

treated as equity rather than debt for U.S. federal income tax purposes; and

2. either:

- a. the security is considered “readily tradable on an established securities market in the United States”;<sup>1</sup>
- b. the foreign corporation is organized in a possession of the United States; or
- c. the foreign corporation is organized in a country whose income tax treaty with the United States is comprehensive, is satisfactory to the Secretary for purposes of section 1(h)(11), and includes an exchange of information program,<sup>2</sup> and if the relevant treaty contains a limitation on benefits provision, the corporation’s common or ordinary stock is listed on an exchange covered by that limitation on benefits provision’s public trading test, unless the person required to file an information return knows or has reason to know that the corporation is not eligible for benefits under that treaty; and

3. the person required to file Form 1099-DIV does not know or have reason to know that the foreign corporation is or expects to be, in the taxable year of the corporation in which the dividend was paid, or was, in the preceding taxable year, a foreign personal holding company (as defined in section 552), a foreign investment company (as defined in section 1246(b)), or a passive foreign investment company (as defined in section 1297);<sup>3</sup> and

4. the person required to make a return under section 6042 determines that the owner of the distribution has satisfied the holding period requirement of section 1(h)(11) or it is impractical for such person to make such determination.

The IRS will exercise its authority under section 6724(a) of the Code to waive penalties under sections 6721 and 6722 with respect to reporting of payments if persons required to file Form 1099-DIV make a good faith effort to report payments consistent with the rules summarized above and described in detail in sections 3.01 through 3.06 of Notice 2003–79. A person required to make a return under section 6042 may report a distribution in Box 1b as a qualified dividend even if the distribution does not satisfy these simplified information reporting procedures, subject to the applicable penalty provisions, as described in detail in section 3.07 of Notice 2003–79.

.03 Recipients of Form 1099-DIV.

For taxable years beginning in 2005 and future tax years, a recipient of Form 1099-DIV may treat amounts reported in Box 1b as qualified dividends, unless and to the extent the recipient knows or has reason to know that such amounts are not qualified dividends, as described in detail in section 3.08 of Notice 2003–79.

#### SECTION 4. EFFECTIVE DATE

This notice is effective for taxable years beginning on or after January 1, 2005.

#### SECTION 5. COMMENTS

Treasury and the IRS continue to invite interested persons to comment on the information reporting procedures contained in this notice and the certification procedures outlined in Section 5 of Notice 2003–79. Written comments may be submitted to CC:PA:LPD:PR (Notice 2006–3), room 5207, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 am and 5 pm to: CC:PA:LPD:PR (Notice 2006–3), Courier’s desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively, taxpayers may submit comments electronically via the following e-mail address:

*Notice.Comments@irs.counsel.treas.gov*. Please include “Notice 2006–3” in the subject line of any electronic communications.

#### SECTION 6. PAPERWORK REDUCTION ACT

The information collection referenced in this notice has been previously reviewed and approved by the Office of Management and Budget as part of the promulgation of Form 1099-DIV. See OMB Control Number 1545–0110. This notice merely provides additional guidance regarding the proper filing of such returns and furnishing of such statements.

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

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

#### SECTION 7. CONTACT INFORMATION

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

## Interim Guidance With Respect to the Application of Section 409A to Outstanding Stock Rights

### Notice 2006–4

#### I. Background

Section 409A was added to the Internal Revenue Code as part of the American Jobs Creation Act of 2004, Pub. Law

<sup>1</sup> Notice 2003–71, 2003–2 C.B. 922, and section 3.02 of Notice 2004–71, 2004–2 C.B. 793, provide guidance regarding when a security is considered readily tradable on an established securities market in the United States for purposes of section 1(h)(11).

<sup>2</sup> Notice 2003–69, 2003–2 C.B. 851, contains a list of qualifying treaties for this purpose.

<sup>3</sup> Notice 2004–70, 2004–2 C.B. 724, provides guidance regarding the extent to which distributions, inclusions, and other amounts received by, or included in the income of, individual shareholders as ordinary income from foreign corporations subject to certain anti-deferral regimes may be treated as qualified dividend income for purposes of section 1(h)(11).

No. 108-357, 118 Stat. 1418. Section 409A generally provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are met. The IRS issued Notice 2005-1, 2005-2 I.R.B. 274, on December 20, 2004 (published as modified on January 6, 2005) and issued proposed regulations (REG-158080-04, 2005-43 I.R.B. 786) under section 409A on September 29, 2005 (70 Fed. Reg. 57930 (Oct. 4, 2005)). The proposed regulations are proposed to be effective on January 1, 2007, and do not limit the application of the guidance provided in Notice 2005-1.

## II. Stock Options and Stock Appreciation Rights Granted before January 1, 2005

### A. Application of the Reasonable Valuation Standard

Commentators expressed concern with respect to the application of section 409A to stock options and stock appreciation rights (collectively, stock rights) issued before January 1, 2005. Specifically, commentators expressed concern that although the issuer of a stock right intended to establish an exercise price not less than the fair market value of the stock at the time of grant, the issuer of the stock right may not be able to demonstrate that the exercise price of the stock right was determined using a reasonable valuation method in accordance with the requirements set forth in Notice 2005-1, Q&A-4(d) or § 1.409A-1(b)(5)(i)(B) of the proposed regulations. Commentators noted further that at the time such stock rights were granted, section 409A had not been enacted and thus no guidance with respect to the application of section 409A to stock rights was available.

### B. Application of the Good Faith Standards of § 1.422-2(e)(2)

Section 1.422-2(e)(1) generally provides that except as provided by § 1.422-2(e)(2), the option price of an incentive stock option must not be less than the fair market value of the stock subject to the option at the time the option

is granted. Section 1.422-2(e)(2) generally provides that if a share of stock is transferred to an individual pursuant to the exercise of an option which fails to qualify as an incentive stock option merely because there was a failure of an attempt, made in good faith, to meet the option price requirements of § 1.422-2(e)(1), those option price requirements are considered to have been met. Whether there was a good-faith attempt to set the option price at not less than the fair market value of the stock subject to the option at the time the option was granted depends on the relevant facts and circumstances.

Until further guidance is issued, with respect to a stock right issued before January 1, 2005, for purposes of determining whether the stock option results in a deferral of compensation pursuant to Notice 2005-1, Q&A-4(d)(ii), or the stock appreciation right results in a deferral of compensation pursuant to § 1.409A-1(b)(5)(i)(B) of the proposed regulations, principles similar to those set forth in § 1.422-2(e)(2) will be applied. Accordingly, where there was a good-faith attempt to set the exercise price of a stock right granted before January 1, 2005, at a price not less than the fair market value of the stock subject to the stock right at the time the stock right was granted, then such exercise price will be treated as being not less than the fair market value of the stock at the time of grant for purposes of determining whether the stock right is excluded from the requirements applicable to deferred compensation under section 409A.

## III. Stock Rights Issued on or after January 1, 2005 and Continued Application of Notice 2005-1, Q&A-4(d)(ii)

With respect to stock options granted on or after January 1, 2005 and before the effective date of final regulations, Notice 2005-1, Q&A-4(d)(ii) remains applicable guidance. Taxpayers may also rely on § 1.409A-1(b)(5)(i)(B) of the proposed regulations during this period. With respect to stock appreciation rights issued on or after January 1, 2005 and before the effective date of final regulations, taxpayers may rely on § 1.409A-1(b)(5)(i)(B) of the proposed regulations. In applying the provisions of the proposed regulations relating to stock appreciation rights, and

specifically § 1.409A-1(b)(5)(i)(B)(I) and (2), taxpayers may apply the rule set forth in Notice 2005-1, Q&A-4(d)(ii) that, for purposes of determining the fair market value of the stock at the date of grant, any reasonable valuation method may be used. Accordingly, where a taxpayer can demonstrate that the exercise price of a stock right, granted on or after January 1, 2005, and before the effective date of final regulations, is intended to be not less than the fair market value of the stock at the date of grant and that the value of such stock was determined using a reasonable valuation method, then that valuation will meet the requirements of Notice 2005-1, Q&A-4(d)(ii) regardless of whether that determination satisfies the valuation requirements in § 1.409A-1(b)(5)(i)(B) of the proposed regulations.

## IV. Request for Additional Comments regarding Application of Final Regulations to Outstanding Stock Rights

Final regulations may establish more detailed standards for valuation in the context of stock rights than those provided in this notice and Notice 2005-1. The Treasury Department and the IRS continue to request comments with respect to the proposed regulations, and specifically how the standards proposed with respect to the determination of the fair market value of stock subject to stock rights may be improved both to meet commentators' requests for more certainty with respect to the valuation requirement, and the legislative intent that only stock rights with exercise prices that may not be lower than the fair market value of the underlying stock on the date of grant be excluded from coverage under section 409A. See H.R. Conf. Rep. No. 108-755, at 735 (2004).

In addition, commentators have expressed concerns relating to the definition of service recipient stock for purposes of the exclusions from coverage under section 409A for certain stock rights, and the treatment of modifications, extensions and renewals of otherwise excluded stock rights. The Treasury Department and the IRS are considering comments on these issues, and invite further comments with respect to the rules proposed under the proposed regulations, as well as any additional transitional relief that may be

appropriate in conjunction with the implementation of the final regulations. For information regarding the submission of comments, see the “Comments and Public Hearing” section of the preamble to the proposed regulations.

## V. Drafting Information

The principal author of this guidance is Stephen Tackney of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the Treasury Department and the IRS participated in its development. For further information regarding this notice, contact Stephen Tackney at (202) 927-9639 (not a toll-free call).

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*26 CFR 1.263A-1T: Uniform capitalization of costs (temporary).*  
(Also Part I, §§ 446(e); 1.263A-2T, 1.446-1.)

## Rev. Proc. 2006-11

### SECTION 1. PURPOSE

This revenue procedure provides procedures by which a taxpayer changing its method of accounting to comply with § 1.263A-1T or 1.263A-2T of the Income Tax Regulations as set forth in T.D. 9217, 2005-37 I.R.B. 498 (70 FR 44467) for its first taxable year ending on or after August 2, 2005, may request the consent of the Commissioner utilizing either the advance consent procedures of Rev. Proc. 97-27, 1997-1 C.B. 680 (as modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified and clarified by Rev. Proc. 2002-54, 2002-2 C.B. 432) or the automatic consent procedures of Rev. Proc. 2002-9, 2002-1 C.B. 327 (as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified, clarified and modified by Rev. Proc. 2002-54, 2002-2 C.B. 432).

### SECTION 2. BACKGROUND

.01 Under §§ 446(e) and 1.446-1(e), a taxpayer generally must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. To obtain the Commissioner’s consent to a change in method,

§ 1.446-1(e)(3)(i) generally requires a taxpayer to file Form 3115, *Application for Change in Accounting Method*, during the taxable year in which the taxpayer desires to make the proposed change. Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures that provide the terms and conditions necessary for a taxpayer to obtain consent to change a method of accounting. The terms and conditions the Commissioner may prescribe include whether the change is to be made with a § 481(a) adjustment, and if so, the § 481(a) adjustment period, or on a cut-off basis.

.02 Section 481(c) and §§ 1.446-1(e)(3)(ii) and 1.481-4 provide that the adjustment required by § 481(a) may be taken into account in determining taxable income in the manner and subject to the conditions agreed to by the Commissioner and the taxpayer.

.03 This revenue procedure applies only for a taxpayer’s first taxable year ending on or after August 2, 2005, for a change in method of accounting to comply with § 1.263A-1T or 1.263A-2T. A change in method of accounting under this revenue procedure requires a § 481(a) adjustment, and the § 481(a) adjustment period is two taxable years for a net positive adjustment. It is expected that this two-year adjustment period for a net positive § 481(a) adjustment will apply to changes in methods of accounting made in future years to comply with the rules in §§ 1.263A-1T and 1.263A-2T, and the successor final regulations.

.04 Rev. Proc. 97-27 provides the general procedures under §§ 446(e) and 1.446-1(e) for obtaining the consent of the Commissioner to change a method of accounting for federal income tax purposes. Except as specifically provided in section 4.02 of Rev. Proc. 97-27 or other published guidance, Rev. Proc. 97-27 applies to all taxpayers requesting the Commissioner’s consent to change a method of accounting for federal income tax purposes. See Rev. Proc. 97-27, sections 1.01 and 4.01.

.05 Section 4.02(1) of Rev. Proc. 97-27 provides that Rev. Proc. 97-27 does not apply if the change in method of accounting is required to be made pursuant to a published automatic change procedure.

.06 Rev. Proc. 2002-9 provides procedures under §§ 446(e) and 1.446-1(e)

for obtaining the automatic consent of the Commissioner to change certain methods of accounting for federal income tax purposes. Specifically, Rev. Proc. 2002-9 applies to a taxpayer requesting the Commissioner’s consent to change to a method of accounting described in the APPENDIX of such revenue procedure. Rev. Proc. 2002-9 is the exclusive procedure for a taxpayer within its scope to obtain the Commissioner’s consent. See Rev. Proc. 2002-9, sections 1 and 4.01.

.07 T.D. 9217 contains final and temporary regulations relating to the capitalization of costs under the simplified service cost method provided by § 1.263A-1(h) and the simplified production method provided by § 1.263A-2(b). Specifically, the regulations under § 1.263A-1T and § 1.263A-2T clarify what property qualifies as self-constructed assets produced on a routine and repetitive basis for purposes of the simplified service cost method or the simplified production method, respectively.

.08 Section 1.263A-1T(k)(1) provides that a change in a taxpayer’s treatment of mixed service costs to comply with § 1.263A-1T is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply. Section 1.263A-1T(k)(1) further provides that for a taxpayer’s first taxable year ending on or after August 2, 2005, the taxpayer is granted the consent of the Commissioner to change its method of accounting to comply with § 1.263A-1T, provided the taxpayer follows the administrative procedures issued under § 1.446-1(e)(3)(ii), as modified by § 1.263A-1T(k)(2) through (4), for obtaining the Commissioner’s automatic consent to a change in accounting method.

.09 Section 1.263A-2T(e)(1) provides that a change in a taxpayer’s treatment of additional § 263A costs to comply with § 1.263A-2T is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply. Section 1.263A-2T(e)(1) further provides that for a taxpayer’s first taxable year ending on or after August 2, 2005, the taxpayer is granted the consent of the Commissioner to change its method of accounting to comply with § 1.263A-2T, provided the taxpayer follows the administrative procedures issued under § 1.446-1(e)(3)(ii), as modified