, 293 U.S. 507, 515 (1935) (“Unquestionably the burden of proof is on the taxpayer to show that the Commissioner’s [deficiency] determination is invalid.”); *Merkel v. Commissioner*, 192 F.3d 844, 852 (9th Cir. 1999) (“Determinations made by the Commissioner in a notice of deficiency normally are presumed to be correct, and the taxpayer bears the burden of proving that those determinations are erroneous.”).

Accordingly, section 6402(a) permits the Service to credit an overpayment against an unassessed tax liability if the Service has determined the amount of the tax liability in a notice of deficiency sent to the taxpayer pursuant to section 6212. Similarly, section 6411(b) permits the Service to credit a decrease in tax against

an unassessed tax liability if, within the 90-day period, the Service has determined the amount of the tax liability in a notice of deficiency sent to the taxpayer pursuant to section 6212. See section 1.6411–3(d)(3) of the Income Tax Regulations.

#### *Clarification of Prior Guidance*

In Rev. Rul. 54–378, 1954–2 C.B. 246, the Service announced a policy of making partial allowances of refunds or credits under section 322(a)(1) of the 1939 Code, the predecessor to section 6402(a). In Rev. Rul. 54–378, the Service was required to credit any overpayment resulting from the allowance of partial overassessments against any income or excess profits tax assessed and then due from the taxpayer, and to refund the balance, if any, to the taxpayer. The facts in Rev. Rul. 54–378 focus on allowing partial refunds or credits when the Service and the taxpayer agree on the amount of an overassessment. Revenue Ruling 54–378 does not address the Service’s right to credit an overpayment against a tax liability before the Service assesses the tax liability. This revenue ruling clarifies that Rev. Rul. 54–378 does not limit the Service to crediting overpayments only against assessed tax liabilities.

#### *Crediting Rules Applied to Situations 1 and 2*

*Situation 1.* The \$1,000,000 tax liability determined in the notice of deficiency is an outstanding tax liability within the meaning of section 301.6402–1. Under section 6402(a), the Service may credit the \$500,000 overpayment for tax year 2004 against the \$1,000,000 tax liability identified in the notice of deficiency for tax year 2003.

*Situation 2.* The \$1,000,000 tax liability determined in the notice of deficiency is an amount “then due” for purposes of section 6411(b). The Service may credit the \$250,000 decrease in tax that was generated from the net operating loss carryback against the \$1,000,000 tax liability for tax year 2003.

#### HOLDINGS

(1) Pursuant to section 6402(a), the Service may credit an overpayment against unassessed internal revenue tax liabilities

that have been determined in a notice of deficiency sent to the taxpayer.

(2) Pursuant to section 6411(b), the Service may credit a decrease in tax resulting from a tentative carryback adjustment against unassessed internal revenue tax liabilities determined in a notice of deficiency sent to the taxpayer.

#### EFFECT ON OTHER REVENUE RULINGS

Revenue Ruling 54-378 is clarified. Pursuant to section 6402(a), the Service is authorized to credit an overpayment not only against amounts of tax that are assessed, but also against outstanding tax liabilities such as those identified in a notice of deficiency sent to the taxpayer.

#### DRAFTING INFORMATION

The principal authors of this revenue ruling are Joseph P. Dewald, formerly of the Office of the Associate Chief Counsel (Procedure and Administration), and Cynthia A. McGreevy of the Office of the Associate Chief Counsel (Procedure and Administration). For further information regarding this revenue ruling, contact Cynthia A. McGreevy at (202) 622-4910 (not a toll-free call).

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*26 CFR 301.6402-1: Authority to make credits or refunds.  
(Also: Section 6411; 1.6411-3.)*

**Definition of a liability under section 6402(a) and 6411(b).** This ruling holds that the Service has the right under section 6402 of the Code to credit an overpayment against internal revenue liabilities for which no assessment has been made, or statutory notice of deficiency issued, when the liabilities are identified in a proof of claim filing in a bankruptcy case. Similarly, the ruling holds that the Service has the right under section 6411(b) to credit a decrease in tax resulting from a tentative carryback adjustment against internal revenue tax liabilities for which no assessment has been made, or statutory notice of deficiency issued, when the liabilities are identified in a proof of claim filed in a bankruptcy case.

## Rev. Rul. 2007-52

### ISSUES

(1) Pursuant to section 6402(a) of the Internal Revenue Code (Code), may the Service credit an overpayment against outstanding internal revenue tax liabilities for which no assessment has been made or notice of deficiency sent when the liabilities are identified in a proof of claim filed in a bankruptcy case?

(2) Pursuant to section 6411(b) of the Code, may the Service credit a decrease in tax resulting from a tentative carryback adjustment against internal revenue tax liabilities for which no assessment has been made or notice of deficiency sent when the liabilities are identified in a proof of claim filed in a bankruptcy case?

### SCOPE

This revenue ruling addresses the making of credits for periods ending before the commencement of a bankruptcy case against liabilities for periods also arising before the commencement of the case. This ruling does not address bankruptcy issues that could affect the timing or allowance of the Service's right to credit overpayments and decreases in tax against other liabilities, such as the bankruptcy automatic stay. See 11 U.S.C. § 362. See Rev. Rul. 2007-51 (this Bulletin) for the making of credits when a taxpayer is not in bankruptcy.

### FACTS

*Situation 1.* On February 1, 2005, a corporate taxpayer filed a petition for relief under Chapter 11 of the Bankruptcy Code (11 U.S.C. § 101 *et seq.*). The taxpayer filed a corporate income tax return for the year ending December 31, 2004 on March 15, 2005, reporting an overpayment and claiming a refund of \$500,000. On April 15, 2005, the Service filed a proof of claim in the bankruptcy case identifying liabilities for the taxpayer's 2003 tax year in the amount of \$1,000,000. As of April 15, 2005, the Service had not refunded the \$500,000 overpayment, assessed the \$1,000,000 liability, or sent a notice of deficiency with respect to that liability.

*Situation 2.* On February 1, 2005, a corporate taxpayer filed a petition for relief under Chapter 11 of the Bankruptcy

Code. The taxpayer filed a corporate income tax return for the year ending December 31, 2004 on March 15, 2005, reporting a \$750,000 net operating loss. Also on March 15, 2005, the taxpayer filed an application for a tentative carryback adjustment, carrying the \$750,000 net operating loss from 2004 back to 2003, generating a decrease in tax for the 2003 tax year in the amount of \$250,000, and requesting a refund. On April 15, 2005, the Service filed a proof of claim in the bankruptcy case identifying liabilities for the taxpayer's 2002 tax year in the amount of \$1,000,000. As of April 15, 2005, the Service had not assessed the \$1,000,000 liability, sent a notice of deficiency with respect to that liability, or tentatively refunded the \$250,000 decrease in tax for the 2002 year.

### LAW

#### *Authority to Make Credits or Refunds*

Section 6402(a) of the Code provides that within the applicable period of limitations the Secretary may credit the amount of any overpayment, including interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made the overpayment. The Secretary shall refund any balance to the person who made the overpayment, subject to further credit against amounts specified in sections 6402(c), (d), and (e). Regulations under section 6402(a) similarly provide that credit may be made against "any outstanding liability." See section 301.6402-1 of the Regulations on Procedure and Administration.

#### *Tentative Carryback and Refund Adjustments*

Section 6411(a) of the Code provides that a taxpayer may file an application for a tentative carryback adjustment of the tax for the prior taxable year affected by a net operating loss carryback, a business credit carryback, or a capital loss carryback from any taxable year. The application shall be made on Form 1139 or, in the case of taxpayers other than corporations, on Form 1045, and shall set forth in detail the information required by sections 6411(a)(1) through (a)(6) and by section 1.6411-1 of the Income Tax Regulations.

Section 6411(b) of the Code provides, in general, that within a period of 90 days from the date of filing the application for tentative carryback adjustment, the Secretary shall make a limited examination of the application to discover omissions and errors of computation, and shall determine the amount of the decrease in the tax attributable to the carryback. *See also* section 1.6411-3(b) of the Income Tax Regulations.

Pursuant to section 6411(b) and section 1.6411-3(d) of the Income Tax Regulations, the decrease in tax attributable to the carryback shall, in the following order:

1. be applied under section 1.6411-3(d)(1) against any unpaid amount of the tax with respect to which such decrease was determined (*i.e.*, unpaid tax for the carryback year);
2. be credited under section 1.6411-3(d)(2) against any unsatisfied amount of any tax for the taxable year immediately preceding the taxable year of the net operating loss carryback, business credit carryback, or capital loss carryback, the time for payment of which was extended under section 6164; and
3. be credited against any tax or installment thereof “then due” from the taxpayer and, if not so credited, be refunded to the taxpayer.

#### *Tax Claims in Bankruptcy*

In a bankruptcy case, a properly filed proof of claim identifying a tax liability constitutes *prima facie* evidence of the existence and amount of that liability. Bankruptcy Rule 3001(f); *Bronson v. United States*, 46 F.3d 1573, 1581 (Fed. Cir. 1995). The filing of a proof of claim by the Service, like all routine government actions, is entitled to a presumption of regularity. *See United States v. Chemical Foundation, Inc.*, 272 U.S. 1, 14–15 (1926). *See also United States v. Mangan*, 575 F.2d 32, 41 (2d Cir. 1978); *United States v. Ahrens*, 530 F.2d 781, 785–86 (8th Cir. 1976). Bankruptcy courts have jurisdiction to determine the amount or legality of tax identified on a proof of claim. *See* 11 U.S.C. §§ 502, 505.

#### ANALYSIS

Section 6402 of the Code permits the Service to credit a tax overpayment against “any liability in respect of an internal revenue tax on the part of the person who made the overpayment.” Neither section 6402 nor the associated regulations specify when “any liability” arises for purposes of determining when the Service may credit an overpayment. It is, however, well-established that the Internal Revenue Code imposes income tax liability based on an annual accounting period. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 363 (1931) (tax liability is based on the net result of all transactions occurring during a fixed accounting period); *Edelson v. Commissioner*, 829 F.2d 828, 834 (9th Cir. 1987) (“[T]ax liabilities, though unassessed, are deemed obligations due and owing at the close of the taxable year.”). Moreover, the accrual of an income tax liability is not dependent on the Service sending a notice of deficiency. Nor is the accrual of a tax liability dependent on the Service making an assessment. *Goldston v. United States*, 104 F.3d 1198, 1199–1200 (10th Cir. 1997) (tax liability arises from statutory duty to pay tax, not assessment of liability); *United States v. Latham*, 754 F.2d 747, 750 (7th Cir. 1985) (assessment is an administrative determination that is not a prerequisite to tax liability.)

Section 6411(b) of the Code provides an ordering rule for allowance of carryback adjustments that authorizes the crediting of a decrease in tax resulting from a tentative carryback adjustment against “any tax or installment thereof then due from the taxpayer.” Section 6411(b) does not, by its terms, limit the Service to crediting only against tax liabilities for which an assessment has been made or notice of deficiency sent. Rather, the right to credit arises when the liability is “then due.” Section 6151(a) of the Code prescribes the time when a payment of tax is generally due. The statute provides that a person required to file a return shall, without assessment or notice or demand from the Secretary, pay the tax at the time fixed for filing the return (determined without regard to extensions).

Although sections 6402(a) and 6411(b) do not require a deficiency determination or assessment as a prerequisite to the Ser-

vice crediting an overpayment or a carryback adjustment to a tax liability, the Service generally does not make such credits until the tax liability is determined with specificity. Outside the bankruptcy context, the Service will generally make a credit only after issuance of a notice of deficiency. *See* Rev. Rul. 2007–51. When the Service issues a notice of deficiency, it has determined tax liability with specificity. Liabilities set forth in a notice of deficiency are generally presumed to be correct at the time the notice of deficiency is sent. *See Helvering v. Taylor*, 293 U.S. 507, 515 (1935); *Merkel v. Commissioner*, 192 F.3d 844, 852 (9th Cir. 1999).

When the taxpayer is a debtor in bankruptcy, the same considerations do not compel the Service to limit crediting against liabilities to situations where a notice of deficiency has been sent. A proof of claim filed by the Service in the bankruptcy case represents a specific administrative determination of the nature and amount of the tax debt. A proof of claim is *prima facie* evidence of the validity and amount of the claim and is entitled to a presumption of regularity. *See* Bankruptcy Rule 3001(f); *Chemical Foundation*, 272 U.S. at 14–15. Further, a debtor in a bankruptcy case has a ready forum for the judicial determination of the tax debt since bankruptcy courts have authority to determine tax liabilities identified on a proof of claim. *See* 11 U.S.C. §§ 502, 505. Therefore, in the bankruptcy context, the Service has the authority to make credits under section 6402(a) and section 6411(b) against income tax liabilities where such liabilities are identified on a proof of claim filed in a bankruptcy case.

#### CREDITING RULES APPLIED TO SITUATIONS 1 AND 2

*Situation 1.* The \$1,000,000 liability identified on the proof of claim is an outstanding liability for purposes of section 6402(a). Under section 6402(a), the Service may credit the \$500,000 overpayment for tax year 2004 against the \$1,000,000 tax liability identified on the proof of claim for tax year 2003.

*Situation 2.* The \$1,000,000 liability identified on the proof of claim is an amount “then due” for purposes of section 6411(b). Under section 6411(b), the Service may credit the \$250,000 decrease

in tax generated from the net operating loss carryback against the tax liability for 2002.

## HOLDINGS

(1) Pursuant to section 6402(a), the Service may credit an overpayment against unassessed internal revenue tax liabilities that have not been identified in a notice of deficiency sent to the taxpayer when the liabilities are identified in a proof of claim filed in a bankruptcy case.

(2) Pursuant to section 6411(b), the Service may credit a decrease in tax resulting from a tentative carryback adjustment against unassessed internal revenue tax liabilities that have not been identified in a notice of deficiency sent to the taxpayer when the liabilities are identified in a proof of claim filed in a bankruptcy case.

## DRAFTING INFORMATION

The principal author of this revenue ruling is G. William Beard of the Office of Associate Chief Counsel (Procedure and Administration). For further information regarding this revenue ruling, contact Mr. Beard at 202-622-3620 (not a toll-free call).

## Section 6411.—Tentative Carryback and Refund Adjustments

*26 CFR 1.6411-2T: Computation of tentative carryback adjustment.*

*(Also: Section 6402; 1.6411-3T.)*

**Revocation of Rev. Rul.; tentative allowance.** The IRS has determined that Rev. Rul. 78-369 is inconsistent with the regulations under section 6411 of the Code. Rev. Rul. 78-369 revoked.

## Rev. Rul. 2007-53

### TEXT

The Internal Revenue Service has determined that Rev. Rul. 78-369 is inconsistent with the regulations under section 6411 of the Internal Revenue Code. Temporary, final, and proposed regulations published in this issue of the Internal Revenue Bulletin clarify that the computation and allowance of a tentative refund under section 6411 is a two-step process.

Rev. Rul. 78-369, 1978-2 C.B. 324, is revoked.

The decrease in tax previously determined (tentative allowance) is computed pursuant to Treas. Reg. § 1.6411-2 but applied pursuant to Treas. Reg. § 1.6411-3. For purposes of computing the allowance, the Commissioner will not consider amounts to which the taxpayer and the Commissioner are in disagreement. For purposes of applying the allowance, however, the Commissioner may credit or reduce the tentative adjustment by any assessed tax liabilities, unassessed liabilities determined in a statutory notice of deficiency, unassessed liabilities identified in a proof of claim filed in a bankruptcy proceeding, and other unassessed liabilities in rare and unusual circumstances. See Temp. Treas. Reg. §§ 1.6411-2T and 1.6411-3T; Rev. Rul. 2007-51 and Rev. Rul. 2007-52 (this Bulletin).

## EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 78-369, 1978-2 C.B. 324, is revoked.

## DRAFTING INFORMATION

The principal author of this revenue ruling is Cynthia Ann McGreevy of the Office of Associate Chief Counsel (Procedure & Administration). For further information regarding this revenue ruling, contact Cynthia Ann McGreevy at 202-622-4910 (not a toll-free call).

*26 CFR 1.6411-2: Computation of tentative carryback adjustment.*

## T.D. 9355

## DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

## Clarification of Section 6411 Regulations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

**SUMMARY:** This document contains final and temporary regulations clarifying that for purposes of allowing a tentative adjustment, the IRS may credit or reduce the tentative adjustment by an assessed tax liability, whether or not that tax liability was assessed before the date the application for tentative carryback was filed, and other unassessed tax liabilities in certain other circumstances. The portions of this document that are final regulations provide technical revisions that remove all references to IRS district director and service center director, as those positions no longer exist within the IRS. The offices of the district director and service center director were eliminated by the IRS reorganization implemented pursuant to the IRS Reform and Restructuring Act of 1998. The text of the temporary regulations serves as the text of the proposed regulations (REG-118886-06), set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

**DATES:** *Effective Date:* These regulations are effective August 27, 2007.

*Applicability Date:* These regulations apply with respect to applications for tentative refund filed on or after August 27, 2007.

**FOR FURTHER INFORMATION CONTACT:** Cynthia A. McGreevy, (202) 622-4910 (not a toll-free number).

## SUPPLEMENTARY INFORMATION:

### Background and Explanation of Provisions

These regulations clarify the Income Tax Regulations (26 CFR part 1) under section 6411 relating to the computation and allowance of the tentative carryback adjustment. The tentative allowance is computed pursuant to §1.6411-2 but applied pursuant to §1.6411-3. These temporary regulations clarify that, for purposes of computing the allowance, the Commissioner will not consider amounts to which the taxpayer and the Commissioner are in disagreement. For purposes of applying the allowance, however, the Commissioner may credit or reduce the tentative adjustment by any assessed tax liabilities, unassessed liabilities determined in a statutory notice of deficiency,

unassessed liabilities identified in a proof of claim filed in a bankruptcy proceeding, and other unassessed liabilities in rare and unusual circumstances. Regarding unassessed liabilities determined in a statutory notice of deficiency, see Rev. Rul. 2007-51 (this Bulletin). Regarding unassessed liabilities identified in a proof of claim filed in a bankruptcy proceeding, see Rev. Rul. 2007-52 (this Bulletin). See §601.601(d)(2). The IRS plans to adopt procedures requiring IRS National Office review prior to a credit or reduction of the tentative adjustment by an unassessed liability that constitutes a rare and unusual circumstance.

These regulations also contain final regulations that remove all references to IRS district director or service center director, to account for the IRS's current organizational structure. The text of the temporary regulations serves as the text of the proposed regulations, published elsewhere in this issue of the Bulletin.

### Special Analyses

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

### Drafting Information

The principal author of these final and temporary regulations is

Cynthia A. McGreevy of the Office of the Associate Chief Counsel (Procedure and Administration).

\* \* \* \* \*

### Amendments to the Regulations

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

#### PART 1—INCOME TAXES

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

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

#### §1.6411-2 [Amended]

Par. 2. In the list below, for each section listed in the left column, remove the language in the middle column and add the language in the right column:

<i>Section</i>	<i>Remove</i>	<i>Add</i>
1.6411-2(a), first sentence	, unused investment credit, or unused WIN credit	, or unused investment credit
1.6411-2(a), fourth sentence	Internal Revenue Service	Commissioner
1.6411-2(a), last sentence	32	33
1.6411-2(b), third sentence	Internal Revenue Service	Commissioner
1.6411-2(b), fourth sentence	district director	Commissioner
1.6411-2(b), fourth sentence	Internal Revenue Service	Commissioner

Par. 3. Section 1.6411-2(c) is added to read as follows:

#### §1.6411-2 Computation of tentative carryback adjustment.

\* \* \* \* \*

(c) *Effective/applicability date.* These regulations apply with respect to applications for tentative refund filed on or after August 27, 2007.

Par. 4. Section 1.6411-2T is added to read as follows:

#### §1.6411-2T Computation of tentative carryback adjustment (temporary).

(a) *Tax previously determined.* The taxpayer is to determine the amount of decrease, attributable to the carryback, in tax previously determined for each taxable year before the taxable year of the net operating loss, net capital loss, or unused investment credit. The tax previously determined is to be ascertained in accordance with the method prescribed in section 1314(a). Thus, the tax previously determined will be the tax shown on the return as filed, increased by any amounts assessed (or collected without assessment) as deficiencies before the date of the filing

of the application for a tentative carryback adjustment, and decreased by any amounts abated, credited, refunded, or otherwise repaid prior to that date. Any items as to which the Commissioner and the taxpayer are in disagreement at the time of the filing of the application shall, for purposes of §1.6411-2, be taken into account in ascertaining the tax previously determined only if, and to the extent that, they were reported in the return, or were reflected in any amounts assessed (or collected without assessment) as deficiencies, or in any amounts abated, credited, refunded, or otherwise repaid, before the date of filing the application. The tax previously determined, therefore, will reflect the foreign

tax credit and the credit for tax withheld at source provided in section 33.

(b) *Decrease attributable to carryback.* After ascertaining the tax previously determined in the manner described in paragraph (a) of this section, the taxpayer shall determine the decrease in tax previously determined attributable to the carryback and any related adjustments on the basis of the items of tax taken into account in computing the tax previously determined. In determining any decrease attributable to the carryback or any related adjustment, items shall be taken into account under this subsection only to the extent that they were reported in the return, or were reflected in amounts assessed (or collected without assessment) as deficiencies, or in amounts abated, credited, refunded, or otherwise repaid, before the date of filing the application for a tentative carryback adjustment. If the Commissioner and the taxpayer are in disagreement as to the proper

treatment of any item, it shall be assumed for purposes of determining the decrease in the tax previously determined that the item was correctly reported by the taxpayer unless, and to the extent that, the disagreement has resulted in the assessment of a deficiency (or the collection of an amount without an assessment), or the allowing or making of an abatement, credit, refund, or other repayment, before the date of filing the application. Thus, if the taxpayer claimed a deduction on its return of \$50,000 for salaries paid its officers but the Commissioner proposes that the deduction should not exceed \$20,000, and the Commissioner and the taxpayer have not agreed on the amount properly deductible before the date the application for a tentative carryback adjustment is filed, \$50,000 shall be considered as the amount properly deductible for purposes of determining the decrease in tax previously determined in respect of the application for a tentative

carryback adjustment. In determining the decrease in tax previously determined, any items which are affected by the carryback must be adjusted to reflect the carryback. Thus, unless otherwise provided, any deduction limited, for example, by adjusted gross income, such as the deduction for medical, dental, etc., expenses, is to be recomputed on the basis of the adjusted gross income as affected by the carryback. See §1.6411-3T(d) for rules on the application of the decrease in tax to any tax liability.

(c) *Effective/applicability date.* (1) These regulations apply with respect to applications for tentative refund filed on or after August 27, 2007. (2) The applicability of this section expires on or before August 24, 2010.

Par. 5. **§1.6411-3 [Amended].** In the list below, for each section listed in the left column, remove the language in the middle column and add the language in the right column:

<i>Section</i>	<i>Remove</i>	<i>Add</i>
1.6411-3(a), first sentence	district director or director of a service center (either of whom are sometimes hereinafter referred to in this section as internal revenue officer)	Commissioner
1.6411-3(a)(2), first sentence	, unused investment credit, or unused WIN credit	, or unused investment credit
1.6411-3(b), first sentence	district director or director of a service center	Commissioner
1.6411-3(b), first sentence	he deems	deemed
1.6411-3(b), second sentence	He	The Commissioner
1.6411-3(b), fourth sentence	Such internal revenue officer	The Commissioner
1.6411-3(b), fourth sentence	he may discover	discovered
1.6411-3(b), fifth sentence	he accordingly	the Commissioner accordingly
1.6411-3(b), fifth sentence	he may	may
1.6411-3(b), fifth sentence	, unused investment credit, or unused WIN credit	, or unused investment credit
1.6411-3(b), fifth sentence	, investment credit or WIN credit	, or investment credit
1.6411-3(b), sixth sentence	such internal revenue officer	the Commissioner

<i>Section</i>	<i>Remove</i>	<i>Add</i>
1.6411-3(b), sixth sentence	he	the Commissioner
1.6411-3(b), sixth sentence	his	the Commissioner's
1.6411-3(b), seventh sentence	such internal revenue officer	the Commissioner
1.6411-3(b), seventh sentence	he believes	the Commissioner believes
1.6411-3(b), seventh sentence	he will	the Commissioner will
1.6411-3(b), seventh sentence	such officer	the Commissioner
1.6411-3(c), first sentence	district director or director of a service center	Commissioner
1.6411-3(c), first sentence	he	the Commissioner
1.6411-3(c), second sentence	he deems	the Commissioner deems
1.6411-3(c), second sentence	by him	
1.6411-3(c), second sentence	he	the Commissioner
1.6411-3(c), third sentence	Such internal revenue officer's	The Commissioner's
1.6411-3(c), third sentence	he	the Commissioner
1.6411-3(c), fourth sentence	his	the Commissioner's
1.6411-3(c), fifth sentence	such internal revenue officer	the Commissioner
1.6411-3(d)(1), first sentence	district director or director of a service center	Commissioner
1.6411-3(d)(1)(iii), first sentence	including an amount the time for payment of which has been extended under section 6162, but	
1.6411-3(d)(2), first sentence	district director, or director of a service center	Commissioner
1.6411-3(d)(2), fifth sentence	such internal revenue officer	the Commissioner
1.6411-3(d)(2), fifth sentence	, unused investment credit, or unused WIN credit	, or unused investment credit
1.6411-3(d)(3), first sentence	district director or director of a service center	Commissioner

Par. 6. Section 1.6411-3(e) is added to read as follows:

*§1.6411-3 Allowance of adjustments.*

\* \* \* \* \*

(e) *Effective/applicability date.* These regulations apply with respect to applications for tentative refund filed on or after August 27, 2007.

Par. 7. Section 1.6411-3T is added to read as follows:

*§1.6411-3T Allowance of adjustments (temporary).*

(a) *Time prescribed.* The Commissioner shall act upon any application for a tentative carryback adjustment filed under section 6411(a) within a period of 90 days

from whichever of the following two dates is the later—

- (1) The date the application is filed; or
- (2) The last day of the month in which falls the last date prescribed by law (including any extension of time granted the taxpayer) for filing the return for the taxable year of the net operating loss, net capital loss, or unused investment credit from which the carryback results.

(b) *Examination.* Within the 90-day period described in paragraph (a) of this section, the Commissioner shall make, to the extent deemed practicable within this period, an examination of the application to discover omissions and errors of computation. The Commissioner shall determine within this period the decrease in tax previously determined, affected by the carryback or any related adjustments, upon the basis of the application and examination. The decrease shall be determined in the same manner as that provided in section 1314(a) for the determination by the taxpayer of the decrease in taxes previously determined which must be set forth in the application for a tentative carryback adjustment. The Commissioner, however, may correct any errors of computation or omissions discovered upon examination of the application. In determining the decrease in tax previously determined which is affected by the carryback or any related adjustment, the Commissioner may correct any mathematical error appearing on the application and may likewise correct any modification required by the law and incorrectly made by the taxpayer in computing the net operating loss, net capital loss, or unused investment credit, the resulting carrybacks, or the net operating loss deduction, capital loss deduction, or investment credit allowable. If the required modification has not been made by the taxpayer and the Commissioner has the necessary information to make the modification within the 90-day period, the Commissioner may, in the Commissioner's discretion, make the modification. In determining the decrease, however, the Commissioner will not, for example, change the amount claimed on the return as a deduction for depreciation because the Commissioner believes that the taxpayer has claimed an excessive amount; likewise, the Commissioner will not include in gross income any amount not so included by the taxpayer, even though the Commissioner believes that the amount is subject to tax and properly should be included in gross income.

(c) *Disallowance in whole or in part.* If the Commissioner finds that an application for a tentative carryback adjustment contains material omissions or errors of computation, the Commissioner may disallow

such application in whole or in part without further action. If, however, the Commissioner deems that any error of computation can be corrected within the 90-day period, the Commissioner may do so and allow the application in whole or in part. The Commissioner's determination as to whether the Commissioner can correct any error of computation within the 90-day period shall be conclusive. Similarly, the Commissioner's action in disallowing, in whole or in part, any application for a tentative carryback adjustment shall be final and may not be challenged in any proceeding. The taxpayer may, however, file a claim for credit or refund under section 6402, and may maintain a suit based on the claim if it is disallowed or if the Commissioner does not act upon the claim within 6 months from the date it is filed.

(d) *Application of decrease.* (1) Each decrease determined by the Commissioner in any previously determined tax which is affected by the carryback or any related adjustments shall first be applied against any unpaid amount of the tax with respect to which such decrease was determined. The unpaid amount of tax may include one or more of the following:

(i) An amount with respect to which the taxpayer is delinquent.

(ii) An amount the time for payment of which has been extended under section 6164 and which is due and payable on or after the date of the allowance of the decrease.

(iii) An amount (not including an amount the time for payment of which has been extended under section 6164) which is due and payable on or after the date of the allowance of the decrease, including any assessed liabilities, unassessed liabilities determined in a statutory notice of deficiency, unassessed liabilities identified in a proof of claim filed in a bankruptcy proceeding, and other unassessed liabilities in rare and unusual circumstances.

(2) If the unpaid amount of tax includes more than one unpaid amount, the Commissioner in his discretion, shall determine against which amount or amounts, and in what proportion, the decrease is to be applied. In general, however, the decrease will be applied against any amounts described in paragraphs (d)(1)(i) through (iii) of this section in the order named. If there

are several amounts of the type described in paragraph (d)(1)(iii) of this section, any amount of the decrease which is to be applied against the amount will be applied by assuming that the tax previously determined minus the amount of the decrease to be so applied is "the tax" and that the taxpayer had elected to pay the tax in installments. The unpaid amount of tax against which a decrease may be applied under paragraph (d)(1) of this section may not include any amount of tax for any taxable year other than the year of the decrease. After making the application, the Commissioner will credit any remainder of the decrease against any unsatisfied amount of any tax for the taxable year immediately preceding the taxable year of the net operating loss, capital loss, or unused investment credit, the time for payment of which has been extended under section 6164.

(3) Any remainder of the decrease after the application and credits may, within the 90-day period, in the discretion of the Commissioner, be credited against any tax liability or installment thereof then due from the taxpayer (including assessed liabilities, unassessed liabilities determined in a statutory notice of deficiency, unassessed liabilities identified in a proof of claim filed in a bankruptcy proceeding, and other unassessed liabilities in rare and unusual circumstances), and, if not so credited, shall be refunded to the taxpayer within the 90-day period.

(e) *Effective/applicability date.*

(1) These regulations apply with respect to applications for tentative refund filed on or after August 27, 2007.

(2) The applicability of this section expires on or before August 24, 2010.

Kevin M. Brown,  
*Deputy Commissioner for  
Services and Enforcement.*

Approved August 1, 2007.

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

(Filed by the Office of the Federal Register on August 24, 2007, 8:45 a.m., and published in the issue of the Federal Register for August 27, 2007, 72 F.R. 48933)

## Section 7508.—Time for Performing Certain Acts Postponed by Reason of Service in Combat Zone or Contingency Operation

(Also Sections 6081, 7508A; 11 U.S.C. §§ 507, 523, 727.)

**Bankruptcy effects of disaster and combat zone relief.** This ruling provides that the postponement of the time to file a return under section 7508 or 7508A of the Code does not change the date that the return is last due, including extensions, and therefore does not change the priority and dischargeability of the tax for bankruptcy purposes.

### Rev. Rul. 2007-59

#### ISSUES

(1) Does a grant of relief by the Internal Revenue Service under section 7508A of the Internal Revenue Code, which postpones the time in which a taxpayer affected by a Presidentially-declared disaster may timely file an income tax return, change the date on which the return is “last due, including extensions” under section 507(a)(8)(A)(i) of Title 11 of the United States Code (Bankruptcy Code), and thereby affect the priority and dischargeability of the related tax liability in bankruptcy?

(2) Does relief under section 7508 of the Code, which postpones the time in which an individual taxpayer may timely file an income tax return, change the date on which the return is “last due, including extensions” under section 507(a)(8)(A)(i) of the Bankruptcy Code or “last due, under applicable law or under any extension” under section 523(a)(1)(B)(ii) of the Bankruptcy Code, and thereby affect the priority and dischargeability of the related tax liability in bankruptcy?

#### FACTS

*Situation 1.* A is an individual who uses the cash receipts and disbursements method of accounting and files federal income tax returns on a calendar year basis. On April 12, 2007, A timely requests a 6-month extension of time to file an income tax return for 2006. A’s principal residence for purposes of section

1033(h)(4) of the Code is in County X in State Y. On October 2, 2007, disaster Q strikes State Y. On October 5, 2007, the President declares a disaster within the meaning of section 1033(h)(3). The Service determines that County X is in a covered disaster area within the meaning of section 301.7508A-1(d)(2) of the Procedure and Administration Regulations for purposes of disaster Q. The Service issues a news release announcing relief for taxpayers affected by disaster Q. The news release defines the period from October 2, 2007, through December 31, 2007, as a disaster relief period and provides that the deadlines for specified acts, including the filing of an income tax return, that fall within the disaster relief period are postponed until December 31, 2007. A files an income tax return for 2006 showing a balance due on December 20, 2007. A files a Chapter 7 bankruptcy petition on November 24, 2010, listing the Service as a creditor with respect to the 2006 income tax liability. The case is treated as a “no-asset” Chapter 7 case, and the Service does not file a proof of claim with respect to A’s 2006 federal income tax liability. *See* Fed. R. Bankr. Proc. 2002(e). On January 18, 2011, the bankruptcy court grants A a discharge pursuant to section 727(a) of the Bankruptcy Code.

*Situation 2.* B is an individual who uses the cash receipts and disbursements method of accounting and files federal income tax returns on a calendar year basis. B serves in the United States Armed Forces in an area designated by the President of the United States by Executive Order as a combat zone for purposes of section 112 of the Code from March 17, 2005, through August 1, 2006. On September 20, 2006, B files an income tax return for 2004 showing a balance due. B files a Chapter 7 bankruptcy petition on November 3, 2008, listing the Service as a creditor with respect to the 2004 federal income tax liability. The case is treated as a “no-asset” Chapter 7 case, and the Service does not file a proof of claim. *See* Fed. R. Bankr. Proc. 2002(e). On December 11, 2008, the bankruptcy court grants B a discharge pursuant to section 727(a) of the Bankruptcy Code.

*Situation 3.* Same facts as *Situation 2*, except that B files a Chapter 7 bankruptcy petition on September 1, 2008, instead of November 3, 2008.

#### LAW AND ANALYSIS

Section 6072(a) of the Code provides that calendar year income tax returns for individuals are due on or before the 15th day of April following the close of the calendar year.

Section 6081(a) provides that the Secretary may grant a reasonable extension of time (generally not to exceed six months) for filing any return, declaration, statement, or other document required by the Code or by regulations. An individual who files an application for an extension of time to file an income tax return under section 1.6081-4T(b) of the temporary Income Tax Regulations between December 31, 2005, and November 4, 2008, will be allowed an automatic 6-month extension of time to file the return. Section 1.6081-4T(a) and (f) of the temporary Income Tax Regulations.

Section 7508A(a)(1) provides for the disregard of a period of time of up to one year in determining the timeliness of specified acts performed by taxpayers who are determined by the Service to be affected by a Presidentially-declared disaster or a terrorist or military action. Section 7508A relief is not automatic, but requires a grant of relief by the Service, which is generally in the form of a news release or a notice published in the Internal Revenue Bulletin. The specified acts include the acts described in section 7508(a), such as the filing of income tax returns.

Section 7508(a)(1) provides for the disregard of a period of time in determining the timeliness of specified acts performed by individuals serving in the United States Armed Forces, or serving in support of the Armed Forces, in an area designated by the President as a combat zone pursuant to section 112 or serving with respect to a contingency operation (as defined in 10 U.S.C. § 101(a)(3)). Unlike section 7508A relief, the relief is automatic and not dependent on a grant of relief by the Service. Generally, the relief extends throughout the individual’s period of service in the designated area or operation, plus any period of continuous qualified hospitalization attributable to an injury received while serving in the designated area or operation, plus the next 180 days. The specified acts include the filing of income tax returns. *See* section 7508(a)(1)(A).

An individual debtor in a Chapter 7 case may be granted a discharge. 11 U.S.C. § 727(a). A section 727(a) discharge covers all debts that arose before the bankruptcy case was filed, except those debts listed in section 523 of the Bankruptcy Code. 11 U.S.C. § 727(b). Pursuant to section 523(a)(1)(A) of the Bankruptcy Code, tax debts that are afforded eighth priority are excepted from discharge. Section 507(a)(8)(A)(i) of the Bankruptcy Code provides eighth priority for allowed unsecured pre-petition income tax claims for which a return is “last due, including extensions” after three years before the date of the filing of a bankruptcy petition.

Certain non-priority tax debts are also excepted from discharge under section 523(a)(1)(B) of the Bankruptcy Code. Section 523(a)(1)(B)(ii) of the Bankruptcy Code excepts from discharge any debt for a tax with respect to which a return was filed after the date on which it was “last due, under applicable law or any extension” and after two years before the date of the filing of a bankruptcy petition.

*Situation 1.* The due date for A’s 2006 income tax return is April 15, 2007. See section 6072. Because A timely requests an extension of time to file a 2006 income tax return, the date on which A’s 2006 return is due, including extensions, is October 15, 2007. See section 1.6081-4T of the temporary Income Tax Regulations.

A is an “affected taxpayer” as defined by section 301.7508A-1(d)(1)(i) of the Procedure and Administration Regulations with respect to disaster Q. Because the extended due date for A’s 2006 income tax return (October 15, 2007) falls within the disaster relief period granted in the news release, A may timely file a 2006 income tax return on or before December 31, 2007, the last day of the relief period.

Section 7508A relief does not change or extend the extended due date for filing A’s 2006 income tax return (October 15, 2007), which is fixed by sections 6072 and 6081(a) of the Code. Instead, section 7508A of the Code disregards the period of postponement and makes timely the filing of the 2006 return at any time during this period. Because section 7508A relief neither changes nor extends the extended due date, the postponement does not change the date on which the 2006 return is “last due, including extensions” under section 507(a)(8)(A)(i) of the Bankruptcy Code.

Therefore, the date on which A’s 2006 income tax return is last due, including A’s automatic 6-month extension, remains October 15, 2007, rather than the last day of the relief period, December 31, 2007. In the Chapter 7 bankruptcy proceeding, a claim for A’s 2006 income tax liability would not be entitled to eighth priority under section 507(a)(8)(A)(i) of the Bankruptcy Code because the date on which A’s 2006 income tax return is last due, including extensions, is October 15, 2007, which precedes November 24, 2007, the date that is three years before the filing of the bankruptcy petition. Accordingly, A’s 2006 income tax liability is not excepted from discharge under section 523(a)(1)(A) of the Bankruptcy Code.

*Situation 2.* The due date for B’s 2004 income tax return is April 15, 2005. See section 6072. Because B is an individual serving in the United States Armed Forces in an area designated by the President of the United States by Executive Order as a combat zone from March 17, 2005, through August 1, 2006, the time within which B may timely file a 2004 income tax return is postponed for the period of service in the Armed Forces plus 180 days. Section 7508. The postponement also includes any unexpired portion of the time prescribed for filing a return that existed when B entered the combat zone. See Rev. Rul. 76-425, 1976-2 C.B. 447. B would thus have until February 26, 2007, to timely file a 2004 income tax return.

Section 7508 relief does not change or extend the due date for filing B’s 2004 income tax return, which is fixed by section 6072. Instead, section 7508 of the Code disregards the period of postponement and makes timely the filing of the 2004 return at any time during this period. Because section 7508 relief neither changes nor extends the due date, the postponement does not change the date on which the 2004 return is “last due, including extensions” under section 507(a)(8)(A)(i) of the Bankruptcy Code. Therefore, the date on which B’s 2004 income tax return is “last due, including extensions” remains April 15, 2005, rather than the last day of the relief period, February 26, 2007. In the Chapter 7 bankruptcy proceeding, a claim for B’s 2004 income tax liability would not be entitled to eighth priority under section 507(a)(8)(A)(i) because the date on which B’s 2004 income tax re-

turn is last due, including extensions, is April 15, 2005, which precedes November 3, 2005, the date that is three years before the filing of the bankruptcy petition. Accordingly, B’s 2004 income tax liability is not excepted from discharge under section 523(a)(1)(A) of the Bankruptcy Code.

*Situation 3.* As with Situation 2, the date on which B’s 2004 income tax return is “last due, including extensions” remains April 15, 2005, rather than the last day of the relief period, February 26, 2007. In the Chapter 7 bankruptcy proceeding, a claim for B’s 2004 income tax liability would not be entitled to eighth priority under section 507(a)(8)(A)(i) because the date on which B’s 2004 income tax return is last due, including extensions, is April 15, 2005, which precedes September 1, 2005, the date that is three years before the filing of the bankruptcy petition. Accordingly, B’s 2004 income tax liability is not excepted from discharge under section 523(a)(1)(A) of the Bankruptcy Code.

The date on which B’s 2004 income tax return is “last due, under applicable law or under any extension” under section 523(a)(1)(B)(ii) of the Bankruptcy Code is likewise unaffected by the section 7508 relief. Because B’s 2004 return is filed after April 15, 2005, the date on which the return is “last due, under applicable law or under any extension” and because the date of the petition (September 1, 2008) is less than two years from the date on which the 2004 return is filed (September 20, 2006), the 2004 income tax liability is excepted from discharge under sections 523(a)(1)(B)(ii) and 727(b) of the Bankruptcy Code.

## HOLDINGS

(1) The Service’s grant of relief under section 7508A of the Code, which postpones the time in which a taxpayer affected by a Presidentially-declared disaster may timely file an income tax return, does not change the date on which a return is “last due, including extensions” under section 507(a)(8)(A)(i) of the Bankruptcy Code. This holding would also apply to an “affected taxpayer” other than an individual under section 301.7508A-1(d)(1) of the Procedure and Administration Regulations.

(2) Section 7508 relief, which postpones the time in which an individual

may timely file an income tax return, does not change the date on which the return is “last due, including extensions” under section 507(a)(8)(A)(i) of the Bankruptcy Code or “last due, under applicable law or under any extension” under section 523(a)(1)(B)(ii) of the Bankruptcy Code.

#### DRAFTING INFORMATION

The principal author of this revenue ruling is Micah A. Levy of the Office of Associate Chief Counsel (Procedure & Administration). For further information regarding this revenue ruling, contact

Micah A. Levy at (202) 622–3620 (not a toll-free call).

# Part III. Administrative, Procedural, and Miscellaneous

## Hurricane Katrina Disaster Relief and Bankruptcy

### Notice 2007-74

#### PURPOSE

This notice clarifies Notice 2006-56, 2006-28 I.R.B. 58, which, under the authority of section 7508A of the Internal Revenue Code, postponed until October 16, 2006 the time for certain individuals affected by Hurricane Katrina to file 2005 income tax returns (among other things). Notice 2006-56 also provided that the filing period would be postponed until April 15, 2007 for taxpayers who, under I.R.C. section 6081, requested an extension of time to file their 2005 returns prior to October 16, 2006.

Revenue Ruling 2007-59 held that the Internal Revenue Service's grant of relief under section 7508A does not change the date on which a return is "last due, including extensions" for purposes of Bankruptcy Code sections 507(a)(8)(A)(i) and 523(a)(1)(A), which provide priority and nondischargeability for certain tax claims in bankruptcy cases. Questions have arisen as to the date on which the 2005 return would be "last due, including extensions" if an affected taxpayer receives relief under section 7508A, obtains an extension of time to file under section 6081 within the 7508A postponement period, and files bankruptcy.

#### Bankruptcy Effect of Section 7508A Relief and Section 6081 Extension

Unlike the postponement of time under section 7508A, the grant of a request for extension under section 6081 changes the date on which a return is "last due, including extensions" for purposes of Bankruptcy Code sections 507(a)(8)(A)(i) and 523(a)(1)(A). See *In re McDermott*, 286 B.R. 913 (M.D. Fla. 2002). If an affected taxpayer under Notice 2006-56 requested an extension of time to file 2005 income taxes within the section 7508A postponement period, the return would be considered in a later bankruptcy case to be "last due, including extensions" on October 15, 2006, six months after the original due date. October 15, 2006 will therefore be

the determinative date for priority and dischargeability purposes of 2005 taxes under Bankruptcy Code sections 507(a)(8)(A)(i) and 523(a)(1)(A).

#### EFFECT ON OTHER DOCUMENTS

This document amplifies Revenue Ruling 2007-59 and clarifies Notice 2006-56.

#### DRAFTING INFORMATION

The principal author of this notice is Micah A. Levy of the Office of Associate Chief Counsel (Procedure & Administration). For further information regarding this notice, contact Micah A. Levy at (202) 622-3620 (not a toll-free call).

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*26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of tax liability.*

## Rev. Proc. 2007-58

### SECTION 1. PURPOSE

This revenue procedure provides the domestic asset/liability percentages and domestic investment yields needed by foreign life insurance companies and foreign property and liability insurance companies to compute their minimum effectively connected net investment income under section 842(b) of the Internal Revenue Code for taxable years beginning after December 31, 2005. Instructions are provided for computing foreign insurance companies' liabilities for the estimated tax and installment payments of estimated tax for taxable years beginning after December 31, 2005. For more specific guidance regarding the computation of the amount of net investment income to be included by a foreign insurance company on its U.S. income tax return, see Notice 89-96, 1989-2 C.B. 417. For the domestic asset/liability percentage and domestic investment yield, as well as instructions for computing foreign insurance companies' liabilities for estimated tax and installment payments of estimated tax for taxable years beginning after December 31, 2004, see Rev. Proc. 2006-39, 2006-40 I.R.B. 600.

### SECTION 2. CHANGES

.01 DOMESTIC ASSET/LIABILITY PERCENTAGES FOR 2006. The Secretary determines the domestic asset/liability percentage separately for life insurance companies and property and liability insurance companies. For the first taxable year beginning after December 31, 2005, the relevant domestic asset/liability percentages are:

151.6 percent for foreign life insurance companies, and

192.7 percent for foreign property and liability insurance companies.

.02 DOMESTIC INVESTMENT YIELDS FOR 2006. The Secretary is required to prescribe separate domestic investment yields for foreign life insurance companies and for foreign property and liability insurance companies. For the first taxable year beginning after December 31, 2005, the relevant domestic investment yields are:

4.5 percent for foreign life insurance companies, and

3.3 percent for foreign property and liability insurance companies.

.03 SOURCE OF DATA FOR 2006. The section 842(b) percentages to be used for the 2006 tax year are based on tax return data following the same methodology used for the 2005 year.

### SECTION 3. APPLICATION-ESTIMATED TAXES

To compute estimated tax and the installment payments of estimated tax due for taxable years beginning after December 31, 2005, a foreign insurance company must compute its estimated tax payments by adding to its income other than net investment income the greater of (i) its net investment income as determined under section 842(b)(5), that is actually effectively connected with the conduct of a trade or business within the United States for the relevant period, or (ii) the minimum effectively connected net investment income under section 842(b) that would result from using the most recently available domestic asset/liability percentage and domestic investment yield. Thus, for installment payments due after the publication of

this revenue procedure, the domestic asset/liability percentages and the domestic investment yields provided in this revenue procedure must be used to compute the minimum effectively connected net investment income. However, if the due date of an installment is less than 20 days after the date this revenue procedure is published in the Internal Revenue Bulletin, the asset/liability percentages and domestic investment yields provided in Rev. Proc.

2006–39 may be used to compute the minimum effectively connected net investment income for such installment. For further guidance in computing estimated tax, see Notice 89–96.

#### SECTION 4. EFFECTIVE DATE

This revenue procedure is effective for taxable years beginning after December 31, 2005.

#### SECTION 5. DRAFTING INFORMATION

The principal author of this revenue procedure is Sheila Ramaswamy of the Office of Associate Chief Counsel (International). For further information regarding this revenue procedure, contact Sheila Ramaswamy at (202) 622–3870 (not a toll-free call).

# Part IV. Items of General Interest

## Notice of Proposed Rulemaking

### Severance of a Trust for Generation-Skipping Transfer (GST) Tax Purposes II

#### REG-128843-05

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: These proposed regulations provide guidance regarding the generation-skipping transfer (GST) tax consequences of the severance of trusts in a manner that is effective under state law, but that does not meet the requirements of a qualified severance under section 2642(a)(3) of the Internal Revenue Code. These proposed regulations also provide guidance regarding the GST tax consequences of a qualified severance of a trust with an inclusion ratio between zero and one into more than two resulting trusts. These proposed regulations also provide special funding rules applicable to the non-*pro rata* division of certain assets between or among resulting trusts. The regulations will affect trusts that are subject to the GST tax.

DATES: Written or electronic comments and requests for a public hearing must be received by October 31, 2007.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-128843-05), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-128843-05), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (IRS-REG-128843-05).

FOR FURTHER INFORMATION CONTACT: Mayer R. Samuels, (202) 622-3090 (not a toll-free number).

#### SUPPLEMENTARY INFORMATION:

##### Background

On August 24, 2004, proposed regulations under section 2642(a)(3) regarding qualified severances were published in the **Federal Register** (REG-145987-03, 2004-2 C.B. 519 [69 FR 51967]). Final regulations were published on August 2, 2007. The Treasury Department and the IRS determined that certain comments received in response to the proposed regulations under section 2642(a)(3) should be addressed in a separate notice of proposed rulemaking, instead of in the final regulations published on August 2, 2007. Accordingly, this notice of proposed rulemaking proposes additional changes to the regulations in response to those comments.

Section 2642(a)(3) was added to the Internal Revenue Code (Code) by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Public Law 107-16 (115 Stat. 38 (2001)). Under section 2642(a)(3), if a trust is divided into two or more trusts in a "qualified severance," the trusts resulting from the severance (resulting trusts), which may have different inclusion ratios, will be recognized as separate trusts for GST tax purposes. Once the resulting trusts are recognized as separate trusts, the transferor's lifetime GST tax exemption may be allocated separately to either trust. In addition, whether or not a GST taxable event occurs is determined separately for each resulting trust.

One commentator with respect to the notice of proposed rulemaking under section 2642(a)(3) suggested that those regulations should expressly address the GST tax consequences of dividing a trust in a manner that does not satisfy the regulatory requirements of a qualified severance, but nonetheless is effective to create separate trusts under applicable state law. Specifically, the commentator requested that the regulations be amended to provide that the separate trusts created as the result of a trust's division that is effective under state law, but that does not qualify as a qualified severance, will be respected prospectively as separate trusts for GST tax purposes, but that the inclusion ratio of each of the resulting trusts will be the same as the inclusion

ratio of the original trust immediately before its severance.

As noted by a commentator, however, such a result would require an amendment to the existing regulations under section 2654. Generally, section 2654(b)(2) provides that "substantially separate and independent shares" of different beneficiaries in a trust will be treated as separate trusts for GST tax purposes. Section 26.2654-1(a)(1)(i) provides that, for purposes of section 2654(b)(2), the term "substantially separate and independent shares" generally has the same meaning as provided in §1.663(c)(3). However, these regulations further provide that a portion of a trust is not a separate share "unless such share exists from and at all times after creation of the trust."

Section 26.2654-1(a)(5), *Example 8*, illustrates this rule. In *Example 8*, T creates a discretionary trust with discretionary power in the trustee to distribute income and principal among T's children and grandchildren. The trust agreement directs that, when T's youngest child reaches age 21, the trust be divided into separate shares, with one such share for each child of T; the income from a particular share is to be paid to T's child (for whom that share was created) for life, with the remainder from that share to be distributed to that child's own children. The example concludes that the separate shares that come into existence when the youngest child reaches age 21 are not recognized as separate trusts for GST tax purposes because the separate shares did not constitute separate and independent shares of a single trust at all times from the date of creation of the original trust, as required by §26.2654-1(a)(1). Thus, any allocation of GST tax exemption to the original trust, or to any of the separate shares after the division, will apply with respect to the entire trust. The example provides that the result would be the same if the original trust was divided into separate trusts rather than separate shares.

Another commentator with respect to the notice of proposed rulemaking under section 2642(a)(3) requested that the regulations provide additional flexibility in severing a trust that has an inclusion ratio between zero and one. Generally, the final

regulations apply section 2642(a)(3)(B)(ii) by requiring that the trust first be severed into two identical trusts, one of which would then have an inclusion ratio of zero and the other an inclusion ratio of one. The final regulations confirm that either or both of these trusts may then be further severed into a trust for the benefit of the skip person(s) and a trust for the benefit of the non-skip person(s). However, under this two-step procedure, one of the resulting trusts for the benefit of skip persons would have an inclusion ratio of one, and one of the trusts for the benefit of the non-skip persons would have an inclusion ratio of zero. The commentator requested that the regulations allow severances in a manner that would permit a more effective utilization of the exemption.

The Treasury Department and the IRS believe that each of these suggestions merits further consideration in a new notice of proposed rulemaking. In addition, the new proposed regulations clarify the rules in the final regulations regarding the funding of resulting trusts.

### Explanation of Provisions

The proposed regulations amend the regulations under §26.2642-6 to provide that trusts resulting from a severance that does not meet the requirements of a qualified severance nevertheless will be treated, after the severance, as separate trusts for GST tax purposes, provided that the resulting trusts are recognized as separate trusts under applicable state law. Because the severance is not a qualified severance, each such resulting trust will have the same inclusion ratio immediately after the severance as the original trust immediately before the severance. Nevertheless, GST tax exemption allocated after the severance may be separately allocated to one or more of the resulting trusts, and the trusts will otherwise be treated as separate trusts for GST tax purposes. An example of a nonqualified severance is added to the regulations.

The proposed regulations also revise §26.2654-1(a)(1)(i) and (a)(5), *Example 8*.

In addition, pursuant to the authority granted in section 2642(a)(3)(B)(iii), these proposed regulations provide for an additional type of qualified severance. Specifically, the proposed regulations provide that a trust with an inclusion ratio between

zero and one may be severed in a qualified severance into more than two resulting trusts. One or more of the resulting trusts in the aggregate must receive that fractional share of the total value of the original trust as of the date of severance that is equal to the applicable fraction used to determine the inclusion ratio of the original trust immediately before the severance. The trust or trusts receiving such fractional share shall have an inclusion ratio of zero, and each of the other resulting trust or trusts shall have an inclusion ratio of one. Further, the trustee may designate the beneficiary of each separate resulting trust, provided that the designation results in each beneficiary having the same beneficial interest (within the meaning of §26.2642-6(d)(5)) after the severance as that beneficiary had in the original trust corpus. Guidance illustrating the application of this rule is included in §26.2642-6(d)(7)(ii) and *Example 9* of §26.2642-6(j) of these proposed regulations.

Finally, these proposed regulations clarify a provision of the final regulations (T.D. 9348) issued contemporaneously with these proposed regulations. Specifically, §26.2642-6(d)(4) requires that each resulting trust be funded with a fraction or percentage of the entire trust and that, although particular assets may be divided among the resulting trusts on a non-*pro rata* basis based on the fair market value of the assets on the date of severance, the sum of those fractions or percentages must be one or one hundred percent, respectively. Thus, if the resulting trusts are funded on a non-*pro rata* basis, the sum of the values distributed to the resulting trusts must equal the fair market value of the trust being severed. These proposed regulations clarify that no discounts or other reductions from the value of an asset owned by the original trust, arising by reason of the division of the original trust's interest in the asset between or among the resulting trusts, are permitted in funding the resulting trusts. Instead, solely for funding purposes, each resulting trust's interest in the stock of a closely held corporation, partnership interest, or other single asset must be valued by multiplying the fair market value of the asset held in the original trust as of the date of severance by the fractional or percentage interest in that asset being distributed to

that resulting trust. This clarification is proposed to be effective with respect to severances occurring on or after the date these proposed 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) applies only to §26.2642-6(d)(7)(ii) of these regulations. It is hereby certified that this provision will not have a significant economic impact on a substantial number of small entities. Accordingly, a Regulatory Flexibility Analysis is not required. This provision directly affects individuals, not entities. Because the remaining sections of these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### Comments and Requests for Public Hearing

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

### Drafting Information

The principal author of these proposed regulations is Mayer R. Samuels,

Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. Other personnel from the IRS and the Treasury Department participated in their development.

\* \* \* \* \*

## Proposed Amendments to the Regulations

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

### PART 26—GENERATION-SKIPPING TRANSFER TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1986

Paragraph 1. The authority citation for part 26 continues to read in part as follows:

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

Par. 2. In §26.2600-1, the table of contents is amended by adding the entry for §26.2642-6(h) to read as follows:

§26.2600-1 *Table of contents.*

\* \* \* \* \*

§26.2642-6 *Qualified severance.*

\* \* \* \* \*

(h) Treatment of trusts resulting from a severance that is not a qualified severance.

\* \* \* \* \*

Par. 3. Section 26.2642-6 is amended as follows:

1. Paragraph (d)(4) and (d)(7) are revised.

2. Paragraph (h) is added.

3. Paragraph (j) *Examples 6, 9, 12, and 13* are added.

4. Paragraph (k)(1) is revised.

The additions and revisions read as follows:

§26.2642-6 *Qualified severance.*

\* \* \* \* \*

(d) \* \* \*

(4) The single trust (original trust) is severed on a fractional basis, such that each new trust (resulting trust) is funded with a fraction or percentage of the original trust, and the sum of those fractions or percentages is one or one hundred percent, respectively. For this purpose, the fraction or

percentage may be determined by means of a formula (for example, that fraction of the trust the numerator of which is equal to the transferor's unused GST tax exemption, and the denominator of which is the fair market value of the original trust's assets on the date of severance). The severance of a trust based on a pecuniary amount does not satisfy this requirement. For example, the severance of a trust is not a qualified severance if the trust is divided into two trusts, with one trust to be funded with \$1,500,000 and the other trust to be funded with the balance of the original trust's assets. With respect to the particular assets to be distributed to each resulting trust, each resulting trust may be funded with the appropriate fraction or percentage (*pro rata* portion) of each asset held by the original trust. Alternatively, the assets may be divided among the resulting trusts on a non-*pro rata* basis, based on the fair market value of the assets on the date of severance. However, if a resulting trust is funded on a non-*pro rata* basis, each asset received by a resulting trust must be valued, solely for funding purposes, by multiplying the fair market value of the asset held in the original trust as of the date of severance by the fraction or percentage of that asset received by that resulting trust. Thus, the assets must be valued without taking into account any discount or premium arising from the severance, for example, any valuation discounts that might arise because the resulting trust receives less than the entire interest held by the original trust. See paragraph (j), *Example 6* of this section.

\* \* \* \* \*

(7) In the case of a qualified severance occurring after GST tax exemption has been allocated to the trust (whether by an affirmative allocation, a deemed allocation, or an automatic allocation pursuant to the rules contained in section 2632), if the trust has an inclusion ratio as defined in §26.2642-1 that is greater than zero and less than one, then either paragraph (d)(7)(i) or (ii) of this section must be satisfied.

(i) The trust is severed initially into only two resulting trusts. One resulting trust must receive that fractional share of the total value of the original trust as of the date of severance that is equal to the applicable fraction, as defined in §26.2642-1(b)

and (c), used to determine the inclusion ratio of the original trust immediately before the severance. The other resulting trust must receive that fractional share of the total value of the original trust as of the date of severance that is equal to the excess of one over the fractional share described in the preceding sentence. The trust receiving the fractional share equal to the applicable fraction shall have an inclusion ratio of zero, and the other trust shall have an inclusion ratio of one. If the applicable fraction with respect to the original trust is .50, then, with respect to the two equal trusts resulting from the severance, the Trustee may designate which of the resulting trusts will have an inclusion ratio of zero and which will have an inclusion ratio of one. Each separate trust resulting from the severance then may be further divided in accordance with the rules of this section. See paragraph (j), *Example 7* of this section.

(ii) The trust is severed initially into more than two resulting trusts. One or more of the resulting trusts in the aggregate must receive that fractional share of the total value of the original trust as of the date of severance that is equal to the applicable fraction used to determine the inclusion ratio of the original trust immediately before the severance. The trust or trusts receiving such fractional share shall have an inclusion ratio of zero, and each of the other resulting trust or trusts shall have an inclusion ratio of one. (If, however, two or more of the resulting trusts each receives the fractional share of the total value of the original trust equal to the applicable fraction, the trustee may designate which of those resulting trusts will have an inclusion ratio of zero and which will have an inclusion ratio of one.) The resulting trust or trusts with an inclusion ratio of one must receive in the aggregate that fractional share of the total value of the original trust as of the date of severance that is equal to the excess of one over the fractional share described in the second sentence of this paragraph. See paragraph (j), *Example 9* of this section.

\* \* \* \* \*

(h) *Treatment of trusts resulting from a severance that is not a qualified severance.* Trusts resulting from a severance (other than a severance under §26.2654-1) that does not meet the requirements of a qualified severance under paragraph (b) of

this section will be treated, after the date of severance, as separate trusts for purposes of the generation-skipping transfer (GST) tax, provided that the trusts resulting from such severance are recognized as separate trusts under applicable state law. The post-severance treatment of the resulting trusts as separate trusts for GST tax purposes generally permits the allocation of GST tax exemption, the making of various elections permitted for GST tax purposes, and the occurrence of a taxable distribution or termination with regard to a particular resulting trust, with no GST tax impact on any other trust resulting from that severance. Each trust resulting from a severance described in this paragraph, however, will have the same inclusion ratio immediately after the severance as that of the original trust immediately before the severance. (See §26.2654-1 for the inclusion ratio of each trust resulting from a severance described in that section.)

\* \* \* \* \*

(j) \* \* \*

*Example 6. Funding of severed trusts on a non-pro rata basis.* T's will establishes an irrevocable trust, Trust, for the benefit of T's descendants. As a result of the allocation of GST tax exemption, the applicable fraction with respect to Trust is .60 and Trust's inclusion ratio is .40 [1 - .60]. Pursuant to authority granted under applicable state law, on August 1, 2008, the trustee executes a document severing Trust into two trusts, Trust 1 and Trust 2, each of which is identical to Trust. The instrument of severance provides that the severance is intended to qualify as a qualified severance within the meaning of section 2642(a)(3) and designates August 3, 2008, as the date of severance (within the meaning of paragraph (d)(3) of this section). The instrument further provides that Trust 1 and Trust 2 are to be funded on a non-pro rata basis with Trust 1 funded with assets having a fair market value on the date of severance equal to 40% of the value of Trust's assets on that date and Trust 2 funded with assets having a fair market value equal to 60% of the value of Trust's assets on that date. The fair market value of the assets used to fund each trust is to be determined in compliance with the requirements of paragraph (d)(4) of this section. On August 3, 2008, the fair market value of the Trust assets totals \$4,000,000, consisting of 52% of the outstanding common stock in Company, a closely-held corporation, valued at \$3,000,000 and \$1,000,000 in cash and marketable securities. Trustee proposes to divide the Company stock equally between Trust 1 and Trust 2, and thus transfer 26% of the Company stock to Trust 1 and 26% of the stock to Trust 2. In addition, the appropriate amount of cash and marketable securities will be distributed to each trust. In accordance with paragraph (d)(4) of this section, for funding purposes, the interest in the Company stock distributed to each trust is valued as a pro rata portion of the value of the 52% interest in Company held by Trust before severance, without

taking into account, for example, any valuation discount that might otherwise apply in valuing the non-controlling interest distributed to each resulting trust. Accordingly, for funding purposes, each 26% interest in Company stock distributed to Trust 1 and Trust 2 is valued at \$1,500,000 (.5 x \$3,000,000). Therefore, Trust 1, which is to be funded with \$1,600,000 (.40 x \$4,000,000), receives \$100,000 in cash and marketable securities valued as of August 3, 2008, in addition to the Company stock, and Trust 2, which is to be funded with \$2,400,000 (.60 x \$4,000,000), receives \$900,000 in cash and marketable securities in addition to the Company stock. Therefore, the severance is a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied.

\* \* \* \* \*

*Example 9. Regulatory qualified severance.* In 2004, T establishes an *inter vivos* irrevocable trust (Trust) providing that Trust income is to be paid annually in equal shares to T's children, A and B, for 10 years. If either (or both) dies prior to the expiration of the 10-year term, the deceased child's share of trust income is to be paid to the child's then living descendants, per stirpes, for the balance of the trust term. At the expiration of the 10-year trust term, the corpus is to be distributed equally to A and B; if A and B (or either or them) is not then living, then such decedent's share is to be distributed instead to such decedent's then living descendants, per stirpes. T allocates GST tax exemption to Trust such that Trust's applicable fraction is .25 and its inclusion ratio is .75. In 2006, pursuant to applicable state law, the trustee severs the trust into three trusts: Trust 1, Trust 2, and Trust 3. The instrument severing Trust provides that Trust 1 is to receive 50% of Trust's assets, Trust 2 is to receive 25% of Trust's assets, and Trust 3 is to receive 25% of Trust's assets. All three resulting trusts are identical to Trust, except that each has different beneficiaries: A and A's issue are designated as the beneficiaries of Trust 1, and B and B's issue are designated as the beneficiaries of Trust 2 and Trust 3. The severance constitutes a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied. Trust 1 will have an inclusion ratio of 1. Because both Trust 2 and Trust 3 have each received the fractional share of Trust's assets equal to Trust's applicable fraction of .25, trustee designates that Trust 2 will have an inclusion ratio of one and that Trust 3 will have an inclusion ratio of zero.

\* \* \* \* \*

*Example 12. Mandatory severance that does not qualify as a qualified severance.* In 1996, T creates an irrevocable *inter vivos* trust (Trust) that provides the trustee with the discretionary power to distribute income or corpus from time to time to one or more of T's children and grandchildren. Trust provides that, when T's youngest child reaches age 30, Trust is to be divided equally into separate trusts (resulting trusts), with one resulting trust for each child of T who is then living, and one resulting trust for each child of T who is then deceased and who has then living descendants. The income from a child's resulting trust will be paid to that child during the child's life, with the remainder passing to such child's descendants (grandchildren and younger generation descendants of T). On a timely filed Form 709, "United States Gift (and Generation-Skipping Transfer) Tax

*Return,*" reporting the transfer, T allocates all of T's remaining GST tax exemption to Trust. As a result of the allocation, the applicable fraction with respect to Trust is .20, so Trust's inclusion ratio is .80 [1 - .20]. T's youngest child reaches age 30 in 2008. (No additional gifts are made through 2008 and Trust's inclusion ratio does not change.) In accordance with Trust's terms, Trust is divided in 2008 into three separate trusts (Trust 1, Trust 2, and Trust 3), one trust for each of T's three children, each of whom is then living. Trust 1, Trust 2, and Trust 3 are each recognized as a separate trust under applicable state law. With the consent of all interested parties, each resulting trust is funded with assets different from the assets distributed to the other two resulting trusts in a manner that does not meet the requirements of paragraph (d)(3) of this section. As a result, the severance does not satisfy the requirements of a qualified severance under this section. Under paragraph (h) of this section, however, Trust 1, Trust 2, and Trust 3 are each recognized as a separate trust for GST tax purposes prospectively from the date of severance, because the severance was effective to create three separate trusts under applicable state law. Therefore, after the severance, if T becomes entitled to any additional GST tax exemption pursuant to subsequent changes in applicable Federal tax law, T may allocate that additional GST tax exemption to any one or more of these three resulting trusts. Because the severance is not a qualified severance, however, the inclusion ratio of each of the three new trusts immediately after the severance will be .80, the same as Trust's inclusion ratio immediately before the severance.

*Example 13. Other severance that does not qualify as a qualified severance.* In 2004, T establishes an irrevocable *inter vivos* trust (Trust) providing that Trust income is to be paid to T's children, A and B, in equal shares for their joint lives. Upon the death of the first to die of A and B, all Trust income will be paid to the survivor of A and B. At the death of the survivor, the corpus is to be distributed in equal shares to T's grandchildren, W and X (with any then-deceased grandchild's share being paid in accordance with that grandchild's testamentary general power of appointment). W is A's child and X is B's child. T elects under section 2632(c)(5) not to have the automatic allocation rules contained in section 2632(c) apply with respect to T's transfers to Trust, and T does not otherwise allocate GST tax exemption to Trust. In 2006, the trustee of Trust, as permitted by applicable state law, divides Trust into two separate trusts, Trust 1 and Trust 2. Trust 1 provides that trust income is to be paid to A for life and, on A's death, the remainder is to be distributed to W (or pursuant to W's testamentary general power of appointment). Trust 2 provides that trust income is to be paid to B for life and, on B's death, the remainder is to be distributed to X (or pursuant to X's testamentary general power of appointment). Because Trust 1 and Trust 2 do not provide A and B with the contingent survivor income interests that were provided to A and B under the terms of Trust, Trust 1 and Trust 2 do not provide for the same succession of interests in the aggregate as provided by Trust. Therefore, the severance does not satisfy the requirements of this section and is not a qualified severance. However, under paragraph (h) of this section, provided that Trust 1 and Trust 2 are recognized as separate trusts under applicable state law, Trust 1 and Trust 2 will be recognized as sepa-

rate trusts for GST tax purposes, prospectively from the date of the severance. Trust 1 and Trust 2 each have the same inclusion ratio immediately after the severance as Trust's inclusion ratio immediately before the severance.

(k) \* \* \*

(1) *In general.* Except as otherwise provided, this section applies to severances occurring on or after August 2, 2007. Paragraph (d)(7)(ii), paragraph (h), and *Examples 9, 12, and 13* of paragraph (j) of this section apply to severances occurring on or after August 2, 2007. Paragraph (d)(4) and *Example 6* of paragraph (j) apply to severances occurring on or after August 2, 2007.

Par. 4. Section 26.2654-1 is amended as follows:

1. Paragraph (a)(1)(i) is revised.
2. A new paragraph (a)(1)(iii) is added.
3. In paragraph (a)(5), *Example 8* is revised.

The additions and revisions read as follows:

*§26.2654-1 Certain trusts treated as separate trusts.*

(a) *Single trust treated as separate trusts—(1) Substantially separate and independent shares—(i) In general.* If a single trust consists solely of substantially separate and independent shares for different beneficiaries, the share attributable to each beneficiary (or group of beneficiaries) is treated as a separate trust for purposes of chapter 13. The phrase “substantially separate and independent shares” generally has the same meaning as provided in §1.663(c)-3 of this chapter. However, except as provided in paragraph (a)(1)(iii) of this section, a portion of a trust is not a separate share unless such share exists from and at all times after the creation of the trust. For purposes of this paragraph (a)(1), a trust is treated as created at the date of death of the grantor if the trust is includible in its entirety in the grantor's gross estate for Federal estate tax purposes. Further, treatment of a single trust as separate trusts under this paragraph (a)(1) does not permit treatment of those portions as separate trusts for purposes of filing returns and payment of tax or for purposes of computing any other tax imposed under the Internal Revenue Code. Also, additions to, and distributions from, such trusts are allocated *pro rata* among the separate trusts, unless the governing instrument expressly provides

otherwise. See §26.2642-6 and paragraph (b) of this section regarding the treatment, for purposes of chapter 13, of separate trusts resulting from the actual severance of a single trust.

\* \* \* \* \*

(iii) *Mandatory severances.* For purposes of this section, if the governing instrument of a trust requires the division or severance of a single trust into separate trusts upon the future occurrence of a particular event not within the discretion of the trustee or any other person, and if the trusts resulting from such a division or severance are recognized as separate trusts under applicable state law, then each resulting trust is treated as a separate trust for purposes of chapter 13. For this purpose, the rules of paragraph (b)(1)(ii)(C) of this section apply with respect to the severance and funding of the trusts. Similarly, if the governing instrument requires the division of a single trust into separate shares under the circumstances described in this paragraph, each such resulting share is treated as a separate trust for purposes of chapter 13. The post-severance treatment of the resulting trusts or shares as separate trusts for GST tax purposes generally permits the allocation of GST tax exemption, the making of various elections permitted for GST tax purposes, and the occurrence of a taxable distribution or termination with regard to a particular resulting trust or share, with no GST tax impact on any other trust or share resulting from that severance. The treatment of a single trust as separate trusts under this paragraph (a)(1), however, does not permit treatment of those portions as separate trusts for purposes of filing returns and payment of tax or for purposes of computing any other tax imposed under the Internal Revenue Code. Also, additions to, and distributions from, such trusts are allocated *pro rata* among the separate trusts, unless the governing instrument expressly provides otherwise. Each separate share and each trust resulting from a mandatory division or severance described in this paragraph will have the same inclusion ratio immediately after the severance as that of the original trust immediately before the division or severance.

\* \* \* \* \*

(5) \* \* \*

*Example 8. Subsequent mandatory division into separate trusts.* T creates an irrevocable trust that

provides the trustee with the discretionary power to distribute income or corpus to T's children and grandchildren. The trust provides that, when T's youngest child reaches age 21, the trust will be divided into separate shares, one share for each child of T. The income from a respective child's share will be paid to the child during the child's life, with the remainder passing on the child's death to such child's children (grandchildren of T). The separate shares that come into existence when the youngest child reaches age 21 will be recognized as of that date as separate trusts for purposes of Chapter 13. Any allocation of GST tax exemption to the trust after T's youngest child reaches age 21 may be made to any one or more of the separate shares. The result would be the same if the trust instrument provided that the trust was to be divided into separate trusts when T's youngest child reached age 21, provided that the severance and funding of the separate trusts meets the requirements of this section.

\* \* \* \* \*

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

(Filed by the Office of the Federal Register on August 1, 2007, 8:45 a.m., and published in the issue of the Federal Register for August 2, 2007, 72 F.R. 42340)

## Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations

### Clarification to Section 6411 Regulations

#### REG-118886-06

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: In this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9335) relating to the computation and allowance of the tentative carryback adjustment under section 6411 of the Internal Revenue Code. Those temporary regulations clarify that for purposes of allowing the tentative adjustment, the IRS may credit or reduce the tentative adjustment by an assessed tax liability, whether or not that tax liability was assessed before the date the application for tentative carryback is filed, and other unassessed liabilities in

certain other circumstances. Those regulations also remove all references to IRS district director or service center director, as these positions no longer exist within the IRS. The offices of the district director and service center director were eliminated by the IRS reorganization implemented pursuant to the IRS Reform and Restructuring Act of 1998. The text of the temporary regulations serves as the text of these proposed regulations.

**DATES:** Written and electronic comments and requests for a public hearing must be received by November 26, 2007.

**ADDRESSES:** Send submissions to: CC:PA:LPD:PR (REG-118886-06), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-118886-06), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (IRS REG-118886-06).

**FOR FURTHER INFORMATION CONTACT:** Concerning the proposed regulations, Cynthia A. McGreevy, (202) 622-4910; concerning submissions of comments, Richard Hurst, (202) 622-7180 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:**

### **Background and Explanation of Provisions**

These proposed regulations clarify the Income Tax Regulations (26 CFR part 1) under section 6411 relating to the computation and allowance of the tentative carryback adjustment. The tentative allowance is computed pursuant to §1.6411-2 but applied pursuant to §1.6411-3. These regulations clarify that for purposes of computing the allowance, the Commissioner will not consider amounts to which the taxpayer and the Commissioner are in disagreement. For purposes of applying the allowance, however, the Commissioner may credit or reduce the tentative adjustment by any assessed tax liabilities, unassessed liabilities determined in a

statutory notice of deficiency, unassessed liabilities identified in a proof of claim filed in a bankruptcy proceeding, and other unassessed liabilities in rare and unusual circumstances. Regarding unassessed liabilities determined in a statutory notice of deficiency, see Rev. Rul. 2007-51. Regarding unassessed liabilities identified in a proof of claim filed in a bankruptcy proceeding, see Rev. Rul. 2007-52. See §601.601(d)(2). The IRS plans to adopt procedures requiring IRS National Office review prior to a credit or reduction of the tentative adjustment by an unassessed liability that constitutes a rare and unusual circumstance.

In this issue of the Bulletin, the IRS is issuing temporary regulations relating to the computation and allowance of the tentative carryback adjustment under section 6411 of the Internal Revenue Code. The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations and these proposed regulations.

### **Proposed Effective Date**

These proposed amendments to §§1.6411-2 and 1.6411-3 apply with respect to applications for tentative refund filed on or after the date these rules are published as final regulations in the **Federal Register**. No implication is intended concerning whether or not a rule to be adopted in these regulations is applicable law for applications filed prior to that date.

### **Special Analyses**

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

### **Comments and Requests for a Public Hearing**

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

### **Drafting Information**

The principal author of these regulations is Cynthia A. McGreevy of the Office of the Associate Chief Counsel (Procedure and Administration).

\* \* \* \* \*

### **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. Section 1.6411-2 is revised to read as follows:

*§1.6411-2 Computation of tentative carryback adjustment.*

(a) [The text of proposed §1.6411-2(a) is the same as the text of §1.6411-2T(a) published elsewhere in this issue of the Bulletin].

(b) [The text of proposed §1.6411-2(b) is the same as the text of §1.6411-2T(b) published elsewhere in this issue of the Bulletin].

\* \* \* \* \*

Par. 3. Section 1.6411-3 is revised to read as follows:

*§1.6411-3 Allowance of adjustments.*

(a) [The text of proposed §1.6411-3(a) is the same as the text of §1.6411-3T(a) published elsewhere in this issue of the Bulletin].

(b) [The text of proposed §1.6411-3(b) is the same as the text of §1.6411-3T(b) published elsewhere in this issue of the Bulletin].

(c) [The text of proposed §1.6411-3(c) is the same as the text of §1.6411-3T(c) published elsewhere in this issue of the Bulletin].

(d) [The text of proposed §1.6411-3(d) is the same as the text of §1.6411-3T(d) published elsewhere in this issue of the Bulletin].

\* \* \* \* \*

Kevin M. Brown,  
*Deputy Commissioner for  
Services and Enforcement.*

(Filed by the Office of the Federal Register on August 24, 2007, 8:45 a.m., and published in the issue of the Federal Register for August 27, 2007, 72 F.R. 48952)

## Notice of Proposed Rulemaking

### Diversification Requirements for Variable Annuity, Endowment, and Life Insurance Contracts

#### REG-118719-07

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of Proposed Rulemaking.

SUMMARY: This document proposes changes to the regulations concerning the diversification requirements of section 817(h) of the Internal Revenue Code (Code). The proposed changes would expand the list of holders whose beneficial interests in an investment company, partnership, or trust do not prevent a segregated asset account from looking through to the assets of the investment company, partnership, or trust, to satisfy the requirements of section 817(h). The proposed regulations also would remove

the sentence in §1.817-5(a)(2) that provides that the payment required to remedy an inadvertent diversification failure must be based on the tax that would have been owed by the policyholders if they were treated as receiving the income on the contract. These proposed regulations would affect insurance companies that issue variable contracts and would affect policyholders who purchase such contracts.

DATES: Written or electronic comments and requests for a public hearing must be received by October 29, 2007.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-118719-07), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-118719-07), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the Federal eRulemaking Portal at <http://www.regulations.gov/> (IRS REG-118719-07).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, James Polfer, at (202) 622-3970 (not a toll-free number).

Concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, e-mail [Richard.A.Hurst@irs.counsel.treas.gov](mailto:Richard.A.Hurst@irs.counsel.treas.gov).

SUPPLEMENTARY INFORMATION:

#### Background

Section 817(d) defines a variable contract for purposes of part I of subchapter L of the Code (sections 801-818). For a contract to be a variable contract, it must provide for the allocation of all or a part of the amounts received under the contract to an account that, pursuant to state law or regulation, is segregated from the general asset accounts of the issuing insurance company. In addition, for a life insurance contract to be a variable contract, it must qualify as a life insurance contract for Federal income tax purposes, and the amount of the death benefits (or the period of coverage)

must be adjusted on the basis of the investment return and the market value of the segregated asset account; for an annuity contract to be a variable contract, it must provide for the payment of annuities, and the amounts paid in, or the amount paid out, must reflect the investment return and the market value of the segregated asset account; for a contract that provides funding of insurance on retired lives to be a variable contract, the amounts paid in, or the amounts paid out, must reflect the investment return and the market value of the segregated asset account.

Section 817(h)(1) provides that a variable contract that is based on a segregated asset account is not treated as an annuity, endowment, or life insurance contract unless the segregated asset account is adequately diversified in accordance with regulations prescribed by the Secretary. If a segregated asset account is not adequately diversified for a calendar quarter, then the contracts supported by that segregated asset account are not treated as annuity, endowment, or life insurance contracts for that period and subsequent periods, even if the segregated asset account is adequately diversified in those subsequent periods. Under §1.817-5(a), if a segregated asset account is not adequately diversified, income earned by that segregated asset account is treated as ordinary income received or accrued by the policyholders. Section 1.817-5(a)(2) provides conditions an issuer of a variable contract must satisfy in order to correct an inadvertent failure to diversify. Rev. Proc. 92-25, 1992-1 C.B. 741, see §601.601(d)(2) of this chapter, sets forth in more detail the procedure by which an issuer may request the relief described in §1.817-5(a)(2).

Congress enacted the diversification requirements of section 817(h) to "discourage the use of tax-preferred variable annuity and variable life insurance primarily as investment vehicles." H.R. Conf. Rep. No. 98-861, at 1055 (1984). In section 817(h)(1), Congress granted the Secretary broad regulatory authority to develop rules to carry out this intent. Congress directed that these standards be imposed because "by limiting a customer's ability to select specific investments underlying a variable contract, [adequate diversification] will help ensure that a customer's primary motivation in purchasing the contract is more likely to be the traditional economic

protections provided by annuities and life insurance.” S. Prt. 98–169, Vol. I at 546 (1984). A primary directive from Congress to Treasury in enacting the standards was to “deny annuity or life insurance treatment for investments that are publicly available to investors.” H.R. Conf. Rep. No. 98–861, at 1055 (1984).

Section 817(h)(4) provides a look-through rule under which taxpayers do not treat the interest in a regulated investment company (RIC) or trust as a single asset of the segregated asset account but rather apply the diversification tests by taking into account the assets of the RIC or trust. Section 817(h) further provides that the look-through rule applies only if all of the beneficial interests in a RIC or trust are held by one or more insurance companies (or affiliated companies) in their general account or segregated asset accounts, or by fund managers (or affiliated companies) in connection with the creation or management of the RIC or trust.

Under §1.817–5(f)(1), if look-through treatment is available, a beneficial interest in a RIC, real estate investment trust, partnership, or trust that is treated under sections 671 through 679 as owned by the grantor or another person (“investment company, partnership or trust”) is not treated as a single investment of a segregated asset account for purposes of testing diversification. Instead, a *pro rata* portion of each asset of the investment company, partnership, or trust is treated as an asset of the segregated asset account. Section 1.817–5(f)(2)(i) provides that the look-through rule applies to any investment company, partnership, or trust if (1) all the beneficial interests in the investment company, partnership, or trust are held by one or more segregated asset accounts of one or more insurance companies; and (2) public access to the investment company, partnership, or trust is available exclusively through the purchase of a variable contract (except as otherwise permitted in §1.817–5(f)(3)).

Under §1.817–5(f)(3), look-through treatment is not prevented by reason of beneficial interests in an investment company, partnership, or trust that are

(1) Held by the general account of a life insurance company or a corporation related to a life insurance company, but only if the return on such interests is computed in the same manner as the return on an in-

terest held by a segregated asset account is computed, there is no intent to sell such interests to the public, and a segregated asset account of such life insurance company also holds or will hold a beneficial interest in the investment company, partnership, or trust;

(2) Held by the manager, or a corporation related to the manager, of the investment company, partnership or trust, but only if the holding of the interests is in connection with the creation or management of the investment company, partnership or trust, the return on such interest is computed in the same manner as the return on an interest held by a segregated asset account is computed, and there is no intent to sell such interests to the public;

(3) Held by the trustee of a qualified pension or retirement plan; or

(4) Held by the public, or treated as owned by the policyholders pursuant to Rev. Rul. 81–225, 1981–2 C.B. 12, see §601.601(d)(2) of this chapter, but only if (A) the investment company, partnership or trust was closed to the public in accordance with Rev. Rul. 82–55, 1982–1 C.B. 12, see §601.601(d)(2) of this chapter, or (B) all the assets of the segregated asset account are attributable to premium payments made by policyholders before September 26, 1981, to premium payments made in connection with a qualified pension or retirement plan, or to any combination of such premium payments.

### Explanation of Provisions

This document contains proposed amendments to 26 CFR part 1 under section 817(h).

The amendments would remove the sentence from §1.817–5(a)(2) which provides that the amount required to be paid to remedy an inadvertent failure to diversify must be based on the tax that would have been owed by the policyholders if they were treated as receiving the income on the contract for the period or periods of nondiversification.

The amendments also would expand the list of permitted investors in §1.817–5(f)(3) to include (i) qualified tuition programs as defined in section 529, (ii) trustees of foreign pension plans established and maintained outside the United States, primarily for the benefit of individuals, substantially all of whom are

nonresident aliens, and (iii) accounts that, pursuant to Puerto Rican law or regulation, are segregated from the general asset accounts of the life insurance companies that own the accounts, provided the requirements of section 817(d) and (h) are satisfied (without regard to the requirement the accounts be segregated pursuant to “State” law or regulation).

### Reasons for Change

#### 1. Proposed amendment to §1.817–5(a)(2) (remedy for inadvertent nondiversification).

The proposed regulations would remove the sentence in §1.817–5(a)(2) that provides that the payment required to remedy an inadvertent diversification failure must be based on the tax that would have been owed by the policyholders if they were treated as receiving the income on the contract. In Notice 2007–15, 2007–7 I.R.B. 503 (February 12, 2007), the IRS requested comments on how various correction procedures, including those described in §1.817–5(a)(2) and Rev. Proc. 92–25, may be improved. Section 5.03(e) and (f) of the notice specifically requested comments on the computation of the amounts required to be paid under these correction procedures. Moreover, in the past, the provision in §1.817–5(a)(2) of the amount required to be paid has caused confusion about the scope of the IRS’s authority to provide for amounts that depart from the plain language of the regulation. See, for example, Notice 2000–9, 2000–1 C.B. 449 (reduced amount applied for a limited period of time in the case of failures due to investments in U.S. Treasury securities). See §601.601(d)(2) of this chapter.

Even with the proposed modification of §1.817–5(a)(2), the amount required to be paid to remedy an inadvertent failure to diversify remains the amount set forth in Rev. Proc. 92–25, section 4.02. The modification of §1.817–5(a)(2) will preserve flexibility, however, should the IRS choose to modify this amount by publication in the Internal Revenue Bulletin in response to comments on Notice 2007–15.

#### 2. Expansion of list of permitted investors under §1.817–5(f)(3).

On July 30, 2003, the Treasury Department and the IRS published a notice of

proposed rulemaking (REG-163974-02, 2003-2 C.B. 595) under section 817 in the **Federal Register** (68 FR 44689), proposing to remove a specific rule that applied to nonregistered partnerships for purposes of testing diversification. Written comments were received both on the proposed regulations and on the need for further guidance under section 817 more generally. Comments on the proposed regulations were taken into account in final regulations (T.D. 9185, 2005-1 C.B. 749) that were published March 1, 2005 in the **Federal Register** (70 FR 9869). Comments on section 817 more generally covered a broad range of issues. Two of those issues have since been addressed by revenue ruling. See Rev. Rul. 2005-7, 2005-1 C.B. 464 (concerning application of the look-through rule in the case of tiered regulated investment companies); Rev. Rul. 2007-7, 2007-7 I.R.B. 468 (February 12, 2007) (concluding that an interest held by a permitted investor is not treated as an interest held by the general public for purposes of Rev. Rul. 2003-92, 2003-2 C.B. 350).

These proposed regulations would expand the list of permitted investors in §1.817-5(f)(3) to include two categories of holders that were the subject of comments in 2003: (i) qualified tuition programs as defined in section 529, and (ii) trustees of pension or retirement plans established and maintained outside of the United States primarily for the benefit of individuals substantially all of whom are nonresident aliens.

Section 529 provides for the exemption from Federal income tax of qualified tuition programs. The term “*qualified tuition program*” means a program established and maintained by a state or agency or instrumentality thereof or by one or more eligible educational institutions (A) under which a person (i) may purchase tuition credits or certificates on behalf of a designated beneficiary which entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary, or (ii) in the case of a program established and maintained by a State or agency or instrumentality thereof, may make contributions to an account which is established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account, and

(B) which meets the other requirements of section 529(b).

The Treasury Department and the IRS agree with the 2003 commentators that permitting qualified tuition programs and certain trustees of foreign pension plans to own a beneficial interest in an investment company, partnership, or trust that is also owned by one or more segregated asset accounts would be consistent with the purpose and operation of section 817(h). In addition, neither qualified tuition programs nor the foreign pension plans that are described in the proposed regulations present the possibility of investment by the general public, as that term is used in Rev. Rul. 81-225, 1981-2 C.B. 12, and Rev. Rul. 2003-92. See also Rev. Rul. 2007-7. The inclusion of qualified tuition programs in the list of permitted investors in §1.817-5(f)(3) does not relieve those programs of the need to satisfy all requirements of section 529 and the regulations under that section. In particular, the inclusion of such programs does not imply that an investment in a single investment company, partnership, or trust satisfying the minimum diversification requirements of §1.817-5(b) would necessarily be treated as a permitted investment under section 529, whether as a “broad-based investment strategy” within the meaning of Notice 2001-55, 2001-2 C.B. 299, or otherwise. The Treasury Department and the IRS will continue to evaluate other comments received in this area for future guidance by publication in the Internal Revenue Bulletin.

Finally, the proposed regulations would expand the list of permitted investors in §1.817-5(f)(3) to include investment by an account which, pursuant to Puerto Rican law or regulation, is segregated from the general asset accounts of the life insurance company that owns the account, provided the requirements of section 817(d) and (h) are satisfied (without regard to the requirement that the account be segregated pursuant to “State” law or regulation). The Treasury Department and the IRS have received a number of requests for guidance interpreting the term “*variable contract*” to include a contract issued by a Puerto Rican company, based on accounts that are segregated under Puerto Rican law or regulation. One reason for these requests is to ensure that a beneficial interest held by a Puerto Rican company in an invest-

ment company, partnership, or trust does not prevent look-through treatment for the other holders of an interest in the same investment, company, partnership, or trust under §1.817-5(f)(2). The Treasury Department and the IRS believe that expanding the list of permitted investors as proposed would address this issue without implicating the interpretive question of what constitutes a “State” within the meaning of sections 817(d) and 7701(a)(10).

### **Proposed Effective Date**

The Treasury Department and the IRS intend these regulations to be effective on the date the 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, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

### **Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are timely submitted to the IRS. In addition to comments on the proposed regulations more generally, the Treasury Department and the IRS specifically request comments on (i) the clarity of the proposed regulations and how they can be made easier to understand; and (ii) whether rules similar to those proposed to apply to accounts that are segregated pursuant to Puerto Rican law or regulation should apply to accounts that are segregated pursuant to the laws or regulations of other territories.

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

#### Drafting Information

The principal author of these proposed regulations is James Polfer, Office of the Associate Chief Counsel (Financial Institutions and Products), Internal Revenue Service. However, personnel from other offices of the Treasury Department and the IRS participated in their development.

\* \* \* \* \*

#### Proposed Amendments to the Regulations

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

#### PART 1—INCOME TAX

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

Authority: 26 U.S.C. 7805 \* \* \*  
Section 1.817-5 also issued under 26 U.S.C. 817(h). \* \* \*  
Par. 2. Section 1.817-5 is amended as follows:

1. The last sentence of paragraph (a)(2)(iii) is removed.
2. Paragraph (f)(3)(iii) is revised.
3. Paragraph (f)(3)(iv) is redesignated as paragraph (f)(3)(vii).
4. New paragraphs (f)(3)(iv) through (vi) are added.

The revisions and additions read as follows:

#### *§1.817-5 Diversification requirements for variable annuity, endowment, and life insurance contracts.*

\* \* \* \* \*

- (f) \* \* \*
  - (3) \* \* \*
    - (iii) Held by the trustee of a qualified pension or retirement plan;
    - (iv) Held by a qualified tuition program as defined in section 529;
    - (v) Held by the trustee of a pension plan established and maintained outside of the United States, as defined in section 7701(a)(9), primarily for the benefit of

individuals substantially all of whom are nonresident aliens, as defined in section 7701(b)(1)(B);

(vi) Held by an account which, pursuant to Puerto Rican law or regulation, is segregated from the general asset accounts of the life insurance company that owns the account, provided the requirements of section 817(d) and (h) are satisfied. Solely for purposes of this paragraph (f)(3)(vi), the requirement under section 817(d)(1) that the account be segregated pursuant to State law or regulation shall be disregarded; or  
\* \* \* \* \*

Kevin M. Brown,  
Deputy Commissioner for  
Services and Enforcement.

(Filed by the Office of the Federal Register on July 30, 2007, 8:45 a.m., and published in the issue of the Federal Register for July 31, 2007, 72 FR. 41651)

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

## Announcement 2007-72

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

person to practice before the Internal Revenue Service during a period of suspension, disbarment, or ineligibility of such other person.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify persons to whom these restrictions apply, the Director, Office of Professional Responsibility, will announce in the Internal Revenue Bulletin

their names, their city and state, their professional designation, the effective date of disciplinary action, and the period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks.

# Reinstatement To Practice Before the Internal Revenue Service

Under Title 31, Code of Federal Regulations, Part 10, The Director, Office of Professional Responsibility, may entertain a petition for reinstatement for any attor-

ney, certified public accountant, enrolled agent, or enrolled actuary censured, suspended, or disbarred, from practice before the Internal Revenue Service.

The following individuals' eligibility to practice before the Internal Revenue Service has been restored:

Name	Address	Designation	Date of Reinstatement
Mollo, Charles W.	Anaheim, CA	EA	December 1, 2004
Price, Richard A.	Novato, CA	CPA	April 29, 2005
Reyes, Ruperto D.	Placentia, CA	CPA	December 8, 2005
Schwartz, Kenneth J.	West Hills, CA	Attorney	February 28, 2006
McCarthy III, William P.	Sacramento, CA	EA	March 10, 2006
Deen, Mae T.	Salinas, CA	EA	April 16, 2006
Banks, Jean R.	Van Nuys, CA	EA	December 6, 2006
Eckstein, Matthew	Woodbury, NY	CPA	March 14, 2007
Cunningham, William	Philadelphia, PA	CPA	March 31, 2007
Ganz, Sheldon M.	Great Neck, NY	CPA	April 19, 2007
Smith, Sean M.	Kensington, MD	Enrolled Agent	April 27, 2007
Frascella, Russell B.	Pound Ridge, NY	CPA	April 27, 2007
Lamont, Alice	Atlanta, GA	CPA	May 4, 2007
Carroccio, Ronald P.	Staten Island, NY	CPA	May 15, 2007
Cohen, Ronald J.	Cornwall, NY	Attorney	June 21, 2007
Troese, Jr., Henry A.	Clarion, PA	Enrolled Agent	June 25, 2007
Jacob, Robert T.	Tucson, AZ	Enrolled Agent	June 27, 2007
Simontacchi, Joseph F.	Rockaway, NJ	CPA	July 3, 2007
Kimes, Larry W.	Irving, TX	CPA	July 6, 2007

# Consent Suspensions From Practice Before the Internal Revenue Service

Under Title 31, Code of Federal Regulations, Part 10, an attorney, certified public accountant, enrolled agent, or enrolled actuary, in order to avoid the institution or conclusion of a proceeding for his or her disbarment or suspension from practice before the Internal Revenue Service,

may offer his or her consent to suspension from such practice. The Director, Office of Professional Responsibility, in his discretion, may suspend an attorney, certified public accountant, enrolled agent, or enrolled actuary in accordance with the consent offered.

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

Name	Address	Designation	Date of Suspension
Caplan, Howard A.	Ocean, NJ	CPA	Indefinite from April 1, 2007
Tow, Marc R.	Newport Beach, CA	Attorney	Indefinite from April 1, 2007
Pyburn, Richard E.	Downers Grove, IL	CPA	Indefinite from April 9, 2007
Cook, Jack D.	South Haven, MI	CPA	Indefinite from April 17, 2007
Serban, Daniel E.	Roanoke, IN	Attorney	Indefinite from April 19, 2007
Wentz, Debora B.	Newton, NC	CPA	Indefinite from April 19, 2007
Ferguson, Duane F.	Upland, CA	CPA	Indefinite from May 1, 2007
Mulrey, Robert M.	Milton, MA	CPA	Indefinite from May 1, 2007
Colasuonno, Philip V.	New Rochelle, NY	CPA	Indefinite from May 23, 2007
Bankston, David A.	Land O Lakes, FL	CPA	Indefinite from June 1, 2007
Nagy, Robert J.	Charleston, SC	CPA	Indefinite from June 1, 2007
Wallen, David G.	Beckley, WV	CPA	Indefinite from June 15, 2007

Name	Address	Designation	Date of Suspension
Rudick, Josephine M.	Bear Creek, PA	Enrolled Agent	Indefinite from June 25, 2007
Iglesias, Jorge E.	Roswell, GA	CPA	Indefinite from July 1, 2007
Raimer, Russell B.	Brecksville, OH	CPA	Indefinite from July 1, 2007
Stancukas, Stanley J.	Forth Worth, TX	CPA	Indefinite from July 1, 2007

## Expedited Suspensions From Practice Before the Internal Revenue Service

Under Title 31, Code of Federal Regulations, Part 10, the Director, Office of Professional Responsibility, is authorized to immediately suspend from practice before the Internal Revenue Service any practitioner who, within five years from the date

the expedited proceeding is instituted (1) has had a license to practice as an attorney, certified public accountant, or actuary suspended or revoked for cause or (2) has been convicted of certain crimes.

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

Name	Address	Designation	Date of Suspension
Barach, Malcolm J.	Brookline, MA	Attorney	Indefinite from March 9, 2007
Cox, Marlisa R.	Oklahoma City, OK	CPA	Indefinite from April 2, 2007
Artis, Paris A.	Newberry, FL	Attorney	Indefinite from April 13, 2007
Blackadar, Christine M.	Center Harbor, NH	Attorney	Indefinite from April 13, 2007
Brelje, Brian J.	Laguna Beach, CA	CPA	Indefinite from April 13, 2007
Decker, Craig A.	Mesa, AZ	Attorney	Indefinite from April 13, 2007
House, Stephen M.	Nevada City, CA	CPA	Indefinite from April 13, 2007

Name	Address	Designation	Date of Suspension
Laird, James J.	San Ramon, CA	CPA	Indefinite from April 13, 2007
Milner, Dennis V.	Dublin, CA	Attorney	Indefinite from April 13, 2007
Nutt, Jeremy C.	Forth Worth, TX	Attorney	Indefinite from April 13, 2007
Picl, Frank M.	Peoria, IL	Attorney	Indefinite from April 13, 2007
Britt, Jerry U.	Mount Olive, NC	CPA	Indefinite from April 19, 2007
Lee, Janell M.	Oakland, CA	CPA	Indefinite from April 19, 2007
Baker, Sean W.	Elkridge, MD	Attorney	Indefinite from April 30, 2007
Brett, Stephen M.	York Beach, ME	Attorney	Indefinite from April 30, 2007
Donahue, Richard K.	Lowell, MA	CPA	Indefinite from April 30, 2007
Frank, Mack I.	Eunice, LA	Attorney	Indefinite from April 30, 2007
Leung, Elsie Y.	Pasadena, CA	CPA	Indefinite from April 30, 2007
Pearlman, Stephen E.	Dix Hills, NY	Attorney	Indefinite from April 30, 2007
Peer, Jameelah	Waimanalo, HI	Attorney	Indefinite from April 30, 2007
Riskowski, Patrick T.	Omaha, NE	Attorney	Indefinite from April 30, 2007
Schumacher, Mary M.	Dubuque, IA	Attorney	Indefinite from April 30, 2007

Name	Address	Designation	Date of Suspension
DeVaughn, Donald L.	Plainview, MN	Attorney	Indefinite from May 1, 2007
Waggle, Stephen L.	Los Banos, CA	CPA	Indefinite from May 24, 2007
Nefsky, Melvyn I.	Los Angeles, CA	CPA	Indefinite from June 11, 2007
Neuendorf, Louis E.	Sandwich, IL	Attorney	Indefinite from June 11, 2007
Thomas, Scott C.	Parker, CO	Attorney	Indefinite from June 11, 2007
Todd, Donald J.	South Holland, IL	CPA	Indefinite from June 11, 2007
Winrow, Wayne	Emeryville, CA	Attorney	Indefinite from June 11, 2007
Cannon, Todd R.	Florence, CO	Attorney	Indefinite from June 12, 2007
Hester, Karen H.	Overland Park, KS	Attorney	Indefinite from June 25, 2007
Denman, Dwight E.	Dallas, TX	Attorney	Indefinite from June 25, 2007
Korcan, Barry	Loretto, PA	CPA	Indefinite from June 25, 2007
Lloyd, Max C.	South Jordan, UT	CPA	Indefinite from June 25, 2007
White, Lanny R.	Lindon, UT	CPA	Indefinite from June 25, 2007
Bjorklund, Dennis A.	Coralville, IA	Attorney	Indefinite from June 28, 2007
Noel, Robert	Fairfield, CA	Attorney	Indefinite from June 28, 2007
Sanger, Susan L.	Greenwood Village, CO	Attorney	Indefinite from June 28, 2007

Name	Address	Designation	Date of Suspension
Shatzen, Robert S.	Beaverton, OR	Attorney	Indefinite from June 28, 2007
Stevenson, Albert D.	Olive Branch, MS	CPA	Indefinite from June 28, 2007
Van Beek, Andrea	Orange City, IA	Attorney	Indefinite from June 28, 2007
Sojcher, Stuart H.	Winchester, MA	Attorney	Indefinite from July 3, 2007
Estrada, Severo C.	San Jose, CA	CPA	Indefinite from July 3, 2007
Ferguson, Robert E.	Salt Point, NY	Attorney	Indefinite from July 3, 2007
Wickenkamp, Mary C.	Denison, TX	Attorney	Indefinite from July 3, 2007

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

Under Title 31, Code of Federal Regulations, Part 10, after notice and an opportunity for a proceeding before an ad-

ministrative law judge, the following individuals have been placed under suspension

from practice before the Internal Revenue Service:

Name	Address	Designation	Effective Date
Cettomai, Joseph W.	Rootstown, OH	CPA	Indefinite from April 19, 2007

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

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

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Name	Address	Designation	Effective Date
Haynes, Scott Y.	Valdosta, GA	CPA	March 19, 2007

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## Censure Issued by Consent

Under Title 31, Code of Federal Regulations, Part 10, in lieu of a proceeding being instituted or continued, an attorney, certified public accountant, enrolled agent, or enrolled actuary, may offer his or her consent to the issuance of a censure. Censure is a public reprimand. The following individuals have consented to the issuance of a Censure:

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Name	Address	Designation	Date of Censure
Lyons, John K.	Dingmans Ferry, PA	Attorney	April 4, 2007
Bowman, T. Hardie	Corpus Christi, TX	CPA	May 23, 2007
Kofford, Brian T.	Provo, UT	CPA	June 12, 2007

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## Resignations of Enrolled Agents

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

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Name	Address	Date of Resignation
Hancock, William H.	Plant City, FL	April 10, 2007

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# Definition of Terms

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

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

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

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

*Modified* is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A

and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

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

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

*Superseded* describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance

of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

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

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

## Abbreviations

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

A—Individual.  
Acq.—Acquiescence.  
B—Individual.  
BE—Beneficiary.  
BK—Bank.  
B.T.A.—Board of Tax Appeals.  
C—Individual.  
C.B.—Cumulative Bulletin.  
CFR—Code of Federal Regulations.  
CI—City.  
COOP—Cooperative.  
Ct.D.—Court Decision.  
CY—County.  
D—Decedent.  
DC—Dummy Corporation.  
DE—Donee.  
Del. Order—Delegation Order.  
DISC—Domestic International Sales Corporation.  
DR—Donor.  
E—Estate.  
EE—Employee.  
E.O.—Executive Order.

ER—Employer.  
ERISA—Employee Retirement Income Security Act.  
EX—Executor.  
F—Fiduciary.  
FC—Foreign Country.  
FICA—Federal Insurance Contributions Act.  
FISC—Foreign International Sales Company.  
FPH—Foreign Personal Holding Company.  
F.R.—Federal Register.  
FUTA—Federal Unemployment Tax Act.  
FX—Foreign corporation.  
G.C.M.—Chief Counsel's Memorandum.  
GE—Grantee.  
GP—General Partner.  
GR—Grantor.  
IC—Insurance Company.  
I.R.B.—Internal Revenue Bulletin.  
LE—Lessee.  
LP—Limited Partner.  
LR—Lessor.  
M—Minor.  
Nonacq.—Nonacquiescence.  
O—Organization.  
P—Parent Corporation.  
PHC—Personal Holding Company.  
PO—Possession of the U.S.  
PR—Partner.

PRS—Partnership.  
PTE—Prohibited Transaction Exemption.  
Pub. L.—Public Law.  
REIT—Real Estate Investment Trust.  
Rev. Proc.—Revenue Procedure.  
Rev. Rul.—Revenue Ruling.  
S—Subsidiary.  
S.P.R.—Statement of Procedural Rules.  
Stat.—Statutes at Large.  
T—Target Corporation.  
T.C.—Tax Court.  
T.D.—Treasury Decision.  
TFE—Transferee.  
TFR—Transferor.  
T.I.R.—Technical Information Release.  
TP—Taxpayer.  
TR—Trust.  
TT—Trustee.  
U.S.C.—United States Code.  
X—Corporation.  
Y—Corporation.  
Z—Corporation.

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