Internal Revenue
bulletin

Bulletin No. 2005-39
September 26, 2005

# 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. 2005–63, page 603.

**LIFO; price indexes; department stores.** The July 2005 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, July 31, 2005.

### Rev. Rul. 2005–64, page 600.

**Interaction of sections 469 and 4261.** This ruling describes the circumstances in which losses incurred by an individual who provides air transportation through a passthrough entity can qualify as passive losses under section 469 of the Code. In addition, this ruling describes the applicability of section 4261 to the amounts paid for the air transportation services.

### REG–133578–05, page 610.

Proposed regulations under section 162(k) of the Code provide guidance concerning which corporation is entitled to the deduction for applicable dividends under section 404(k) and also clarify that a payment in redemption of employer securities held by an ESOP is not deductible.

### Notice 2005–61, page 607.

This notice clarifies that employers that amend their cafeteria plans to provide a grace period for dependent care assistance may continue to rely on the safe harbor in Notice 89-111, 1989–2 C.B. 449, and report salary reduction amounts elected by an employee for a calendar year on Form W–2. Notice 89-111 amplified.

### Notice 2005–65, page 607.

The Department of Homeland Security issued a temporary waiver of the Jones Act as a result of Hurricane Katrina. The waiver permits foreign corporations to operate ships in the U.S. domestic trade to transport petroleum and refined petroleum products between U.S. ports for a limited period. The notice provides that the IRS will not challenge certain positions taken by foreign corporations operating ships pursuant to the waiver and by ships' nonresident alien crewmembers.

### Announcement 2005–66, page 613.

This announcement advises donee organizations of the release of new Form 1098–C, *Contributions of Motor Vehicles, Boats, and Airplanes*. The form is used by donee organizations to file with the IRS to satisfy the reporting requirements of new section 170(f)(12) of the Code. The form may also be used to furnish the donor of a qualified vehicle with a contemporaneous written acknowledgment.

## EMPLOYEE PLANS

### T.D. 9220, page 596.
### REG–122857–05, page 609.

Temporary and proposed regulations under section 408A of the Code provide guidance concerning the tax consequences of converting a non-Roth IRA annuity to a Roth IRA. The regulations affect individuals establishing Roth IRAs, beneficiaries under Roth IRAs, and trustees, custodians and issuers of Roth IRAs.

**(Continued on the next page)**

**Finding Lists begin on page ii.**
**Index for July through September begins on page v.**

Department of the Treasury
Internal Revenue Service

### T.D. 9223, page 591.

Final regulations under section 402 of the Code address the amount includible in a distributee's income when life insurance contracts are distributed by a qualified retirement plan and also address the treatment of property sold by a qualified retirement plan to a plan participant or beneficiary for less than fair market value. The regulations also provide guidance regarding the amounts includible in income when an employee is provided permanent benefits in combination with group-term life insurance or when a life insurance contract is transferred in connection with the performance of services.

### REG–133578–05, page 610.

Proposed regulations under section 162(k) of the Code provide guidance concerning which corporation is entitled to the deduction for applicable dividends under section 404(k) and also clarify that a payment in redemption of employer securities held by an ESOP is not deductible.

### Notice 2005–60, page 606.

**Minimum funding standards; disaster relief.** The Internal Revenue Service, the Employee Benefits Security Administration of the Department of Labor, and the Pension Benefit Guaranty Corporation are providing relief in connection with certain employee benefit plans because of damage in Louisiana, Mississippi, and Alabama caused by Hurricane Katrina. The relief provided by this notice is in addition to the relief already provided by the Service to victims of Hurricane Katrina.

## EXEMPT ORGANIZATIONS

### Announcement 2005–66, page 613.

This announcement advises donee organizations of the release of new Form 1098–C, *Contributions of Motor Vehicles, Boats, and Airplanes*. The form is used by donee organizations to file with the IRS to satisfy the reporting requirements of new section 170(f)(12) of the Code. The form may also be used to furnish the donor of a qualified vehicle with a contemporaneous written acknowledgment.

## EXCISE TAX

### Rev. Rul. 2005–64, page 600.

**Interaction of sections 469 and 4261.** This ruling describes the circumstances in which losses incurred by an individual who provides air transportation through a passthrough entity can qualify as passive losses under section 469 of the Code. In addition, this ruling describes the applicability of section 4261 to the amounts paid for the air transportation services.

### T.D. 9221, page 604.

Final regulations under section 4291 of the Code provide guidance for collectors of communications excise taxes under section 4251 and excise taxes on amounts paid for taxable transportation under sections 4261 and 4271. These regulations clarify the time by which collectors must report refusals to pay or other failures to collect these excise taxes.

## ADMINISTRATIVE

### Announcement 2005–68, page 613.

This document contains corrections to proposed regulations (REG–108524–00, 2005–23 I.R.B. 1209) under section 1446 of the Code relating to the circumstances under which a partnership may take partner-level deductions and losses into account in computing its withholding tax obligation with respect to a foreign partner's allocable share of effectively connected taxable income.

# 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 402.—Taxability of Beneficiary of Employees' Trust

*26 CFR 1.402(a)–1: Taxability of beneficiary under a trust which meets the requirements of section 401(a).*

## T.D. 9223

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

## Value of Life Insurance Contracts When Distributed From a Qualified Retirement Plan

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

**ACTION**: Final regulations.

**SUMMARY**: This document contains final regulations under section 402(a) of the Internal Revenue Code regarding the amount includible in a distributee's income when life insurance contracts are distributed by a qualified retirement plan and regarding the treatment of property sold by a qualified retirement plan to a plan participant or beneficiary for less than fair market value. This document also contains final regulations under sections 79 and 83 of the Internal Revenue Code regarding the amounts includible in income when an employee is provided permanent benefits in combination with group-term life insurance or when a life insurance contract is transferred in connection with the performance of services. These regulations will affect administrators of, participants in, and beneficiaries of qualified retirement plans. These regulations will also affect employers who provide permanent benefits in combination with group-term life insurance for their employees and employees who receive those permanent benefits, as well as service recipients who transfer life insurance contracts to service providers in connection with the performance of services, and service providers to whom those life insurance contracts are transferred.

**DATES**: These regulations are effective August 29, 2005.

**FOR FURTHER INFORMATION CONTACT**: Concerning the section 79 regulations, Betty Clary at (202) 622–6080; concerning the section 83 regulations, Robert Misner at (202) 622–6030; concerning the section 402 regulations, Bruce Perlin or Linda Marshall at (202) 622–6090 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION**:

**Background**

**A. In General**

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 402(a) of the Internal Revenue Code (Code) relating to the amount includible in a distributee's income when a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection is distributed by a retirement plan qualified under section 401(a), and relating to the sale of property by a qualified retirement plan to a plan participant or beneficiary for less than the fair market value of the property. This document also contains amendments to the regulations under sections 79 and 83 relating, respectively, to permanent benefits that are provided to employees in combination with group-term life insurance, and to life insurance contracts that are transferred in connection with the performance of services.

Section 402(a) generally provides that any amount actually distributed to any distributee by any employees' trust described in section 401(a) which is exempt from tax under section 501(a) is taxable to the distributee in the taxable year of the distributee in which distributed, in accordance with section 72. Distributions from a qualified employees' trust generally are subject to withholding and reporting requirements pursuant to section 3405 and regulations thereunder. Section 1.402(a)–1(a)(1)(iii) provides, in general, that a distribution of property by a section 401(a) plan is taken into account by the distributee at its *fair market value*. Prior to its amendment by this Treasury decision, §1.402(a)–1(a)(2) (which was originally published in 1956) provided, in general, that upon the distribution of a life insurance contract, the "entire cash value" of the contract must be included in the distributee's income.[1] Section 1.402(a)–1(a) did not define *fair market value* or *entire cash value*, and questions have arisen regarding the interaction between these two provisions and regarding whether the term *entire cash value* includes a reduction for surrender charges.

On April 30, 1975, proposed regulations under section 402 regarding the taxation of certain lump sum distributions from qualified plans (the 1975 proposed regulations) were published in the **Federal Register** (40 FR 18798) to reflect changes to section 402 made by the Employee Retirement Income Security Act of 1974 (ERISA) (Public Law 93–406, 88 Stat. 829). Under §1.402(a)–1(a)(2) of the 1975 proposed regulations, the distribution of an annuity contract must be treated as a lump sum distribution under section 402(e) for purposes of determining the separate tax imposed under section 402(e)(1)(A),[2] even if the distribution of the annuity contract itself is not currently taxable. The 1975 proposed regulations also expanded the situations in which the distribution of a retirement income, endowment, or other life insurance contract is not currently taxable to include the situation where, within 60 days after the distribution of such contract, the contract is treated as a rollover contribution under

[1] Section 1.402(a)–1(a)(2) also provides rules regarding the taxation of the distribution of an annuity contract. In certain cases, the distribution of an annuity contract is not includible in the participant's gross income until distributions are made from the annuity contract.

[2] The tax imposed under section 402(e)(1)(A), as in effect at the time of the 1975 proposed regulations, generally was based on 10-year averaging of the tax otherwise payable with respect to a lump-sum distribution.

section 402(a)(5), as in effect after December 31, 1973.

Section 79 generally requires that the cost of group-term life insurance coverage provided by an employer on the life of an employee that is in excess of $50,000 of coverage be included in the income of the employee. Pursuant to §1.79–1(b), under specified circumstances, group-term life insurance may be combined with other benefits, referred to as permanent benefits. A permanent benefit is defined in §1.79–0 as an economic value extending beyond one policy year (for example, a paid-up or cash surrender value) that is provided under a life insurance policy. Section 1.79–0 further provides that certain features are not permanent benefits, including: (a) a right to convert (or continue) life insurance after group life insurance coverage terminates, (b) any other feature that provides no economic benefit (other than current insurance protection) to the employee, and (c) a feature under which term life insurance is provided at a level premium for a period of five years or less.

Permanent benefits provided to an employee are subject to taxation under rules described in §1.79–1(d). Under those rules, the cost of the permanent benefits, reduced by the amount paid for those benefits by the employee, is included in the employee's income. Section 1.79–1(d) provides that the cost of the permanent benefits cannot be less than an amount determined under a formula set forth in the regulations. Prior to its amendment by this Treasury decision, §1.79–1(d) provided that one of the factors used in the formula for determining the cost of permanent benefits was "the net level premium reserve at the end of that policy year for all benefits provided to the employee by the policy or, if greater, the cash value of the policy at the end of that policy year."

Section 83(a) generally provides that when property is transferred to any person in connection with the performance of services, the service provider must include in gross income (as compensation income) the excess of the fair market value of the property over the amount (if any) paid for the property. For this purpose, the fair market value of the property is determined without regard to lapse restrictions and is determined at the first time that the transferee's rights in the property are either transferable or not subject to a substantial risk of forfeiture. Prior to its amendment by this Treasury decision, §1.83–3(e) generally provided that in the case of "a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, only the cash surrender value of the contract is considered to be property."

In T.D. 9092, 2003–2 I.R.B. 1055, published in the **Federal Register** on September 17, 2003 (68 FR 54336), relating to split-dollar life insurance arrangements, §1.83–3(e) was amended to add the following sentence: "Notwithstanding the previous sentence, in the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, or any undivided interest therein, that is part of a split-dollar life insurance arrangement (as defined in §1.61–22(b)(1) or (2)) that is entered into, or materially modified (within the meaning of §1.61–22(j)(2)), after September 17, 2003, the policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed), other than current life insurance protection, are treated as property for purposes of this section."

The prohibited transaction provisions of ERISA generally prohibit various transactions between plans covered by Title I of ERISA and certain parties in interest (including plan participants) with respect to such plans. Specifically, unless an exemption from the prohibited transaction rules applies, sections 406(a)(1)(A) and (D) of ERISA provide that a fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect sale or exchange, or leasing, of any property between the plan and a party in interest; or transfer to, or use by or for the benefit of, a party in interest of any assets of the plan. Accordingly, unless a statutory or administrative exemption is applicable, the prohibited transaction rules are applicable to the sale of a life insurance contract, or annuity contract, by a plan to a party in interest.

Section 4975 of the Code sets forth parallel rules that impose excise taxes on the amount involved with respect to prohibited transactions involving certain plans. The prohibited transaction provisions under section 4975, as well as the exemptions from the application of such rules, generally parallel the prohibited transaction provisions under Title I of ERISA.

Prohibited Transaction Exemption (PTE) 77–8 (1977–2 C.B. 425), subsequently amended and redesignated as Prohibited Transaction Exemption 92–6, was jointly issued in 1977 by the Department of Labor and the IRS to provide an exemption from the restrictions of sections 406(a) and 406(b)(1) and (b)(2) of ERISA and from the taxes imposed by sections 4975(a) and (b) of the Code for certain transactions. Under the exemption set forth in PTE 77–8 and PTE 92–6, an employee benefit plan is permitted to sell individual life insurance contracts and annuities for the cash surrender value of the contracts to certain specified parties, provided conditions are satisfied. Under PTE 77–8 and PTE 92–6, such specified parties are: (1) a plan participant insured under such policies, (2) a relative of such insured participant who is the beneficiary under the contract, (3) an employer any of whose employees are covered by the plan, or (4) another employee benefit plan.

The preamble to PTE 77–8 (citing Rev. Rul. 59–195, 1959–1 C.B. 18) noted that, for Federal income tax purposes, the value of an insurance policy is not the same as, and may exceed, its cash surrender value, and that a purchase of an insurance policy at its cash surrender value may therefore be a purchase of property for less than its fair market value. At the time PTE 77–8 was issued, the regulations under section 402 did not address the consequences of a sale of property by a section 401(a) plan to a plan participant or beneficiary for less than the fair market value of that property. In this regard, the preamble to PTE 77–8 stated that the Federal income tax consequences of such a bargain purchase was required to be determined in accordance with generally applicable Federal income tax rules but that any income realized by a participant or relative of such participant upon such a purchase under the conditions of PTE 77–8 would not be deemed a distribution from the plan to such participant for purposes of subchapter D of chapter 1 of subtitle A of the Internal Revenue Code (*i.e.*, sections 401 to 424 relating to qualified pension, profit-sharing, and stock bonus plans).

## B. The 2004 Proposed Regulations

In February 2004, the IRS issued proposed amendments to the regulations under section 402(a) (REG–126967–03, 2004–1 C.B. 566 [69 FR 7384]) to clarify that the requirement that a distribution of property be included in the distributee's income at fair market value is controlling in those situations where the regulations provided for the inclusion of the entire cash value of a retirement income, endowment, or other life insurance contract. The 2004 proposed regulations provided that the fair market value of a life insurance contract is determined taking into account the value of all rights under the contract, including any supplemental agreements thereto and whether or not guaranteed. The proposed regulations also provided that, if a qualified retirement plan transfers property to a plan participant or beneficiary for consideration that is less than the fair market value of the property, the transfer would be treated as a distribution by the plan to the participant or beneficiary to the extent the fair market value of the distributed property exceeds the value of the consideration received. Thus, under the proposed regulations, such a transfer would be treated as a distribution for purposes of applying the plan qualification requirements of section 401(a).

The 2004 proposed regulations also contained proposed amendments to existing regulations under section 83 to clarify that fair market value is also controlling with respect to a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection and thus all of the rights under the contract (including any supplemental agreements thereto and whether or not guaranteed) must be considered in determining that fair market value. The proposed regulations contained proposed amendments to §1.83–3(e), which generally apply the definition of property for new split-dollar life insurance arrangements to all situations subject to section 83 involving the transfer of life insurance contracts. The proposed regulations also contained proposed amendments to §1.79–(d) to replace the term "cash value" in the formula for determining the cost of permanent benefits with the term "fair market value."

## C. Determination of Fair Market Value

As noted under the heading *In General*, §1.402(a)–1(a)(1)(iii) does not define the term *fair market value*. In Rev. Rul. 59–195, the IRS addressed the determination of fair market value of a life insurance contract in situations similar to those in which an employer purchases and pays the premiums on an insurance policy on the life of one of its employees for several years and on which further premiums must be paid, and subsequently sells such policy. The IRS held that the value of such a policy for purposes of computing taxable gain to the employee in the year of purchase should be determined under the method of valuation prescribed in §25.2512–6 of the Gift Tax Regulations. Under this method, the value of such a policy is not its cash surrender value but the interpolated terminal reserve at the date of sale plus the proportionate part of any premium paid by the employer prior to the date of the sale which is applicable to a period subsequent to the date of the sale. Section 25.2512–6 also provides that if "because of the unusual nature of the contract such approximation is not reasonably close to the full value, this method may not be used." Thus, this method may not be used to determine the fair market value of an insurance policy where the reserve does not reflect the value of all of the relevant features of the policy.

Q&A–10 of Notice 89–25, 1989–1 C.B. 662, described a distribution from a qualified plan of a life insurance policy with a value substantially higher than the cash surrender value stated in the policy. The notice concluded that the practice of using cash surrender value as fair market value is not appropriate where the total policy reserves, including life insurance reserves (if any) computed under section 807(d), together with any reserves for advance premiums, dividend accumulations, etc., represent a much more accurate approximation of the policy's fair market value.

Since Notice 89–25 was issued, life insurance contracts have been marketed that are structured in a manner which results in a temporary period during which neither a contract's reserves nor its cash surrender value represent the fair market value of the contract. For example, some life insurance contracts may provide for large surrender charges and other charges that are not expected to be paid because they are expected to be eliminated or reversed in the future (under the contract or under another contract for which the first contract is exchanged), but this future elimination or reversal is not always reflected in the calculation of the contract's reserve. If such a contract is distributed prior to the elimination or reversal of those charges, both the cash surrender value and the reserve under the contract could significantly understate the fair market value of the contract. Thus, in some cases, it would not be appropriate to use either the net surrender value (*i.e.*, the contract's cash value after reduction for any surrender charges) or, because of the unusual nature of the contract, the contract's reserves to determine the fair market value of the contract. Accordingly, Q&A–10 of Notice 89–25 should not be interpreted to provide that a contract's reserves (including life insurance reserves (if any) computed under section 807(d), together with any reserves for advance premiums, dividend accumulations, etc.) are always an accurate representation of the contract's fair market value.

The IRS and Treasury recognized that taxpayers could have difficulty determining the fair market value of a life insurance contract for which the contract's reserves (including life insurance reserves (if any) computed under section 807(d), together with any reserves for advance premiums, dividend accumulations, etc.) are not an accurate representation of the contract's fair market value. Accordingly, the IRS issued Rev. Proc. 2004–16, 2004–1 C.B. 559), which provided interim rules under which the cash value (without reduction for surrender charges) of a life insurance contract distributed from a qualified plan may be treated as the fair market value of that contract, provided that certain requirements are satisfied. This safe harbor for determining fair market value was also available for purposes of sections 79 and 83.

## D. Comments and Public Hearing on the 2004 Proposed Regulations and Rev. Proc. 2004–16

The IRS received comments on the 2004 proposed regulations, and a public hearing was held on June 9, 2004. While none of the commentators objected to the proposed amendments to the regulations, a number of commentators raised concerns regarding the safe harbor formula for fair market value set forth in Rev. Proc. 2004–16. Several commentators recommended that final guidance provide more than one safe harbor for determining the fair market value of a policy and asserted that the safe harbor formulas under Rev. Proc. 2004–16 produce a value that is too high and does not reflect market realities. Suggestions were made that the interpolated terminal reserve (ITR) and tax reserve valuation methods under section 807(d) be used as alternatives to the interim safe harbor formula.

Some commentators claimed that the interim safe harbor provided by Rev. Proc 2004–16 was not usable for all types of life insurance policies. In particular, these commentators asserted that the formulas did not function well for traditional whole life policies. In addition, commentators were concerned about the possible double-counting of certain dividends under the formulas, and the fact that the formulas did not make an explicit adjustment for withdrawals or distributions, nor did they provide for any recognition of the possibility that a surrender charge would apply in the future.

**E. Rev. Proc. 2005–25 — Safe Harbors for Determining Fair Market Value**

After reviewing the comments to the prior guidance, the IRS and Treasury concluded that the safe harbor formulas in Rev. Proc. 2004–16 did not function well for certain types of traditional policies, and also should be revised to reflect a discount for the possibility that a surrender charge would apply in certain situations. Accordingly, Rev. Proc. 2005–25, 2005–17 I.R.B. 962, was issued to modify and supersede Rev. Proc. 2004–16 in order to make adjustments to the safe harbor formulas. These new safe harbor formulas replace the formulas in Rev. Proc. 2004–16 for distributions, sales, and other transfers made on or after February 13, 2004, and for permanent benefits provided on or after February 13, 2004. For all periods, including periods before May 1, 2005, taxpayers may rely on the safe harbors in Rev. Proc. 2005–25. In addition, for periods on or after February 13, 2004, and before May 1, 2005, taxpayers may rely on the safe harbors in Rev. Proc. 2004–16.

**Explanation of Provisions**

These final regulations retain the rules set forth in the 2004 proposed regulations under section 402(a) providing that the requirement that a distribution of property be included in the distributee's income at fair market value is controlling in those situations where the former regulations provided for the inclusion of the entire cash value of a retirement income, endowment, or other life insurance contract. Thus, these final regulations clarify that, in those cases where a qualified plan distributes a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, the fair market value of such a contract (*i.e.*, the value of all rights under the contract, including any supplemental agreements thereto and whether or not guaranteed) is generally included in the distributee's income, and not merely the entire cash value of the contract. However, these final regulations retain the rules from existing final regulations setting forth the situations under which a distribution of such a contract is not currently includible in income.

These final regulations also set forth a portion of the rules included in the 1975 proposed regulations. Under those rules, the distribution of an annuity contract must be treated as a lump sum distribution for purposes of determining the amount of tax under the 10-year averaging rule of section 402(e) (as in effect prior to the amendment by the Tax Reform Act of 1986, Public Law 99–514, 100 Stat. 2085), even if the distribution of the annuity contract itself is not currently taxable. The distribution of a retirement income, endowment, or other life insurance contract is not taxable in the situation where within 60 days after the distribution of such contract, the contract is treated as a rollover contribution under section 402(a)(5), as in effect after December 31, 1973. Although the final regulations reject the use of the term *entire cash value* as found in the 1975 proposed regulations, no inference should be made that other rules in the 1975 proposed regulations that have not been included in these final regulations have also been rejected.

These final regulations retain the rules provided in the 2004 proposed regulations that, if a qualified plan transfers property to a plan participant or beneficiary for consideration that is less than the fair market value of the property, the transfer is treated as a distribution under the plan to the participant or beneficiary to the extent the fair market value of the distributed property exceeds the value of the consideration. Thus, in contrast to the statement to the contrary in the preamble to PTE 77–8, these regulations provide that any bargain element in the sale is treated as a distribution under section 402(a). In addition, any such bargain element is treated as a distribution under the plan for all other purposes of the Code, including the qualification requirements of section 401(a). Thus, for example, this bargain element is treated as a distribution for purposes of applying the limitations on in-service distributions from certain qualified retirement plans and the limitations of section 415. The rule treating the bargain element in a sale as a distribution from a qualified plan applies to transfers that occur on or after August 29, 2005. For transfers before that date, the bargain element in the sale must be included in the plan participant's income under section 61. However, such a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection occurring before that date is deemed not to give rise to a distribution for purposes of applying the requirements of subchapter D of chapter 1 of subtitle A of the Code.

These final regulations also retain the rules set forth in the 2004 proposed regulations under sections 79 and 83 that clarify that fair market value is also controlling with respect to life insurance contracts under those sections and, thus, that all of the rights under the contract (including any supplemental agreements thereto and whether or not guaranteed) must be considered in determining that fair market value. These final regulations amend §1.79–1(d) to replace the term *cash value* in the formula for determining the cost of permanent benefits with the term *fair market value*. These final regulations also amend §1.83–3(e) generally to apply the definition of property for new split-dollar life insurance arrangements to all situations involving the transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection. Section 83(a) requires that the excess of the fair market value of the property over the amount paid for the property be included in income. The purpose of the changes to the regulations is to clarify that, unless specifically excepted from the definition of permanent benefits or fair market value, the value of all features of a life insurance policy providing an economic benefit to a service provider (including, for example, the value of a springing cash value feature) must be included in determining the employee's income.

These final regulations do not affect the relief granted by the provisions of Section IV, paragraph 4 of Notice 2002–8, 2002–1 C.B. 398, to the parties to any insurance contract that is part of a pre-January 28, 2002, split-dollar life insurance arrangement. Also, consistent with the effective date of the final split-dollar life insurance regulations at §1.61–22(j), these final regulations do not apply to the transfer of a life insurance contract which is part of a split-dollar life insurance arrangement entered into on or before September 17, 2003, and not materially modified after that date. However, taxpayers are reminded that, in determining the fair market value of property transferred under section 83, lapse restrictions (such as life insurance contract surrender charges) are ignored.

**Effective Date**

These regulations are effective August 29, 2005. The amendments to §1.402(a)–1(a) apply to any distribution of a retirement income, endowment, or other life insurance contract occurring on or after February 13, 2004. The amendment to §1.79–1 is applicable to permanent benefits provided on or after February 13, 2004. The amendment to §1.83–3(e) is applicable to any transfer occurring on or after February 13, 2004.

**Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. In addition, because no collection of information is imposed on small entities, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply, and therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

**Drafting Information**

The principal authors of these regulations are Bruce Perlin and Linda Marshall, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in the development of these regulations.

* * * * *

**Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. In §1.79–1, paragraph (d)(3) is revised to read as follows:

*§1.79–1 Group-term life insurance—general rules.*

* * * * *

(d) * * *

(3) *Formula for determining deemed death benefit*. The deemed death benefit (DDB) at the end of any policy year for any particular employee is equal to—

R/Y

where —

R is the net level premium reserve at the end of that policy year for all benefits provided to the employee by the policy or, if greater, the fair market value of the policy at the end of that policy year; and

Y is the net single premium for insurance (the premium for one dollar of paid-up, whole life insurance) at the employee's age at the end of that policy year.

* * * * *

Par. 3. In §1.83–3, paragraph (e), the fourth and fifth sentences are revised to read as follows:

*§1.83–3 Meaning and use of certain terms.*

* * * * *

(e) * * * In the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, or any undivided interest therein, the policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed), other than current life insurance protection, are treated as property for purposes of this section. However, in the case of the transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, which was part of a split-dollar arrangement (as defined in §1.61–22(b)) entered into (as defined in §1.61–22(j)) on or before September 17, 2003, and which is not materially modified (as defined in §1.61–22(j)(2)) after September 17, 2003, only the cash surrender value of the contract is considered to be property. * * *

* * * * *

Par. 4. Section 1.402(a)–1 is amended by:

1. Revising paragraph (a)(1)(iii).
2. Revising paragraph (a)(2).

The revisions read as follows:

*§1.402(a)–1 Taxability of beneficiary under a trust which meets the requirements of section 401(a).*

(a) * * *

(1) * * *

(iii) Except as provided in paragraph (b) of this section, a distribution of property by a trust described in section 401(a) and exempt under section 501(a) shall be taken into account by the distributee at its fair market value. In the case of a distribution of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, or any interest therein, the policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed) are included in determining the fair market value of the contract. In addition, in the case of a transfer of property that occurs on or after August 29, 2005, where a trust described in section 401(a) and exempt under section 501(a) transfers property to a plan participant or beneficiary in exchange for consideration and where the fair market value of the property transferred exceeds the value of the consideration, then the excess of the fair market value of the property transferred by the trust over the value of the consideration received by the trust is treated as a distribution to the distributee under the plan for all purposes under the Internal Revenue Code. Where such a transfer occurs before that date, the excess of the fair market value of the property transferred by the trust over the value of the consideration received by the trust is includible in the gross income of the participant or beneficiary under section 61. However, such a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection occurring before that date is not treated as a distribution for purposes of applying the requirements of subchapter D of chapter 1 of subtitle A of the Internal Revenue Code.

* * * * *

(2) If a trust described in section 401(a) and exempt under section 501(a) purchases an annuity contract for an employee and distributes it to the employee in a year in which the trust is exempt, and the contract contains a cash surrender value which may be available to an employee by surrendering the contract, such cash surrender value will not be considered income to the employee unless and until the contract is surrendered. For the rule as to nontransferability of annuity contracts issued after 1962, see §1.401–9(b)(1). For additional requirements regarding distributions of annuity contracts, see, *e.g.*, §§1.401(a)–20, Q&A–2, 1.401(a)(31)–1, Q&A–17, and 1.401(a)(9)–6, Q&A–4. However, the distribution of an annuity contract must be treated as a lump sum distribution for purposes of determining the amount of tax under the 10-year averaging rule of section 402(e) (as in effect prior to amendment by the Tax Reform Act of 1986, Public Law 99–514, 100 Stat. 2085). If, however, the contract distributed by such exempt trust is a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, the fair market value of the contract at the time of distribution must be included in the distributee's income in accordance with the provisions of section 402(a), except to the extent that, within 60 days after the distribution of the contract, all or any portion of such value is irrevocably converted into a contract under which no part of any proceeds payable on death at any time would be excludable under section 101(a) (relating to life insurance proceeds), or the contract is treated as a rollover contribution under section 402(c). If the contract distributed by such trust is a transferable annuity contract, or a retirement income, endowment, or other life insurance contract and such contract is not treated as a rollover contribution under section 402(c), then, notwithstanding the preceding sentence, the fair market value of the contract is includible in the distributee's gross income unless, within such 60 days, such contract is made nontransferable.

* * * * *

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

Approved August 9, 2005.

Eric Solomon,
*Acting Deputy Assistant Secretary for Tax Policy.*

(Filed by the Office of the Federal Register on August 26, 2005, 8:45 a.m., and published in the issue of the Federal Register for August 29, 2005, 70 F.R. 50967)

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## Section 408A.—Roth IRAs

*26 CFR 1.408A–4T: Converting amounts to Roth IRAs.*

## T.D. 9220

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

## Converting an IRA Annuity to a Roth IRA

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary Regulations.

SUMMARY: This document contains temporary regulations under section 408A of the Internal Revenue Code (Code). These temporary regulations provide guidance concerning the tax consequences of converting a non-Roth IRA annuity to a Roth IRA. These temporary regulations affect individuals establishing Roth IRAs, beneficiaries under Roth IRAs, and trustees, custodians and issuers of Roth IRAs. The text of these temporary regulations also serves as the text of proposed regulations (REG–122857–05) set forth in a notice of proposed rulemaking in this issue of the Bulletin.

DATES: *Effective Date*: These regulations are effective August 19, 2005.

*Applicability Date*: These regulations are applicable to any Roth IRA conversion where an annuity contract is distributed or treated as distributed from a traditional IRA on or after August 19, 2005.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Cathy A. Vohs, 202–622–6090.

SUPPLEMENTARY INFORMATION:

**Background**

*Roth IRAs and Conversions*

This document contains temporary regulations that amend the Income Tax Regulations (26 CFR part 1) under section 408A of the Code relating to Roth IRAs. Section 408A of the Code, which was added by section 302 of the Taxpayer Relief Act of 1997, Public Law 105–34 (111 Stat. 788), establishes the Roth IRA as a type of individual retirement plan, effective for taxable years beginning on or after January 1, 1998.

Under Code section 408A, a Roth IRA is treated like a traditional IRA with several significant exceptions. Like amounts held in traditional IRAs, amounts held in Roth IRAs generally are exempt from Federal income tax under Code section 408(e)(1). Likewise, contributions to traditional IRAs and Roth IRAs are subject to specific limitations.

The identifying characteristic of Roth IRAs is that all contributions are after-tax contributions, and qualified distributions are tax free. Thus, unlike certain contributions to traditional IRAs, which may be deductible, contributions to Roth IRAs cannot be deducted from gross income. Distributions from a traditional IRA are includable in gross income except to the extent attributable to a return of basis. However, qualified distributions from Roth IRAs are excludable from gross income. Under section 408A(d)(2), a qualified distribution from a Roth IRA is a distribution that is made: (1) at least 5 years after the account owner (or the account owner's spouse) made a Roth IRA contribution, and (2) after age 59½, after death, on account of disability, or for a first-time home purchase.

A taxpayer whose modified adjusted gross income for a year does not exceed $100,000 may convert an amount held in a non-Roth IRA (*i.e.*, a traditional IRA or SIMPLE IRA) to an amount held in a Roth IRA. This conversion requires taking into income the value of the non-Roth IRA being converted (to the extent the conversion is not a conversion of basis in the non-Roth IRA), essentially converting the value into an after-tax rollover contribution to the Roth IRA. A conversion may be accomplished by means of a rollover, trustee-to-trustee transfer, or account redesignation.

Regardless of the means used to convert, any amount converted from a non-Roth IRA to a Roth IRA is treated as distributed from the non-Roth IRA and rolled over to the Roth IRA. The conversion amount is generally includible in gross income for the year of the conversion under section 408(d)(1) and (2). In the case of a conversion involving property, the conversion amount generally is the fair market value of the property on the date of distribution or the date the property is treated as distributed from the traditional IRA.

Final regulations regarding Roth IRAs were published in the **Federal Register** on February 4, 1999 (T.D. 8816, 1999–1 C.B. 518 [64 FR 5597). Section 1.408A–4 provides rules relating to converting amounts from a traditional IRA to a Roth IRA. Section 1.408A–4, A–7, which sets forth the tax consequences of converting an amount held in a traditional IRA to a Roth IRA, provides that any amount that is converted to a Roth IRA is includible in gross income as a distribution according to the rules of section 408(d)(1) and (2) for the taxable year in which the amount is distributed or transferred from the traditional IRA.

Under A–1 of §1.408A–7, any amount converted from a non-Roth IRA to a Roth IRA is treated as a distribution for which a Form 1099-R, "*Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*" must be filed by the trustee maintaining the non-Roth IRA.

*Fair Market Value of Annuity Contracts*

Before the enactment of section 408A, the need to value an annuity contract as a result of distribution from a qualified plan or IRA rarely arose. The distribution of an annuity contract from a qualified plan or a traditional IRA is generally not a taxable event because, in most cases, the distributed annuity account contract continues to be subject to requirements necessary for tax deferral, *e.g.*, the annuity remains subject to the minimum distribution requirements of section 401(a)(9). In such a case, no amount is includible in income until amounts are actually distributed from the annuity contract. However, in certain situations, the Code provides that the fair market value of an individual retirement annuity is treated as a taxable distribution. For example, under section 408(e), the fair market value of the annuity is included in taxable income if the annuity ceases to be an individual retirement annuity because of violations of requirements set forth under that subsection.

Section 25.2512–6 of the Gift Tax Regulations provides rules regarding the valuation of certain life insurance contracts for gift tax purposes[1]. Under these rules, the value of a life insurance contract or of a contract for the payment of an annuity issued by a company regularly engaged in the selling of contracts of that character is established through the sale of the particular contract by the company, or through the sale by the company of comparable contracts. In addition, §25.2512–6 provides that, as the value of an insurance policy through sale of comparable contracts is not readily ascertainable when the gift is of a contract which has been in force for some time and on which further premium payments are to be made, the value may be approximated by adding to the interpolated terminal reserve at the date of the gift the proportionate part of the gross premium last paid before the date of the gift which covers the period extending beyond that date. If, however, because of the unusual nature of the contract, such approximation is not reasonably close to the full value, this method may not be used. Thus, this method may not be used to determine the fair market value of an insurance policy where the reserve does not reflect the value of all relevant features of the policy. These gift tax valuation rules also apply for purposes of commercial annuity contracts. See *Examples 1* and *2* of §25.2512–6. In addition, under §20.2031–8 of the Estate Tax Regulations, the same rules govern the valuation of such life insurance and commercial annuity contracts for estate tax purposes. See §§20.2031–7(b) and 20.2039–1(c).

Under A–12 of §1.401(a)(9)–6, an employee's entire interest under an annuity contract is the dollar amount credited to the employee or beneficiary under the contract plus the actuarial value of any additional benefits (such as survivor benefits in excess of the account balance) that will be provided under the contract. This rule requiring that the value of additional benefits under an annuity contract be included in the employee's entire interest, for purposes of determining the required minimum distribution under section 401(a)(9), is based on the general requirement that the fair market value of all assets must be reflected in valuing an account balance under a defined contribution plan. However, certain additional benefits may be disregarded for purposes of calculating the required minimum distribution, such as when there is a *pro-rata* reduction in additional benefits for a withdrawal and a guaranteed return of premiums upon death, to reflect the fact that distributions are being made to satisfy section 401(a)(9).

Rev. Proc. 2005–25, 2005–17 I.R.B. 962, provides safe harbor formulas that, if used to determine the value of a life insurance contact, retirement income contract, endowment contract, or other contract providing life insurance protection that is dis-

[1] In Rev. Rul. 59–195, 1959–1 C.B. 18, the IRS ruled that, in situations similar to those in which an employer purchases and pays the premiums on an insurance policy on the life of one of its employees and subsequently sells such policy, on which further premiums must be paid, the value of such policy for computing taxable gain in the year of purchase should be determined under the method of valuation prescribed in §25.2512–6 of the Gift Tax Regulations.

tributed or otherwise transferred from a qualified plan, will meet the definition of fair market value for purposes of applying the rules of section 402(a) (as well as sections 79, 83, and 402(b)).

**Explanation of Provisions**

These temporary regulations under section 408A clarify that, when a non-Roth individual retirement annuity is converted to a Roth IRA, the amount that is treated as distributed is the fair market value of the annuity contract on the date the annuity contract is converted. Similarly, when a non-Roth individual retirement account holds an annuity contract as an account asset and the account is converted to a Roth IRA, the amount that is treated as distributed with respect to the annuity contract is the fair market value of the annuity contract on the date the annuity contract is distributed or treated as distributed from the non-Roth IRA.

Some taxpayers and their advisers assert that the only amount includible in income as a distribution when a non-Roth individual retirement annuity is converted to a Roth IRA is the cash surrender value of the contract, even when the cash surrender value does not accurately reflect the fair market value of the contract. In particular, some advisers market a transaction in which taxpayers are encouraged to invest their non-Roth IRA funds in a single premium annuity contract with significant artificial penalties that apply in the first year (or years) of the contract if the annuity is surrendered, causing the annuity to have a low cash surrender value in the early years of the contract. Under this transaction, shortly after the annuity contract is purchased by the non-Roth IRA, the taxpayer converts the IRA to a Roth IRA. In such a case, the taxpayer asserts that the only amount includible in gross income as a result of the conversion is the low cash surrender value. This assertion is made even though the surrender penalties are unlikely to be paid because the taxpayers do not expect to surrender the contract during the early years. In this case, the taxpayers expect that the ultimate payments under the contract will be qualified distributions from the Roth IRA (*i.e.*, tax-exempt), and thus, they also expect the artificially depressed cash surrender value to be the only amount ever includible in gross income.

In another situation, a taxpayer purchases a non-Roth individual retirement variable annuity with a guaranteed minimum death benefit equal to the highest account value ever attained under the contract, adjusted for withdrawals. If an amount is withdrawn from the contract, the death benefit is reduced dollar for dollar (rather than a *pro-rata* reduction) by the amount of the withdrawal. Prior to the date of conversion, the annuity has a death benefit far in excess of the account value and the taxpayer withdraws from the IRA annuity all but a minimum account value that will keep the IRA annuity in force. Because the withdrawal reduces the guaranteed minimum death benefit on a dollar-for-dollar basis, the remaining death benefit will be significantly greater than the current account value, and accordingly, the current account value will not reflect the fair market value of the contract. For example, suppose such an individual retirement variable annuity has a guaranteed minimum death benefit of $200,000 with an account value of $100,000. The taxpayer withdraws $99,000 leaving a $1,000 account value and a $101,000 death benefit ($200,000 less $99,000). The taxpayer then converts the IRA annuity into a Roth IRA and takes the position that the $1,000 account value is the conversion amount even though the account value does not reflect the fair market value of the additional $100,000 that will be paid upon the taxpayer's death. In this case, the taxpayer expects that the entire benefit payment of $101,000 will be a qualified distribution from the Roth IRA (*i.e.*, tax-exempt), and thus, expects that the $1,000 account value on the date of conversion will be the only amount ever includible in gross income.

The IRS and Treasury Department have concluded that cash surrender value is not always an appropriate measure of fair market value with respect to non-Roth IRA annuities that are converted to Roth IRA annuities. Rather than use the cash surrender value as the basis for determining fair market value, these temporary regulations follow the gift tax regulations in providing that the fair market value of an individual retirement annuity is established by the premiums paid for such annuity if the conversion occurs soon after the annuity was purchased.

Under the temporary regulations, if the conversion occurs after the annuity contract has been in force for some time and no further premium payments are to be made, fair market value is determined through the sale by the company of comparable contracts. The temporary regulations further provide that, if the conversion occurs after the annuity contract has been in force for some time and future premium payments are to be made, fair market value is determined through an approximation that is based on the interpolated terminal reserve at the date of the conversion, plus the proportionate part of the gross premium last paid before the date of the conversion which covers the period extending beyond that date. However, if, because of the unusual nature of the contract, this approximation is not reasonably close to the full value, this method may not be used.

These temporary regulations also provide authority for the Commissioner to issue additional guidance regarding the fair market value of an individual retirement annuity, including formulas to be used for determining fair market value. The IRS and Treasury Department expect to issue additional guidance regarding the rules to be used in determining the fair market value of a non-Roth IRA annuity. It is anticipated that such guidance will be similar to the provisions of Rev. Proc. 2005–25, 2005–17 I.R.B. 962 (April 25, 2005), except that the adjustment for potential surrender charges, to the extent permitted, will not exceed 9 percent. It is also anticipated that such guidance will provide that in determining fair market value, the value of all additional benefits (such as guaranteed minimum death benefits) under the contract must be taken into account. The IRS and Treasury Department request comments regarding this anticipated guidance. The IRS and Treasury Department also request comments regarding whether the method used to calculate the fair market value of an annuity contract that is converted to a Roth IRA should also apply for purposes of the determining fair market value of an annuity contract under sections 408(e) and 401(a)(9). These comments may be submitted in conjunction with the comments submitted on the proposed regulations discussed below.

Proposed regulations regarding the determination of fair market value of an annuity contract are contained in this issue of the Bulletin. The preamble and text of these temporary regulations also serves as the preamble and text of the proposed regulations.

**Effective Date**

The temporary amendments to §1.408A–4 of the regulations are applicable to any Roth IRA conversion where an annuity contract is distributed or treated as distributed from a traditional IRA on or after August 19, 2005. No implication is intended concerning whether or not a rule to be adopted in these regulations is applicable law for taxable years ending before that date.

**Special Analyses**

It has been determined that these temporary 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 temporary regulations. For applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the notice of proposed rulemaking published in this issue of the Bulletin. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

**Drafting Information**

The principal author of these temporary regulations is Cathy A. Vohs of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in the development of these regulations.

* * * * *

**Adoption of Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

§1.408A–4T also issued under 26 U.S.C. 408A * * *

Par. 2. Section 1.408A–4 is amended by adding, in numerical order, Q–14 and A–14, to read as follows:

*§1.408A–4 Converting amounts to Roth IRAs.*

* * * * *

Q–14. [Reserved]. For further guidance, see §1.408A–4T, Q–14.

A–14. [Reserved]. For further guidance, see §1.408A–4T, A–14.

Par. 3. Section 1.408A–4T is added to read as follows:

*§1. 408A–4T Converting amounts to Roth IRAs.*

* * * * *

Q–14. What is the amount that is includable in income as a distribution when a conversion involves an annuity contract?

A–14. (a) *In general*. Notwithstanding §1.408–4(e), when part or all of a traditional IRA that is an individual retirement annuity described in section 408(b) is converted to a Roth IRA, for purposes of determining the amount includible in gross income as a distribution under §1.408A–4, A–7, the amount that is treated as distributed is the fair market value of the annuity contract on the date the annuity contract is converted. Similarly, when a traditional IRA that is an individual retirement account described in section 408(a) holds an annuity contract as an account asset and the traditional IRA is converted to a Roth IRA, for purposes of determining the amount includible in gross income as a distribution under §1.408A–4, A–7, the amount that is treated as distributed with respect to the annuity contract is the fair market value of the annuity contract on the date that the annuity contract is distributed or treated as distributed from the traditional IRA.

(b) *Determination of fair market value*—(1) *General rule*. For purposes of this A–14, the fair market value of an individual retirement annuity issued by a company regularly engaged in the selling of contracts of that character generally is established as follows—

(A) If the conversion occurs soon after the contract was sold and there have been no material changes in market conditions, the fair market value of the contract is established through the sale of the particular contract by the company (*i.e.*, the actual premiums paid for such contract);

(B) If the conversion occurs after the contract has been in force for some time and no further premium payments are to be made, the fair market value of the contract is established through the sale by the company of comparable contracts;

(C) If the conversion occurs after the contract has been in force for some time and future premium payments are to be made, the fair market value of the contract is established through an approximation that is based on the interpolated terminal reserve at the date of the conversion, plus the proportionate part of the gross premium last paid before the date of the conversion which covers the period extending beyond that date. However, if, because of the unusual nature of the contract, this approximation is not reasonably close to the full value, this method may not be used. Thus, this method may not be used to determine the fair market value of an annuity contract where the reserve does not reflect the value of all relevant features of the contract.

(2) *Additional guidance*. Additional guidance regarding the fair market value of an individual retirement annuity, including formulas to be used for determining fair market value, may be issued by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (See §601.601(d)(2)(ii)(b)).

(c) *Effective date*. The provisions of this A–14 are applicable to any conversion where an annuity contract is distributed or treated as distributed from a traditional IRA on or after August 19, 2005.

(d) *Definitions*. The definitions set forth in §1.408A–8 apply for purposes of this A–14.

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

Approved August 9, 2005.

Eric Solomon,
*Acting Deputy Assistant Secretary for Tax Policy.*

(Filed by the Office of the Federal Register on August 19, 2005, 8:45 a.m., and published in the issue of the Federal Register for August 22, 2005, 70 F.R. 48868)

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## Section 469.—Passive Activity Losses and Credits Limited

*26 CFR 1.469–1T: General rules (Temporary).*

If an individual provides air transportation services through a passthrough entity, may those services qualify as extraordinary personal services. See Rev. Rul. 2005-64, page 600.

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*26 CFR 1.469–1T: General rules.*
*(Also §§ 4261, 4262, 4291; 1.469–4, 1.469–5, 1.469–5T, 40.6011(a)–1.)*

**Interaction of sections 469 and 4261.** This ruling describes the circumstances in which losses incurred by an individual who provides air transportation through a passthrough entity can qualify as passive losses under section 469 of the Code. In addition, this ruling describes the applicability of section 4261 to the amounts paid for the air transportation services.

## Rev. Rul. 2005–64

ISSUES

(1) Whether the losses incurred by an individual who engages in an air transportation activity in the circumstances described below are passive losses within the meaning of § 469 of the Internal Revenue Code?

(2) Whether the amounts paid for the air transportation services described below are subject to the tax imposed by § 4261?

FACTS

*Situation 1*. *A* is the CEO and part owner of the closely held C corporation, *Corp1*. *A* participates in the activities of *Corp1* for more than 500 hours during the year. *A* is also the sole owner of *SCorp1*, an S corporation. *SCorp1*'s sole asset is an aircraft with a maximum certificated takeoff weight of more than six thousand (6,000) pounds. *SCorp1* leases the aircraft to *Corp1* to satisfy *Corp1*'s air transportation needs, but supplies neither the pilot necessary to operate the aircraft nor the crew necessary to maintain the aircraft. *Corp1* pays *SCorp1* only for the lease of the aircraft. *A* has incurred significant losses from the operation of *SCorp1*.

*Situation 2*. *B* is the CEO and part owner of the closely held C corporation, *Corp2*. *B* participates in the activities of *Corp2* for more than 500 hours during the year. *B* is also the sole owner of *SCorp2*, an S corporation. *SCorp2*'s sole asset is an aircraft with a maximum certificated takeoff weight of more than six thousand (6,000) pounds. *SCorp2* employs a pilot and crew to operate and maintain the aircraft. *Corp2* pays *SCorp2* a guaranteed monthly fee plus an additional amount for each flying hour. *Corp2* uses the aircraft to transport its employees throughout the continental United States. In the conduct of its air transportation activity, *SCorp2* usually supplies its own aircraft, but is solely responsible for the provision of alternative aircraft in the event that *SCorp2*'s aircraft is undergoing maintenance or is being provided to other customers. *SCorp2*'s activities include the provision of air transportation services to *Corp2*, including, but not limited to, the use of the aircraft, with pilot and crew, fuel, and food provided by *SCorp2*. *SCorp2* is the only air transportation business in which *B* is involved. Upon initiation of *SCorp2*'s business, *B* decided to group *B*'s activities conducted through *SCorp2* with *B*'s activities conducted through *Corp2* for purposes of § 1.469–4 of the Income Tax Regulations. *B* has incurred significant losses from the operation of *SCorp2*.

LAW AND ANALYSIS

Section 469(a) disallows passive activity losses and credits for the taxable year for individuals, estates, trusts, closely held C corporations, and personal service corporations. Section 469(c)(2) provides that, except as provided in § 469(c)(7) (concerning special rules for taxpayers engaged in real property businesses), the term passive activity includes any rental activity. Section 469(c)(4) provides that § 469(c)(2) shall be applied without regard to whether or not the taxpayer materially participates in the activity.

Section 469(j)(8) defines "rental activity" as any activity where payments are principally for the use of tangible property.

Section 1.469–1T(e)(1) of the temporary Income Tax Regulations provides in general that an activity is a passive activity of the taxpayer for a taxable year if and only if the activity: (i) is a trade or business activity (within the meaning of § 1.469–1T(e)(2)) in which the taxpayer does not materially participate for the taxable year; or (ii) a rental activity (within the meaning of § 1.469–1T(e)(3)), without regard to whether or to what extent the taxpayer participates in the activity.

Section 1.469–1T(e)(3)(i) provides in general that an activity is a rental activity for a taxable year if: (A) during the taxable year, tangible property held in connection with the activity is used by customers or held for use by customers; and (B) the gross income attributable to the conduct of the activity during the taxable year represents (or, in the case of an activity in which property is held for use by customers, the expected gross income from the conduct of the activity will represent) amounts paid or to be paid principally for the use of the tangible property (without regard to whether the use of the property by customers is pursuant to a lease or pursuant to a service contract or other arrangement that is not denominated a lease).

Section 1.469–1T(e)(3)(ii)(C) provides that an activity involving the use of tangible property is not a rental activity for a taxable year if for the taxable year extraordinary personal services (within the meaning of § 1.469–1T(e)(3)(v)) are provided by or on behalf of the owner of the property in connection with making the property available for use by customers (without regard to the average period of customer use).

Section 1.469–1T(e)(3)(v) provides that for purposes of § 1.469–1T(e)(3)(ii)(C), extraordinary personal services are provided in connection with making property available for use by customers only if the services provided in connection with the use of the property are performed by individuals, and the use by customers of the property is incidental to their receipt of the services. For example, the use by patients of a hospital's boarding facilities generally is incidental to their receipt of the personal services provided by the hospital's medical and nursing staff. Similarly, the use by students of a boarding school's dormitories generally is incidental to their receipt of the personal services provided by the school's teaching staff.

Section 1.469–1T(e)(3)(viii) provides several examples to illustrate the operation of § 1.469–1T(e)(3). In Example (1), the taxpayer is engaged in an activity of leasing photocopying equipment. The average period of customer use for the equipment exceeds 30 days. Pursuant to the lease agreements, skilled technicians employed by the taxpayer maintain the equipment and service malfunctioning equipment for no additional charge. Service calls occur frequently (three times per week on average) and require substantial labor. The value of the maintenance and repair services (measured by the cost to the taxpayer of employees performing these services) exceeds 50 percent of the amount charged for the use of the equipment. Under these facts, services performed by individuals are provided in connection with the use of the photocopying equipment, but the customers' use of the photocopying equipment is not incidental to their receipt of the services. Therefore, extraordinary personal services (within the meaning of § 1.469–1T(e)(3)(v)) are not provided in connection with making the photocopying equipment available for use by customers, and the activity is a rental activity.

In Example (3) of § 1.469–1T (e)(3)(viii), the taxpayer is engaged in an activity of transporting goods for customers. In conducting the activity, the taxpayer provides tractor-trailers to transport goods for customers pursuant to arrangements under which the tractor-trailers are selected by the taxpayer, may be replaced at the sole option of the taxpayer, and are operated and maintained by drivers and mechanics employed by the taxpayer. The average period of customer use for the tractor-trailers exceeds 30 days. Under these facts, the use of tractor-trailers by taxpayer's customers is incidental to their receipt of personal services provided by the taxpayer. Accordingly, the services performed in the activity are extraordinary personal services (within the meaning of § 1.469–1T(e)(3)(v)) and, under § 1.469–1T(e)(3)(ii)(C), the activity is not a rental activity.

Section 1.469–4 sets forth the rules for grouping a taxpayer's trade or business activities and rental activities for purposes of applying the passive activity loss and credit limitation rules of § 469. Section 1.469–4(a) further states that a taxpayer's activities include those conducted through C corporations that are subject to § 469, S corporations, and partnerships.

Section 1.469–4(b)(1) states that "trade or business activities" are activities, other than rental activities or activities that are treated under § 1.469–1T(e)(3)(vi)(B) as incidental to an activity of holding property for investment, that: (i) involve the conduct of a trade or business (within the meaning of § 162); (ii) are conducted in anticipation of the commencement of a trade or business; or (iii) involve research or experimental expenditures that are deductible under § 174 (or would be deductible if the taxpayer adopted the method described in § 174(a)). Section 1.469–4(b)(2) provides that "rental activities" are activities that constitute rental activities within the meaning of § 1.469–1T(e)(3).

Section 1.469–4(c)(1) states that one or more trade or business activities or rental activities may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of § 469. Section 1.469–4(c)(2) provides that a facts and circumstances test determines whether activities constitute an appropriate economic unit.

Section 1.469–4(c)(3) provides several examples that illustrate the application of § 1.469–4(c). In Example (2), Taxpayer *B*, an individual, is a partner in a business that sells non-food items to grocery stores (partnership *L*). *B* also is a partner in a partnership that owns and operates a trucking business (partnership *Q*). The two partnerships are under common control. The predominant portion of *Q*'s business is transporting goods for *L*, and *Q* is the only trucking business in which *B* is involved. Under § 1.469–4(c), *B* appropriately treats *L*'s wholesale activity and *Q*'s trucking activity as a single activity.

Section 1.469–4(d)(1) limits a taxpayer's ability to group a rental activity with a trade or business activity and § 1.469–4(d)(5)(ii) provides that an activity that a taxpayer conducts through a C corporation subject to § 469 may be grouped with another activity of the taxpayer, but only for purposes of determining whether the taxpayer materially or significantly participates in the other activity.

Section 1.469–5(f)(1) provides in general that any work done by an individual (without regard to the capacity in which the individual does the work) in connection with an activity in which the individual owns an interest at the time the work is done shall be treated as participation of the individual in the activity.

Section 1.469–5T(a) provides in general that an individual shall be treated, for purposes of § 469 and the regulations thereunder, as materially participating in an activity for the taxable year if and only if: (1) the individual participates in the activity for more than 500 hours during the year; (2) the individual's participation in the activity for the taxable year constitutes substantially all of the participation in the activity of all individuals (including individuals who are not owners of interests in the activity) for the year; (3) the individual participates in the activity for more than 100 hours during the taxable year, and the individual's participation in the activity is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year; (4) the activity is a significant participation activity (within the meaning of § 1.469–5T(c)) for the taxable year, and the individual's aggregate participation in all significant participation activities during the year exceeds 500 hours; (5) the individual materially participated in the activity (determined without regard to § 1.469–5T(a)(5)) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year; (6) the activity is a personal service activity (within the meaning of § 1.469–5T(d)), and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or (7) based on all of the facts and circumstances (taking into account the rules in § 1.469–5T(b)), the individual participates in the activity on a regular, continuous, and substantial basis during the year.

Section 4261(a) imposes a tax on the amount paid for taxable transportation of any person by air and § 4261(b) imposes a tax on the amount paid for each domestic segment of taxable transportation. Section 4262(a)(1) generally defines taxable transportation as including transportation by air which begins and ends in the

United States. Section 4262(d) provides that the term "transportation" includes layover or waiting time and movement of the aircraft in deadhead service. All amounts paid for air transportation service, including hourly, *per diem*, or monthly fees, are subject to the tax imposed by § 4261. Rev. Rul. 76–556, 1976–2 C.B. 354.

Under § 4261(d), the tax generally is paid by the person making payment for the air transportation service and § 4291 generally provides that the person receiving the payment is responsible for collecting the tax. Section 40.6011(a)–1(a)(3) of the Excise Tax Procedural Regulations provides that the person required to collect the tax must file the return.

If the owner of an aircraft leases it to others for the transportation of persons but retains possession, command, and control of the aircraft, the owner is furnishing taxable transportation within the meaning of § 4261. However, if the owner of the aircraft transfers the complete possession, command, and control of the aircraft, the owner is not engaging in a taxable transportation service, but is merely leasing the aircraft. Rev. Rul. 60–311, 1960–2 C.B. 341. If the owner of the aircraft employs the pilot and crew and provides their services with the aircraft, the owner is deemed to have the essential elements of possession, command, and control of the aircraft at all times, irrespective of the fact that the lessee may direct the pilot as to destination and other details concerning actual flights when using the aircraft. Rev. Rul. 76–394, 1976–2 C.B. 355.

*Situation 1*. In this situation, *SCorp1* holds an aircraft in connection with its activities, such aircraft is used by customers or held for use by customers, and the gross income attributable to the conduct of the activities represents an amount paid or to be paid principally for the use of the aircraft. Therefore, the activity conducted in *SCorp1* is a rental activity. Section 1.469–1T(e)(3)(i). Section 1.469–1T(e)(3)(ii)(C) does not alter this conclusion because there are no extraordinary personal services provided in connection with making the aircraft available to *Corp1* and because the use of the aircraft, rather than the provision of services, is the dominant element of the relationship between *SCorp1* and *Corp1*. *See Frank v. Commissioner*, T.C. Memo 1996–177 (1996) (holding that taxpayer's losses from its airplane leasing activities were passive because the services rendered to the lessee were not the dominant element of the relationship between the taxpayer and the lessee).

This ruling does not address whether § 1.469–4(d)(1), which limits a taxpayer's ability to group a rental activity with a trade or business activity, would prevent *A* from grouping the rental activity conducted through *SCorp1* with the trade or business activity conducted through *Corp1*. Even if such a grouping were permitted, however, § 1.469–4(d)(5)(ii) provides that a taxpayer can group activities conducted through a closely held C corporation with other activities of the taxpayer only for the purpose of establishing material or significant participation in the other activities. Consequently, grouping the activities *A* conducts through *Corp1* and *SCorp1* will not change the character of the activity *A* conducts through *SCorp1*. The activity will remain a rental activity because the grouping is only for purposes of establishing material or significant participation and will remain a passive activity because, under § 469(c)(4), material participation in rental activities does not change their passive nature. Accordingly, the losses incurred by *A* through *SCorp1* are losses from a passive activity and are subject to the limitations of § 469.

*SCorp1* does not provide taxable transportation within the meaning of § 4262(a)(1) to *Corp1* because *SCorp1* does not retain possession, command and control of the aircraft; thus, the taxes imposed by § 4261 do not apply to amounts paid by *Corp1* to *SCorp1* for the lease of the aircraft.

*Situation 2*. In this situation, the services provided by *SCorp2* in connection with the use of the aircraft by *Corp2* are provided by individuals. In addition, the use of the aircraft by *Corp2* is incidental to *Corp2*'s receipt of the services provided, as the use of a seat on the aircraft is incidental to the passenger's receipt of the personal services provided by the aircraft's air transportation staff. Accordingly, extraordinary personal services within the meaning of § 1.469–1T(e)(3)(v) are provided on behalf of the owner of the aircraft in connection with making the aircraft available for use by customers. Therefore, the activity *B* conducts through *SCorp2* is not a rental activity for purposes of § 469. Section 1.469–1T(e)(3)(ii)(C).

Pursuant to § 1.469–1T(e)(1)(i), the air transportation activity is not a passive activity if *B* materially participates in the activity. In this situation, *Corp2* and *SCorp2* are under common control, the predominant portion of *SCorp2*'s air transportation service business is transporting executives for *Corp2*, and *SCorp2* is the only air transportation service business in which *B* is involved. *B* has consistently chosen to group the activity conducted through *SCorp2* with *Corp2*'s trade or business activity and to treat those activities as a single activity for the measurement of material participation in the activity of *SCorp2*. Section 1.469–4(c)(1) and (c)(3), Example (2). Because *B* participates for more than 500 hours in the *Corp2* activity that is grouped with the activity conducted through *SCorp2* for purposes of measuring material participation in the *SCorp2* activity, *B* materially participates in the *SCorp2* activity under § 1.469–5T(a)(1). Accordingly, the provision of air transportation services is not a passive activity, and losses incurred by *B* through *SCorp2* are not subject to the limitations of § 469. If, however, *B* did not participate in *Corp 2* for more than 500 hours and did not otherwise materially participate in the grouped activities, the losses incurred by *B* through *SCorp2* would be subject to the passive loss limitations of § 469.

*SCorp2* provides taxable transportation service to *Corp2* because *SCorp2* retains possession, command and control of the aircraft; thus, the taxes imposed by § 4261 apply to the amounts paid (including monthly and hourly fees) by *Corp2* to *SCorp2* for the taxable transportation. *Corp2* is liable for the tax and *SCorp2* is responsible for collecting the § 4261 taxes and filing the return.

HOLDINGS

(1) In *Situation 1*, *A*'s activities conducted through *SCorp1* are rental activities, and therefore the losses incurred in the activities are passive losses subject to the limitations of § 469. In *Situation 2*, *B*'s activities conducted through *SCorp2* are not rental activities because extraordinary personal services are provided. Because *B* consistently grouped the activities conducted through *Corp2* and *SCorp2* for

purposes of measuring material participation in the activity of *SCorp2*, and participates in the *Corp2* activity for more than 500 hours a year, *B* materially participates in the *SCorp2* activity. Therefore, the losses incurred by *B* through *SCorp2* are not losses from a passive activity.

(2) In *Situation 1*, *Corp1* does not pay *SCorp1* for taxable transportation and § 4261 does not apply. In *Situation 2*, *Corp2* pays *SCorp2* for taxable transportation; therefore, § 4261 applies to the amount paid for the services.

DRAFTING INFORMATION

The principal author of the § 469 portion of this revenue ruling is Timothy J. Leska of the Office of Associate Chief Counsel (Passthroughs & Special Industries). The principal author of the § 4261 portion of this revenue ruling is Taylor Cortright of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this revenue ruling, contact Mr. Leska at (202) 622–3050 or Ms. Cortright at (202) 622–3130 (not toll-free calls).

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

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

**LIFO; price indexes; department stores.** The July 2005 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, July 31, 2005.

## Rev. Rul. 2005–63

The following Department Store Inventory Price Indexes for July 2005 were issued by the Bureau of Labor Statistics. The indexes are accepted by the Internal Revenue Service, under § 1.472–1(k) of the Income Tax Regulations and Rev. Proc. 86–46, 1986–2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, July 31, 2005.

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

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

| | Groups | July 2004 | July 2005 | Percent Change from July 2004 to July 2005[1] |
|---|---|---|---|---|
| 1. | Piece Goods | 507.8 | 495.0 | -2.5 |
| 2. | Domestics and Draperies | 525.0 | 517.7 | -1.4 |
| 3. | Women's and Children's Shoes | 608.5 | 629.0 | 3.4 |
| 4. | Men's Shoes | 831.7 | 867.0 | 4.2 |
| 5. | Infants' Wear | 560.5 | 548.0 | -2.2 |
| 6. | Women's Underwear | 508.0 | 541.2 | 6.5 |
| 7. | Women's Hosiery | 330.4 | 339.7 | 2.8 |
| 8. | Women's and Girls' Accessories | 565.8 | 580.5 | 2.6 |
| 9. | Women's Outerwear and Girls' Wear | 335.9 | 321.7 | -4.2 |
| 10. | Men's Clothing | 532.7 | 520.6 | -2.3 |
| 11. | Men's Furnishings | 567.0 | 552.6 | -2.5 |
| 12. | Boys' Clothing and Furnishings | 420.9 | 386.1 | -8.3 |
| 13. | Jewelry | 907.8 | 870.2 | -4.1 |
| 14. | Notions | 798.6 | 809.2 | 1.3 |
| 15. | Toilet Articles and Drugs | 993.3 | 997.1 | 0.4 |
| 16. | Furniture and Bedding | 616.3 | 599.1 | -2.8 |
| 17. | Floor Coverings | 587.7 | 609.8 | 3.8 |
| 18. | Housewares | 712.1 | 712.2 | 0.0 |
| 19. | Major Appliances | 199.6 | 203.5 | 2.0 |
| 20. | Radio and Television | 41.6 | 38.9 | -6.5 |
| 21. | Recreation and Education[2] | 80.3 | 77.9 | -3.0 |
| 22. | Home Improvements[2] | 129.8 | 137.6 | 6.0 |
| 23. | Automotive Accessories[2] | 112.7 | 115.1 | 2.1 |

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

| Groups | July 2004 | July 2005 | Percent Change from July 2004 to July 2005[1] |
|---|---|---|---|
| Groups 1–15: Soft Goods | 545.1 | 537.3 | -1.4 |
| Groups 16–20: Durable Goods | 382.3 | 379.6 | -0.7 |
| Groups 21–23: Misc. Goods[2] | 93.3 | 93.0 | -0.3 |
| Store Total[3] | 487.2 | 481.6 | -1.1 |

[1]Absence of a minus sign before the percentage change in this column signifies a price increase.

[2]Indexes on a January 1986 = 100 base.

[3]The store total index covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco and contract departments.

DRAFTING INFORMATION

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

## Section 4261.—Imposition of Tax

*26 CFR 49.4261–1: Imposition of tax; in general.*

If an individual provides air transportation services through a passthrough entity, may the amounts paid for those services be subject to tax. See Rev. Rul. 2005-64, page 600.

## Section 4291.—Cases Where Persons Receiving Payment Must Collect Tax

*26 CFR 49.4291–1: Persons receiving payment must collect tax.*

## T.D. 9221

## DEPARTMENT OF THE TREASURY
## Internal Revenue Service
## 26 CFR Parts 40 and 49

## Collected Excise Taxes; Duties of Collector

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations relating to the reporting obligations of persons that receive payments for air transportation or communications services subject to excise tax when persons liable for tax refuse to pay the tax. The final regulations affect persons that receive payments subject to tax and persons liable for those taxes.

DATES: *Effective Date*: These regulations are effective August 26, 2005.

*Applicability Date*: For dates of applicability, see §§40.6302(c)–3(g) and 49.4291–1.

FOR FURTHER INFORMATION CONTACT: Taylor Cortright, (202) 622–3130 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

**Background**

This document amends the Excise Tax Procedural Regulations (26 CFR part 40) and the Facilities and Services Excise Tax Regulations (26 CFR part 49). On August 10, 2004, a temporary regulation (T.D. 9149, 2004–38 I.R.B. 494 [60 FR 48393]) was published in the **Federal Register**. A notice of proposed rulemaking (REG–163909–02, 2004–38 I.R.B. 499 [69 FR 48432]) cross-referencing the temporary regulations was published in the **Federal Register** on the same day. A written comment was received and no public hearing was requested or held. After considering the comment, the proposed regulations are adopted by this Treasury decision with clarifying changes. The corresponding temporary regulations are removed.

**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, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue 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 their impact on small business.

**Drafting Information**

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

* * * * *

**Adoption of Amendments to the Regulations**

Accordingly, 26 CFR parts 40 and 49 are amended as follows:

PART 40—EXCISE TAX PROCEDURAL REGULATIONS

Paragraph 1. The authority citation for part 40 is amended by removing the entry for §40.6302(c)–3T to read, in part, as follows:

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

Par. 2. Section 40.6302(c)–3 is amended as follows:

1. Paragraph (b)(2)(ii) is revised.

2. Paragraph (g) is amended by removing the language "October 1, 2001" and adding the language "October 1, 2001, except that paragraph (b)(2)(ii)(B) of this section is applicable October 1, 2004" in its place.

The revision reads as follows:

*§40.6302(c)–3 Special rules for use of Government depositaries under chapter 33.*

* * * * *

(b) * * *

(2) * * *

(ii) *Separate account*. The account required under paragraph (b)(2)(i)(A) of this section (the separate account)—

(A) Must reflect for each month all items of tax that are included in amounts billed or tickets sold to customers during the month;

(B) May not reflect an item of adjustment for any month during a quarter if the adjustment results from a refusal to pay or inability to collect the tax and the uncollected tax has not been reported under §49.4291–1 of this chapter on or before the due date of the return for that quarter; and

(C) Must reflect for each month items of adjustment (including bad debts and errors) relating to the tax for prior months within the period of limitations on credits or refunds.

* * * * *

**§40.6302(c)–3T [Removed]**

Par. 3. Section 40.6302(c)–3T is removed.

PART 49—FACILITIES AND SERVICES EXCISE TAXES

Par. 4. The authority citation for part 49 continues to read, in part, as follows:

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

Par. 5. Section 49.4291–1 is amended as follows:

1. The fourth sentence is revised.

2. The fifth sentence is amended by removing the language "this information" and adding the language "this report" in its place.

3. A new sentence is added at the end of the paragraph.

4. Paragraphs (a) and (b) are added.

The revisions and addition read as follows:

*§49.4291–1 Persons receiving payment must collect tax.*

* * * Applicable October 1, 2004, this report must be made on or before the report due date. * * * For purposes of this section, the report due date is—

(a) In the case of a person using the alternative method of making deposits described in §40.6302(c)–3 of this chapter, the due date of the return on which the item of adjustment relating to the uncollected tax would be reflected if items of adjustment were determined without regard to the limitation in §40.6302(c)–3 of this chapter; and

(b) In any other case, the due date of the return on which the tax would have been reported but for the refusal to pay or inability to collect.

**§49.4291–1T [Removed]**

Par. 6. Section 49.4291–1T is removed.

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

Approved July 20, 2005.

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

(Filed by the Office of the Federal Register on August 24, 2005, 8:45 a.m., and published in the issue of the Federal Register for August 25, 2005, 70 F.R. 49869)

# Part III. Administrative, Procedural, and Miscellaneous

## Additional Relief for Certain Employee Benefit Plans as a Result of Hurricane Katrina

## Notice 2005–60

### I. PURPOSE

The Internal Revenue Service, the Department of Labor's Employee Benefits Security Administration ("EBSA") and the Pension Benefit Guaranty Corporation ("PBGC") are providing relief in connection with certain employee benefit plans because of damage caused by Hurricane Katrina ("Katrina"). The relief provided by this notice is in addition to the relief already provided by the Service and the PBGC to victims of Katrina.

### II. BACKGROUND

Section 412(a) of the Code and § 302(a) of the Employee Retirement Income Security Act of 1974, Pub. L. No. 93–406 ("ERISA") provide that, in order for a plan to meet the minimum funding standards of the Code and ERISA, the plan must not have an accumulated funding deficiency as of the end of each plan year. Section 412(c)(10) of the Code and § 302(c)(10) of ERISA provide that, for purposes of satisfying the minimum funding requirements of the Code and ERISA, any contributions for a plan year made by an employer by the end of the 8½-month period following the end of such plan year are deemed to have been made on the last day of the year.

Section 412(d) of the Code and § 303 of ERISA provide for waivers of the minimum funding requirements in the event of temporary substantial business hardship. In order for a plan other than a multiemployer plan to receive such a waiver, § 412(d)(4) of the Code and § 303(d)(1) of ERISA provide that an application for such a waiver must be submitted no later than the 15th day of the 3rd month beginning after the close of the plan year for which the waiver is sought. Thus, for example, in order for a plan to receive a waiver of the minimum funding requirements for the plan year ending on June 30, 2005, the sponsor of the plan must have submitted an application by September 15, 2005.

Section 412(m)(1) of the Code and § 302(e)(1) of ERISA require that, with respect to certain plans with a funded current liability percentage of less than 100 percent, a higher rate of interest be charged on any unpaid required quarterly installments. Section 412(m)(5) of the Code and § 302(e)(5) of ERISA increase the required quarterly installments to the amount needed to prevent a liquidity shortfall (as defined in those sections). For a plan with a calendar-year plan year, the due dates for the required installments for the 2005 calendar year are April 15, 2005, July 15, 2005, October 15, 2005, and January 15, 2006.

Section 412(n)(1) of the Code and § 302(f)(1) of ERISA provide that, with respect to certain plans with a funded current liability percentage of less than 100 percent, if the required installments or any other payment required under those sections are not made to the plan before the due date for such installment or other payment, and if the aggregate unpaid balance of such installments or other payments exceeds $1,000,000, then there shall be a lien in favor of the plan. The lien may be perfected by the PBGC.

Section 7508A(b) of the Code provides that, in the case of a pension or other employee benefit plan, or any sponsor, administrator, participant, beneficiary, or other person with respect to such plan, affected by a Presidentially declared disaster or a terroristic or military action, the Secretary of the Treasury may prescribe a period of up to 1 year which may be disregarded in determining the date by which any action is required or permitted to be completed. No plan shall be treated as failing to be operated in accordance with its terms solely because the plan disregards any period by reason of such relief. Parallel provisions are in Titles I and IV of ERISA.

Under the PBGC's premium regulations, contributions may be taken into account for determining a plan's unfunded vested benefits for a premium payment year or a plan's entitlement to the full funding limit exemption from the variable-rate premium for a premium payment year if the contributions (1) are for a plan year before the premium payment year and (2) are made on or before the earlier of (a) the due date for payment of the variable-rate premium or (b) the date the variable-rate premium is paid (29 CFR §§ 4006.4(b)(2)(iv) and 4006.5(a)(5)). In addition, there are Title IV reporting and disclosure requirements arising from certain late contributions (*e.g.*, 29 CFR § 4043.25, 29 CFR § 4011.10(b)(6)).

### III. RELIEF

For any plan that is affected by Katrina (an "Affected Plan"), if the date described in § 412(c)(10) or 412(m) of the Code and § 302(c)(10) or 302(e) of ERISA for making contributions falls within the period beginning on August 29, 2005, and ending on October 30, 2005, then the date such contributions must be made is postponed to October 31, 2005. If the date described in § 412(d)(4) of the Code and § 303(d)(1) of ERISA for applying for a waiver for an Affected Plan falls within the period beginning on August 29, 2005, and ending on October 30, 2005, then the date such waiver must be applied for is postponed to October 31, 2005.

For purposes of the notice, a plan is an Affected Plan only if any of the following were located at the time of Katrina in any of the parishes or counties declared by the President to be eligible for individual assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act of 1988, Pub. L. No. 93–288: the principal place of business of the employer that maintains the plan (in the case of a single-employer plan, determined disregarding the rules of § 414(b) and (c) of the Code); the principal place of business of employers that employ more than 50 percent of the active participants covered by the plan (in the case of a plan covering employees of more than one employer, determined disregarding the rules of § 414(b) and (c)); the office of the plan or the plan administrator; the office of the primary recordkeeper serving the plan; or the office of the enrolled actuary or other advisor that had been retained by the plan or the employer at the time of Katrina to determine the funding requirements for which the due date falls between the period beginning on August 29, 2005, and ending on October 30, 2005. For purposes of the preceding sentence, the term "office" includes only the worksite of those individuals, and the location of any records, necessary to determine the plan's funding requirements for the relevant period.

The following rule applies under Title IV of ERISA for purposes of determining a plan's unfunded vested benefits for a premium payment year or entitlement to the full funding limit exemption from the variable-rate premium for a premium payment year. For any plan for which this notice extends a date described in § 412(c)(10) of the Code and § 302(c)(10) of ERISA, contributions for any plan year before the premium payment year may be taken into account if they are made on or before the earlier of (1) the extended § 412(c)(10)/§ 302(c)(10) date under this notice or (2) the date of the plan's variable-rate premium filing (or, if applicable, amended variable-rate premium filing) for the premium payment year. In addition, for any plan for which this notice extends a date described in § 412(c)(10) of the Code and § 302(c)(10) of ERISA, contributions are treated as timely for purposes of any Title IV reporting and disclosure requirement if they are made on or before the extended § 412(c)(10)/§ 302(c)(10) date under this notice.

**DRAFTING INFORMATION**

The principal authors of this notice are Donna Prestia and Roger Kuehnle of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at 1–877–829–5500, between the hours of 8:30 a.m. and 6:30 p.m. Eastern Time, Monday through Friday (a toll-free number). Ms. Prestia may be reached at (202) 283–9543 (not a toll-free number).

## Reporting Requirements for Dependent Care Assistance Programs

## Notice 2005–61

PURPOSE

The purpose of this notice is to clarify the Form W–2 reporting requirements when an employer has amended a cafeteria plan document to provide a grace period for qualified dependent care assistance immediately following the end of a cafeteria plan year.

BACKGROUND AND APPLICATION

Notice 2005–42, 2005–23 I.R.B. 1204, modifies the application of the rule prohibiting deferred compensation under a cafeteria plan. That notice permits an employer to amend a cafeteria plan document to provide a grace period immediately following the end of each plan year during which unused benefits or contributions remaining at the end of the plan year, including contributions for dependent care assistance as described in § 129, may be used to pay or reimburse expenses incurred during the grace period.

Notice 89–111, 1989–2 C.B. 449, *amplified*, Notice 90–66, 1990–2 C.B. 350 (extending Notice 89–111 to years following 1989), provides guidance concerning the reporting requirements for dependent care assistance furnished by an employer to an employee under a qualified dependent care assistance program. The notice states that in a cash reimbursement arrangement, the amount reported on Form W–2, *Wage and Tax Statement*, is the total amount of cash reimbursement furnished to the employee during the calendar year. However, if the employer does not know the actual total amount of cash reimbursement at the time the Form W–2 is prepared, the employer may report a reasonable estimate of the total amount on Form W–2. Notice 89–111 states that for a salary reduction arrangement under a § 125 cafeteria plan, the amount electively contributed by an employee for the year for dependent care assistance (plus any employer matching contributions attributable thereto) will be considered a reasonable estimate.

An employer that amends its cafeteria plan to provide a grace period for dependent care assistance may continue to rely on Notice 89–111, by reporting in Box 10 of Form W–2 the salary reduction amount elected by the employee for the year for dependent care assistance (plus any employer matching contributions attributable thereto). For example, suppose an employer amends its calendar year cafeteria plan to permit a grace period for dependent care assistance until March 15 of the subsequent year, that an employee elects salary reduction of $5,000 for dependent care assistance for the 2005 calendar year and elects an additional $5,000 salary reduction for dependent care assistance for the 2006 calendar year, and that the employee has $500 of dependent care contributions remaining unused at the end of the 2005 plan year, which is available to reimburse dependent care expenses incurred during the grace period. For the 2005 calendar year, the employer may report in Box 10 of Form W–2 the $5,000 salary reduction amount elected by the employee for dependent care assistance in 2005. Similarly, for the 2006 calendar year, the employer may report in Box 10 of Form W–2 the $5,000 salary reduction amount elected by the employee for dependent care assistance in 2006.

EFFECT ON OTHER DOCUMENTS

Notice 89–111, 1989–2 C.B. 449, is amplified.

DRAFTING INFORMATION

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

## Announcement of Rules Relating to the Temporary Operation of Ships in the Domestic Trade as a Result of Hurricane Katrina

## Notice 2005–65

As a result of the devastation caused by Hurricane Katrina, the Treasury Department and the Internal Revenue Service (IRS) understand that on September 1, 2005, the Secretary of the Department of Homeland Security waived the Merchant Marine Act of 1920 and related laws for the transportation of petroleum and refined petroleum products for the period until 12:01 a.m., September 19, 2005, and for the transportation of petroleum released from the Strategic Petroleum Reserve undertaken in response to the circumstances arising from Katrina (the waiver). As a result of these unique circumstances, Treasury and the IRS announce the following guidance with respect to the temporary operation of ships in the domestic trade pursuant to the waiver.

The IRS will not challenge a position taken by a foreign corporation that is otherwise engaged in the international operation of ships, that the transport of petroleum pursuant to the waiver is an activity incidental to its international operation of ships under Treas. Reg. § 1.883–1(g). In addition, Treasury and the IRS consider such activities conducted pursuant to the waiver by enterprises otherwise engaged in the operation of ships in international traffic to be ancillary activities the income from which will qualify for exemption under the shipping article of U.S. income tax treaties.

In light of these unique circumstances, and the special consideration given to foreign crew members reflected in section 861(a)(3), the IRS will not challenge a position that compensation for labor or services performed by a nonresident alien as a regular member of a crew of a foreign vessel during the use of the vessel pursuant to the waiver is income from sources without the United States.

For purposes of section 7701(b)(7), the IRS will not challenge a position taken by an individual who is temporarily present in the United States on any day as a regular member of the crew of a foreign vessel operating in the United States pursuant to the waiver that the individual is not present in the United States on such day unless such individual otherwise engages in any trade or business in the United States on such day.

In addition, for purposes of the alternative tax under subchapter R of the Internal Revenue Code, the IRS will not challenge a position that days operating in the United States pursuant to the waiver are not included in the computation of the 30-day limitation of section 1355(f)(4).

## EFFECTIVE DATE

This notice is an emergency measure and relates to the specific circumstances described in the waiver. Except as otherwise provided, the rules of this notice are applicable from September 1, 2005, through September 18, 2005. With respect to the transportation of petroleum released from the Strategic Petroleum Reserve undertaken pursuant to the waiver, the rules of this notice are applicable from September 1, 2005, through October 31, 2005.

## DRAFTING INFORMATION

The principal author of this notice is Patricia A. Bray of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Patricia Bray or David Lundy at (202) 622–3880 (not a toll-free call).

# Part IV. Items of General Interest

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

## Converting an IRA Annuity to a Roth IRA

## REG–122857–05

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. 9220) under section 408A of the Internal Revenue Code (Code). The temporary regulations provide guidance concerning the tax consequences of converting a non-Roth IRA annuity to a Roth IRA. The temporary regulations affect individuals establishing Roth IRAs, beneficiaries under Roth IRAs, and trustees, custodians and issuers of Roth IRAs. The text of those temporary regulations also serves as the text of these proposed regulations.

DATES: Written or electronic comments and requests for a public hearing must be received by November 21, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–122857–05), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–122857–05), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the IRS Internet site at *www.irs.gov/regs* or the Federal eRulemaking Portal at *www.regulations.gov* (IRS–REG–122857–05).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Cathy A. Vohs, 202–622–6090; concerning submissions and requests for a public hearing, contact Treena Garrett, 202–622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

**Background**

Temporary regulations in this issue of the Bulletin amend the Income Tax Regulations (26 CFR part 1) relating to section 408A. The temporary regulations (§1.408A–4T) contain rules concerning the tax consequences of converting a traditional IRA annuity to a Roth IRA. The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary and proposed regulations.

**Applicability Date**

These regulations are proposed to be applicable to any Roth IRA conversion where an annuity contract is distributed or treated as distributed from a traditional IRA on or after August 19, 2005. No implication is intended concerning whether or not a rule to be adopted in these regulations is applicable law for taxable years ending before 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 proposed regulations, and, because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, these proposed regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

**Comments and Requests for a Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. Comments are specifically requested regarding the proposed additional guidance discussed in the preamble to the Temporary Regulations under section 408A (*i.e.*, §1.408A–4T). The IRS and Treasury Department also request comments regarding whether the method used to calculate the fair market value of an annuity contract that is converted to a Roth IRA should also apply for purposes of determining the fair market value of an annuity contact under sections 408(e) and 401(a)(9). 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 Cathy A. Vohs of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in the development of these regulations.

* * * * *

**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 * * *

§1.408A–4 also issued under 26 U.S.C. 408A * * *

Par. 2. Section 1.408A–4 is amended by adding, in numerical order, Q–14 and A–14, to read as follows:

*§1. 408A–4 Converting amounts to Roth IRAs.*

* * * * *

Q–14. [The text of proposed regulation §1.408A–4, Q–14 is the same as the text of §1.408A–4T, Q–14 published elsewhere in this issue of the Bulletin].

A–14. [The text of proposed regulation §1.408A–4, A–14, is the same as the text of §1.408A–4T, A–14, published elsewhere in this issue of the Bulletin].

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

(Filed by the Office of the Federal Register on August 19, 2005, 8:45 a.m., and published in the issue of the Federal Register for August 22, 2005, 70 F.R. 48924)

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## Notice of Proposed Rulemaking

## Dividends Paid Deduction for Stock Held in Employee Stock Ownership Plan

## REG–133578–05

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under sections 162(k) and 404(k) of the Internal Revenue Code (Code) relating to employee stock ownership plans (ESOPs). The regulations provide guidance concerning which corporation is entitled to the deduction for applicable dividends under section 404(k). These regulations also clarify that a payment in redemption of employer securities held by an ESOP is not deductible. These regulations will affect administrators of, employers maintaining, participants in, and beneficiaries of ESOPs. In addition, they will affect corporations that make distributions in redemption of stock held in an ESOP.

DATES: Written or electronic comments and requests for a public hearing must be received by November 23, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–133578–05), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG–133578–05), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington D.C. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at *www.irs.gov/regs*, or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS–REG–133578–05).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, John T. Ricotta at (202) 622–6060 with respect to section 404(k) or Martin Huck at (202) 622–7750 with respect to section 162(k); concerning submission of comments or to request a public hearing, Robin Jones at (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

### Background and Explanation of Provisions

This document contains proposed regulations under sections 162(k) and 404(k) of the Internal Revenue Code (Code). These regulations address two issues that have arisen in the application of these sections. The first issue arises in a case in which the applicable employer securities held in an employee stock ownership plan (ESOP) are not securities of the corporation or corporations that maintain the plan. The issue is which corporation is entitled to the deduction under section 404(k) for certain dividends paid with respect to the stock held in the ESOP. The second issue is whether payments in redemption of stock held by an ESOP are deductible.

*Code and Regulations*

Section 404(a) provides that contributions paid by an employer to or under a stock bonus, pension, profit sharing, or annuity plan are deductible under section 404(a), if they would be otherwise deductible, within the limitations of that section. Section 404(k)(1) provides that, in the case of a C corporation, there is allowed as a deduction for a taxable year the amount of any applicable dividend paid in cash by such corporation during the taxable year with respect to applicable employer securities held by an ESOP. The deduction under section 404(k) is in addition to the deductions allowed under section 404(a).

Section 4975(e)(7) provides, in relevant part, that an ESOP is a defined contribution plan that is a stock bonus plan qualified under section 401(a) and designed to invest primarily in qualifying employer securities. Section 4975(e)(8) states that the term *qualifying employer security* means any employer security within the meaning of section 409(l). Section 409(l) generally provides that the term *employer security* means common stock issued by the employer (or a corporation that is a member of the same controlled group) that is readily tradable on an established securities market, if the corporation (or a member of the controlled group) has common stock that is readily tradable on an established securities market. Section 409(l)(4)(A) provides that, for purposes of section 409(l), the term *controlled group of corporations* has the meaning given to that term by section 1563(a) (determined without regard to subsections (a)(4) and (e)(3)(C) of section 1563). Section 409(l)(4)(B) provides that, for purposes of section 409(l)(4)(A), if a common parent owns directly stock possessing at least 50 percent of the voting power of all classes of stock and at least 50 percent of each class of nonvoting stock in a first tier subsidiary, such subsidiary (and all corporations below it in the chain which would meet the 80 percent test of section 1563(a) if the first tier subsidiary were the common parent) are treated as includible corporations.

Section 404(k)(2), for taxable years beginning on or after January 1, 2002, generally provides that the term *applicable dividend* means any dividend which, in accordance with the plan provisions — (i) is paid in cash to the participants in the plan or their beneficiaries, (ii) is paid to the plan and is distributed in cash to participants in the plan or their beneficiaries not later than 90 days after the close of the plan year in which paid, (iii) is, at the election of such participants or their beneficiaries — (I) payable as provided in clause (i) or (ii), or (II) paid to the plan and reinvested in qualifying employer securities, or (iv) is used to make payments on a loan described in section 404(a)(9), the proceeds of which were used to acquire the employer securities (whether or not allocated to participants) with respect to which the dividend is paid. Under section 404(k)(4), the deduction is allowable in the taxable year of the corporation in which the dividend is paid or distributed to a participant or beneficiary.

Prior to 2002, section 404(k)(5)(A) provided that the Secretary may disallow the deduction under section 404(k) for any dividend if the Secretary determines that such dividend constitutes, in substance, an evasion of taxation. Section 662(b) of the Economic Growth and Tax Relief Reconciliation Act of 2001 (115 Stat. 38, 2001) amended section 404(k)(5)(A) to provide that the Secretary may disallow a deduction under section 404(k) for any dividend the Secretary determines constitutes, in substance, an avoidance or evasion of taxation. The amendment is effective for tax years after December 31, 2001.

Section 162(k)(1) generally provides that no deduction otherwise allowable under chapter 1 of the Code is allowed for any amount paid or incurred by a corporation in connection with the reacquisition of its stock or the stock of any related person (as defined in section 465(b)(3)(C)). The legislative history of section 162(k) states that the phrase "in connection with" is "intended to be construed broadly." H.R. Conf. Rep. No. 99–841, at 168 (1986).

*Corporation Entitled to Section 404(k) Deduction*

An ESOP may benefit employees of more than one corporation. In addition, an ESOP may be maintained by a corporation other than the payor of a dividend. In these cases, the issue arises as to which entity is entitled to the deduction provided under section 404(k). Assume, for example, that a publicly traded corporation owns all of the stock of a subsidiary. The subsidiary operates a trade or business with employees in the U.S. and maintains an ESOP that holds stock of its parent for its employees. If the parent distributes a dividend with respect to its stock held in the ESOP maintained by the subsidiary, questions have arisen as to whether the parent or subsidiary is entitled to the deduction under section 404(k). This question arises in cases in which the parent and subsidiary file a consolidated return as well as in cases in which the parent and subsidiary do not file a consolidated return.

The IRS and Treasury Department believe that the statutory language of section 404(k) clearly provides that only the payor of the applicable dividend is entitled to the deduction under section 404(k), regardless of whether the employees of multiple corporations benefit under the ESOP and regardless of whether another member of the controlled group maintains the ESOP. Therefore, in the example above, the parent, not the subsidiary, is entitled to the deduction under section 404(k).

*Treatment of Payments Made to Reacquire Stock*

Some corporations have claimed deductions under section 404(k) for payments in redemption of stock held by an ESOP that are used to make benefit distributions to participants or beneficiaries, including distributions of a participant's account balance upon severance from employment. These taxpayers have argued that the payments in redemption qualify as dividends under sections 301 and 316 and, therefore, are deductible under section 404(k).

In Rev. Rul. 2001–6, 2001–1 C.B. 491, the IRS concluded that section 162(k) bars a deduction for payments made in redemption of stock from an ESOP. This conclusion was based on the fact that section 162(k)(1) disallows a deduction for payments paid in connection with the reacquisition of an issuer's stock and that the redemption payments are such payments. The IRS also concluded that such payments were not applicable dividends under section 404(k)(1). The IRS reasoned that allowing a deduction for redemption amounts would vitiate important rights and protections for recipients of ESOP distributions, including the right to reduce taxes by utilizing the return of basis provisions under section 72, the right to make rollovers of ESOP distributions received upon separation from service, and the protection against involuntary cash-outs. Finally, the IRS stated that a deduction under section 404(k)(1) for such amounts would constitute, in substance, an evasion of tax.

In *Boise Cascade Corporation v. United States*, 329 F.3d 751 (9th Cir. 2003), the Court of Appeals for the Ninth Circuit held that payments made by a corporation to redeem its stock held by its ESOP were deductible as dividends paid under section 404(k), and that the deduction was not precluded by section 162(k). The court reasoned that the distribution by the ESOP of the redemption proceeds to the participants was a transaction separate from the redemption transaction. Therefore, the court concluded that the distribution did not constitute a payment *in connection with* the corporation's reacquisition of its stock, and section 162(k) did not bar the deduction of such payments.

For the reasons stated in Rev. Rul. 2001–6, the IRS and Treasury Department continue to believe that allowing a deduction for amounts paid to reacquire stock is inconsistent with the intent of, and policies underlying, section 404. In addition, the IRS and Treasury Department believe that allowing such a deduction would constitute, in substance, an avoidance or evasion of taxation within the meaning of section 404(k)(5)(A) because it would allow a corporation to claim two deductions for the same economic cost: once for the value of the stock originally contributed to the ESOP and again for the amount paid to redeem the same stock. See *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934). Moreover, despite the Ninth Circuit's conclusion in *Boise Cascade*, the IRS and Treasury Department continue to believe that, even if a payment in redemption of stock held by an ESOP were to qualify as an applicable dividend, section 162(k) would disallow a deduction for that amount because such payment would be in connection with the reacquisition of the corporation's stock.

This notice of proposed rulemaking, therefore, includes proposed regulations under section 404(k) that confirm that payments made to reacquire stock held by an ESOP are not deductible under section 404(k) because such payments do not constitute applicable dividends under section 404(k)(2) and a deduction for such payments would constitute, in substance, an avoidance or evasion of taxation within the meaning of section 404(k)(5). It also includes proposed regulations under section 162(k) that provide that section 162(k), subject to certain exceptions, disallows any deduction for amounts paid or incurred by a corporation in connection with the reacquisition of its stock or the stock of any related person (as defined in section 465(b)(3)(C)). The proposed regulations also provide that amounts paid or incurred in connection with the reacquisition of stock include amounts paid by a corporation to reacquire its stock from an ESOP that are then distributed by the ESOP to its participants (or their beneficiaries) or otherwise used in a manner described in section 404(k)(2)(A).

**Proposed Effective Date**

These regulations are proposed to be effective on the date of issuance of final regulations. However, before these regulations become effective, the IRS will continue to assert in any matter in controversy outside of the Ninth Circuit that sections 162(k) and 404(k) disallow a deduction for payments to reacquire employer securities held by an ESOP. See Chief Counsel Notice 2004–038 (October 1, 2004) available at *www.irs.gov/foia* through the *electronic reading room*.

**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 has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, 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 Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

**Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying. A public hearing 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 authors of these regulations are John T. Ricotta, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) and Martin Huck of Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury participated in the development of these regulations.

* * * * *

**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 is amended to read, in part, as follows:

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

Section 1.162(k)–1 is also issued under 26 U.S.C. 162(k) * * *

Section 1.404(k)–3 is also issued under 26 U.S.C. 162(k) and 404(k)(5)(A) * * *

Par. 2. Section 1.162(k)–1 is added to read as follows:

*§1.162(k)–1 Disallowance of deduction for reacquisition payments.*

(a) *In general*. Except as provided in paragraph (b) of this section, no deduction otherwise allowable is allowed under Chapter 1 of the Internal Revenue Code for any amount paid or incurred by a corporation in connection with the reacquisition of its stock or the stock of any related person (as defined in section 465(b)(3)(C)). Amounts paid or incurred in connection with the reacquisition of stock include amounts paid by a corporation to reacquire its stock from an ESOP that are used in a manner described in section 404(k)(2)(A). See §1.404(k)–3.

(b) *Exceptions*. Paragraph (a) of this section does not apply to any—

(i) Deduction allowable under section 163 (relating to interest);

(ii) Deduction for amounts that are properly allocable to indebtedness and amortized over the term of such indebtedness;

(iii) Deduction for dividends paid (within the meaning of section 561); or

(iv) Amount paid or incurred in connection with the redemption of any stock in a regulated investment company that issues only stock which is redeemable upon the demand of the shareholder.

(c) *Effective date*. This section applies with respect to amounts paid or incurred on or after the date these regulations are published as final regulations in the **Federal Register**.

Par. 3. Section 1.404(k)–2 is added to read as follows:

*§1.404(k)–2 Dividends paid by corporation not maintaining ESOP.*

Q–1: What corporation is entitled to the deduction provided under section 404(k) for applicable dividends paid on applicable employer securities of a C corporation held by an ESOP if the ESOP benefits employees of more than one corporation or if the corporation paying the dividend is not the corporation maintaining the plan?

A–1: (a) *In general*. Under section 404(k), only the corporation paying the dividend is entitled to the deduction with respect to applicable employer securities held by an ESOP. Thus, no deduction is permitted to a corporation maintaining the ESOP if that corporation does not pay the dividend.

(b) *Example*. (i) *Facts*. S is a U.S. corporation that is wholly owned by P, an entity organized under the laws of Country A that is classified as a corporation for Federal income tax purposes. P is not engaged in a U.S. trade or business. P has a single class of common stock that is listed on a stock exchange in a foreign country. In addition, these shares are listed on the New York Stock Exchange, in the form of American Depositary Shares, and are actively traded through American Depositary Receipts (ADRs) meeting the requirements of section 409(l). S maintains an ESOP for its employees. The ESOP holds ADRs of P on Date X and receives a dividend with respect to those employer securities. The dividends received by the ESOP constitute applicable dividends as described in section 404(k)(2).

(ii) *Conclusion*. P, as the payor of the dividend, is entitled to a deduction under section 404(k) with respect to the dividends, although as a foreign corporation P does not obtain a U.S. tax benefit from the deduction. No corporation other than the corporation paying the dividend is entitled to the deduction under section 404(k). Thus, because S did not pay the dividends, S is not entitled to a deduction under section 404(k). The answer would be the same if P is a U.S. C corporation.

Q–2: What is the effective date of this section?

A–2: This section applies with respect to dividends paid on or after the date these regulations are published as final regulations in the **Federal Register**.

Par. 4. Section 1.404(k)–3 is added to read as follows:

*§1.404(k)–3 Disallowance of deduction for reacquisition payments.*

Q–1: Are payments to reacquire stock held by an ESOP applicable dividends that are deductible under section 404(k)(1)?

A–1: (a) Payments to reacquire stock held by an ESOP, including reacquisition payments that are used to make benefit distributions to participants or beneficiaries, are not deductible under section 404(k) because—

(1) Those payments do not constitute *applicable dividends* under section 404(k)(2); and

(2) The treatment of those payments as applicable dividends would constitute, in substance, an avoidance or evasion of taxation within the meaning of section 404(k)(5).

(b) See §1.162(k)–1 concerning the disallowance of deductions for amounts paid or incurred by a corporation in connection with the reacquisition of its stock from an ESOP.

Q–2: What is the effective date of this section?

A–2: This section applies with respect to payments to reacquire stock that are made on or after the date these regulations are published as final regulations in the **Federal Register**.

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

(Filed by the Office of the Federal Register on August 24, 2005, 8:45 a.m., and published in the issue of the Federal Register for August 25, 2005, 70 F.R. 49897)

## Release of Form 1098–C, *Contributions of Motor Vehicles, Boats, and Airplanes*

## Announcement 2005–66

The IRS has released new Form 1098–C, *Contributions of Motor Vehicles, Boats, and Airplanes*. The form is used by donee organizations to report the contribution of qualified vehicles to the IRS under new IRC section 170(f)(12). The form may also be used to provide the donor with a contemporaneous written acknowledgment of the contribution.

## Section 1446 Regulations; Withholding on Effectively-Connected Taxable Income Allocable to Foreign Partners; Correction

## Announcement 2005–68

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document corrects a notice of proposed rulemaking (REG–108524–00, 2005–23 I.R.B. 1209) that was published in the **Federal Register** on Wednesday, May 18, 2005 (70 FR 28743). The document contains regulations providing guidance under section 1446 of the Internal Revenue Code relating to the circumstances under which a partnership may take partner-level deductions and losses into account in computing its withholding tax obligation with respect to a foreign partner's allocable share of effectively connected taxable income.

FOR FURTHER INFORMATION CONTACT: Ronald M. Gootzeit, (202) 622–3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

**Background**

The notice of proposed rulemaking and notice of public hearing (REG–108524–00) that is the subject of these corrections are under section 1446 of the Internal Revenue Code.

**Need for Correction**

As published, REG–108524–00 contains errors that may prove to be misleading and are in need of clarification.

**Correction of Publication**

Accordingly, the notice of proposed rulemaking and notice of public hearing (REG–108524–00), that was the subject of FR Doc. 05–9423, is corrected as follows:

1. On page 28743, column 1, in the preamble, under the caption "DATES:", last line, the language "must be received by August 16, 2005." is corrected to read "must be received by September 12, 2005.".

2. On page 28743, column 2, in the preamble, under the caption "FOR FURTHER INFORMATION CONTACT:", line 3, the language "the hearing, Jacqueline Turner at (202)" is corrected to read "the hearing, Richard A. Hurst at (202)".

3. On page 28744, column 1, in the preamble, under the paragraph heading, "Comments and Public Hearing", third paragraph, line 8, the language "and eight (8) copies) by August 16," is corrected to read "and eight (8) copies) by September 12,".

Cynthia Grigsby,
*Acting Chief, Publications and Regulations Branch, Legal Processing Division, Associate Chief Counsel (Procedure and Administration).*

(Filed by the Office of the Federal Register on September 2, 2005, 8:45 a.m., and published in the issue of the Federal Register for September 6, 2005, 70 F.R. 52952)

# 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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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2005–1 through 2005–26 is in Internal Revenue Bulletin 2005–26, dated June 27, 2005.

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[1] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2005–1 through 2005–26 is in Internal Revenue Bulletin 2005–26, dated June 27, 2005.

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| | |
|---|---|
| Ann | Announcement |
| CD | Court Decision |
| DO | Delegation Order |
| EO | Executive Order |
| PL | Public Law |
| PTE | Prohibited Transaction Exemption |
| RP | Revenue Procedure |
| RR | Revenue Ruling |
| SPR | Statement of Procedural Rules |
| TC | Tax Convention |
| TD | Treasury Decision |
| TDO | Treasury Department Order |

# EMPLOYEE PLANS



# EMPLOYEE PLANS—Cont.



# EMPLOYMENT TAX

# INCOME TAX

## INCOME TAX—Cont.



## SELF-EMPLOYMENT TAX




*U.S. Government Printing Office: 2005—310–365/20024