INTERNAL REVENUE
BULLETIN

HIGHLIGHTS OF THIS ISSUE

Bulletin No. 2025–8
February 18, 2025

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.

EMPLOYEE PLANS

REG-100669-24, page 819.

These proposed regulations would provide guidance regarding a change made by the SECURE 2.0 Act that requires certain retirement plans to automatically enroll eligible employees beginning in 2025. Among other exceptions, this requirement does not apply to plans established before December 29, 2022. These proposed regulations also would amend the rules regarding notice requirements for plans that include eligible automatic contributions arrangements to reflect changes made by the SECURE 2.0 Act. The proposed regulations would affect participants in, beneficiaries of, employers maintaining, and administrators of these plans.

EMPLOYEE PLANS, EXCISE TAX

Notice 2025-12, page 813.

This notice provides the indexing factors to be used by group health plans and health insurance issuers to calculate the qualifying payment amount (QPA) for items or services provided on or after January 1, 2025, and before January 1, 2026. The QPA is the basis for determining individual cost sharing for items and services covered by the balance-billing protections in the NSA, under certain circumstances. The QPA for a given calendar year is based on information regarding median rates for certain items and services from prior years and is indexed based on changes in the consumer price index. In addition to providing the indexing factor for adjusting 2024 amounts for 2025, the notice also provides cumulative adjustments for prior years.

EMPLOYEE PLANS, INCOME TAX

REG-101268-24, page 836.

These proposed regulations would provide guidance for retirement plans that permit participants who have attained age 50 to make additional elective deferrals (catch-up contributions) under section 414(v) of the Code. Specifically, these proposed regulations would amend the regulations under sections 414(v), 401(k), and 403(b) to reflect statutory changes made by section 603 of the SECURE 2.0 Act of 2022 (SECURE 2.0 Act), which require that catch-up contributions made by certain catch-up eligible participants be designated Roth contributions. These proposed regulations also would amend the regulations under section 414(v) of the Code to reflect the statutory changes made by sections 109 and 117 of the SECURE 2.0 Act, which increase the catch-up contribution limits under section 414(v) of the Code in certain cases.

REG-118988-22, page 869.

Section 162(m)(1) generally limits to $1,000,000 the allowable deduction for a taxable year for applicable employee remuneration paid by any publicly held corporation with respect to a covered employee. Section 9708 of the American Rescue Plan Act of 2021 (ARP) (Pub. L. 117-2, 135 Stat. 206 (2021)) amended the definition of "covered employee." In addition to the principal executive officer, principal financial officer, and the three other highest compensated executive officers for the taxable year or any previous taxable year, ARP added §162(m)(3)(C) to expand the definition of "covered employee" to include any other employee who is among the five highest compensated employees for the taxable year. This amendment is effective for taxable years beginning after December 31, 2026. The proposed regulations propose guidance on the application of §162(m) as amended by section 9708 of ARP.

INCOME TAX

Notice 2025-6, page 799.

This notice requests comments on any potential implications if the characterization rules currently contained in §§1.861-18 and 1.861-19, as amended and added, respectively, by Treasury Decision 10022, were to apply to all provisions of the Internal Revenue Code, including the need for additional guidance, and seeks specific comments on the possible

Finding Lists begin on page ii.

impacts and guidance that may be necessary with respect to certain identified provisions.

Notice 2025-8, page 800.

This notice contains modifications to Notice 2023-38, 2023-22 I.R.B. 872, that are similar to the modifications contained in section 3 of Notice 2024-41, 2024-24 I.R.B. 1615. For electing Applicable Projects, this notice modifies and supersedes Notice 2024-41 by expanding the elective safe harbor cost table in Notice 2024-41 for Solar Photovoltaic (PV) facilities to include updated cost percentages, providing new cost percentages for PV modules that incorporate crystalline silicon PV cells and wafers that are manufactured in the U.S., renaming, redefining, reclassifying, and removing certain solar PV components, and expanding and clarifying the type of facilities eligible to qualify as a representative type of solar PV facility. This notice further modifies and supersedes Notice 2024-41 by renaming certain components for the Land-Based Wind Table; renaming, redefining, and reclassifying certain Battery Electric Storage System (BESS) Table components; providing updated cost percentages for these BESS components; and permitting taxpayers that are eligible to claim a Domestic Content Bonus Credit by virtue of the 80/20 Rule to elect to use the safe harbor cost tables in this notice, or the safe harbor in Notice 2024-41, before Notice 2024-41 is superseded.

REG-107420-24, page 854.

This document contains proposed rules for determining the source of income from cloud transactions for purposes of the international provisions of the Internal Revenue Code. These proposed rules would generally affect taxpayers who earn gross income from engaging in cloud transactions.

REG-116085-23, page 865.

These proposed regulations would require multi-year tax reporting for corporate separations and related transactions. The information to be reported under these proposed regulations would establish the taxpayer's position that the corporate separation and related transactions qualify for nonrecognition treatment under subchapter C of the Internal Revenue Code.

Rev. Proc. 2025-13, page 816.

The revenue procedure provides a streamlined method by which taxpayers who have elected the application of the alternative tax under section 831(b) may obtain automatic consent of the Secretary to revoke such election by making certain representations.

T.D. 10022, page 773.

This document contains final regulations modifying the rules for classifying transactions involving computer programs, including by applying the rules to transfers of digital content. These final regulations also provide rules for the classification of cloud transactions. These rules apply for purposes of the international provisions of the Internal Revenue Code and generally affect taxpayers engaging in transactions involving digital content or cloud transactions.

The IRS Mission

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

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

Treasury Regulation Section 1.861-18 and Treasury Regulation Section 1.861-19

TD 10022

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Classification of Digital Content Transactions and Cloud Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations modifying the rules for classifying transactions involving computer programs, including by applying the rules to transfers of digital content. These final regulations also provide rules for the classification of cloud transactions. These rules apply for purposes of the international provisions of the Internal Revenue Code and generally affect taxpayers engaging in transactions involving digital content or cloud transactions.

DATES: *Effective Date*: These regulations are effective on January 14, 2025.

Applicability Date: For dates of applicability, see §§1.861-18(i) and 1.861-19(e).

FOR FURTHER INFORMATION CONTACT: Christopher E. Fulle, (202) 317-5367, or Michelle L. Ng, (202) 317-6989 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Authority

These final regulations are issued under the express delegation of authority under section 7805 of the Internal Revenue Code (Code). Section 7805(a) directs the Secretary of the Treasury or her delegate to prescribe all needful rules and regulations for the enforcement of that section and others in the Code, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

Background

On August 14, 2019, the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) published proposed regulations (REG-130700-14) under section 861 of the Code in the ***Federal Register*** (84 FR 40317) (the proposed regulations). The Treasury Department and the IRS received written comments on the proposed regulations, and a public hearing was held on February 11, 2020. All written comments received in response to the proposed regulations are available at www.regulations.gov or upon request. Terms used but not defined in this preamble have the meaning provided in these final regulations.

These regulations (the final regulations) extend the classification rules in existing §1.861-18 to transfers of digital content other than computer programs and clarify the source of income for certain transfers of digital content. The final regulations also clarify the classification of transactions involving on-demand network access to computing and other similar resources.

The final regulations retain the overall approach of the proposed regulations, with certain revisions discussed in the preamble. The preamble also discusses comments received in response to the solicitation of comments in the notice of proposed rulemaking.

Summary of Comments and Explanation of Revisions

I. *General Classification Issues*

A. *Replacement of de minimis rule with a predominant character rule*

Section 1.861-18(b)(1), as in effect before this Treasury decision, described four transactions involving computer programs: the transfer of a copyright right, the transfer of a copyrighted article, the provision of services for the development or modification of a computer program, and the provision of know-how relating to the development of a computer program. Section 1.861-18(b)(2) required any transaction that consisted of more than one of the transactions described in §1.861-18(b)(1) to be treated as separate transactions, unless a transaction was de minimis, in which case it would be treated as part of another transaction. The proposed regulations generally retained the four types of transactions (with the expansions described in Part II.A of this Summary of Comments and Explanation of Revisions) and preserved the de minimis rule, but for clarification purposes, §1.861-18(b)(2) was proposed to be modified by introducing the term "arrangement" and providing that multiple transactions in an arrangement generally must be characterized separately.

Proposed §1.861-19(b) defined a cloud transaction as a transaction through which a person obtains on-demand network access to computer hardware, digital content (as defined in proposed §1.861-18(a)(3)), or other similar resources, other than on-demand network access that is de minimis taking into account the overall arrangement and the surrounding facts and circumstances. Similar to proposed §1.861-18(b)(2), proposed §1.861-19(c)(3) required separate classification of each transaction comprising an arrangement, except that any transaction that was de minimis would be treated as part of another transaction rather than being classified separately.

Comments recommended replacing these rules in proposed §§1.861-18(b)(1) and (b)(2), and 1.861-19(c)(3), with a predominant character rule, such that a transaction consisting of more than one category of transactions described in proposed §1.861-18(b)(1), or a transaction consisting of one or more categories of transactions described in both proposed §§1.861-18(b)(1) and 1.861-19(b), would be characterized as only one of those categories of digital content transactions or as a cloud transaction in accordance with the predominant character of that transaction. As an example of a mixed transaction that

would be difficult to characterize under the proposed regulations, comments pointed to video game business models where the customer purchases a copy of the game but primarily plays the video game online with other players. As another example, comments pointed to software antivirus programs that include code that executes on the user's equipment as well as code that is deployed in the cloud to detect and capture viruses before they reach the user's equipment. The comments argued that the predominant character rule would avoid the difficult and burdensome task of determining whether an element is de minimis in the context of the overall transaction and allocating income from the transaction among the non-de minimis categories as if they were separate transactions. The comments also argued that a de minimis standard is imprecise, and a predominant character rule that compares components of a transaction to determine which component is predominant would be much more administrable. Furthermore, one comment suggested that a predominant character standard would better align with existing Treasury regulations and other authorities, for instance, §1.954-1(e)(3), which provides for a predominant character approach in the subpart F context. Finally, the comments noted confusion arising from the use of the term "transaction" to mean two different things in the same provision under proposed §1.861-18(b)(2), and also recommended removing the term "arrangement" on the grounds that the term was unclear, particularly because it was not defined and rarely appears in other tax rules.

The comments recommended that the predominant character of a transaction be determined based on the facts and circumstances. Comments suggested that the relevant facts may include the overall commercial purpose, the taxpayer's treatment for non-tax purposes, the relative cost of each component (including the cost of maintaining online and offline components), and a comparison of unit prices for components sold separately. Comments suggested that the facts and circumstances should provide at least a reasonable basis for determining the predominant character of the transaction.

Further, the comments suggested defining a transaction based on the facts and circumstances or as an agreement entered into in the ordinary course. Several comments suggested that relevant factors for determining the scope of a transaction could include the availability of separate pricing, the use of separate stock keeping units ("SKUs"), and the taxpayer's definition for non-tax purposes.

The final regulations adopt these comments, in part. The final regulations replace the de minimis rule and the concept of an arrangement with a predominant character rule, which applies to both digital content transactions and cloud transactions. The Treasury Department and the IRS agree that, for purposes of the final regulations, a transaction with multiple elements (including de minimis elements) should be characterized based on the predominant character of the transaction. Predominant character rules also exist in other regulations for international provisions of the Code, such as foreign-derived intangible income and subpart F, and thus are familiar to taxpayers. *See* §§1.250(b)-3(d) and 1.954-1(e)(3). Further, in many business models that include both online and offline functionality it may be difficult to bifurcate a single transaction into a digital content transaction and a cloud transaction. The Treasury Department and the IRS expect that bifurcation will remain difficult and may increase in difficulty as business models and technology evolve. Therefore, §1.861-18(b)(2) of the final regulations provides that, taking into account the overall transaction and the surrounding facts and circumstances, a transaction that has multiple elements, one or more of which would be a digital content transaction if considered separately, is classified in its entirety as a digital content transaction under one of the categories described in §1.861-18(b)(1) if the predominant character of the transaction is described in one of the categories in that paragraph. Section 1.861-19(c)(2) of the final regulations provides a corresponding rule for transactions that have multiple elements, one or more of which is a cloud transaction. Further, the references to "de minimis" and "arrangement" are also removed in §1.861-19(a) of the final regulations so that the final regulations define a cloud transaction as a transaction through which a person obtains on-demand network access to computer hardware, digital content (as defined in §1.861-18(a)(2)), or other similar resources.

The final regulations define a digital content transaction as a transaction that constitutes a transfer of digital content or the provision of modification or development services or of know-how with respect to digital content. *See* §1.861-18(b)(1). The final regulations do not, however, define the term transaction. The Treasury Department and the IRS have concluded that it is not necessary to introduce a specialized definition in these regulations because the concept is already well-established under general tax principles, case law, and existing administrative guidance.

Section 1.861-18(b)(3) of the final regulations (cross-referenced in §1.861-19(c)(2)) provides a general rule and a special rule for determining the predominant character of a transaction that contains multiple elements, one or more of which would be a digital content transaction or a cloud transaction if considered separately. Under the general rule, the predominant character is determined by the primary benefit or value received by the customer. If that information is not reasonably ascertainable, the special rule provides that the predominant character is determined by the primary benefit or value received by a typical customer in a substantially similar transaction, which is determined by data on how a typical customer uses or accesses the digital content. If data on how a typical customer uses or accesses the digital content is not available, then all factors indicative of the primary benefit or value received by a typical customer must be examined, including how the transaction is marketed, the relative development costs of each element of the transaction, and the relative price paid in an uncontrolled transaction for one or more elements compared to the total contract price of the transaction in question.

B. *Distinction between temporary downloads and streaming*

One comment requested guidance on "streaming" and "temporary downloading" transactions. The comment expressed the view that whether a customer can download digital content should not determine whether a trans-

action is characterized as a service or a lease. The comment noted that when a customer's rights are limited to downloading and viewing a discrete item of digital content, such as a movie, for a limited time, the transaction would be treated as a lease of digital content. However, if the customer can access and download as many movies as desired from a catalog of thousands of movies for a monthly fee, and once the subscription ends access to the downloaded movies ends, the transaction would be treated as a cloud transaction and classified as a service according to the comment. The comment suggested that the characterization of these two transactions should not depend on whether the content is actually downloaded by any particular customer.

Another comment asserted that on-demand access to digital content should not be treated differently than temporary downloads of digital content because the two transactions are functionally equivalent in that both provide temporary access to digital content. The comment observed that the decision to provide on-demand access or temporary downloads of digital content is typically driven by the nature of the technology involved (for example, the memory capacity of a user's computer or the download speeds available), and generally has no bearing on the economic substance of the transaction.

Where the provider chooses whether to offer either temporary downloads or streaming the Treasury Department and the IRS disagree that these two types of transactions should be treated the same. A fundamental requirement of a digital content transaction, unlike a cloud transaction involving digital content, is that there must be a transfer of digital content to the customer. This distinction between property and services transactions has been in place since the original issuance of §1.861-18 in 1998 and applying it consistently provides a degree of certainty for an otherwise factual case-by-case determination.

When a customer downloads digital content, there is a transfer of a copy of that digital content to the customer and the customer must use its own device to host the copy of content for viewing or listening, for example. In contrast, when a customer streams digital content, there is no transfer of digital content. Instead, the customer receives access to the digital content through the provider's servers. Especially for large file-size content, performing the hosting function in order to allow the customer continuous access places a higher burden on the provider. Similarly, for a temporary download, the customer must have sufficient storage on its device for the temporary download that is not necessary in a streaming transaction. There are also differences in how the customer may experience the digital content. For example, once a customer downloads digital content, the customer is able to access the content regardless of whether the customer is connected to the Internet and could thus watch a downloaded movie or read a downloaded book when the customer is unable to connect to the Internet. In these ways, there are fundamental differences in character between a temporary download and streaming that warrant different characterization and sourcing rules for each type of transaction. Where the customer may choose whether to temporarily download or stream content, the predominant character rule in the final regulations would apply to characterize the transaction. *See* §1.861-19(d)(7) (Example 7) and (d)(9) (Example 9) of the final regulations.

II. *Transactions Involving Digital Content*

A. *Definition of digital content*

Section 1.861-18, as in effect before this Treasury decision, applied only to computer programs. The proposed regulations expanded the scope of §1.861-18 to apply to transactions involving "digital content," defined as "a computer program or any other content in digital format that is either protected by copyright law or no longer protected by copyright law solely due to the passage of time."

Several comments recommended broadening the definition of digital content to encompass content not protected by copyright law that is transferred electronically and is similar to copyrightable content, such as consumer or user data, text files of recipes, government-produced documents, and sets of font and typefaces. One comment suggested expansion to any property in digital format in which a person has a right or interest, including any property bought and sold in real marketplaces, in virtual marketplaces and in in-game economies. These comments generally suggested that transfers of this non-copyrightable digital property are economically and functionally equivalent to the transfer of digital content and that characterization of the transfers should be treated the same. One comment asserted that such content may be subject to other forms of intellectual property protection such as contractual restrictions and non-disclosure agreements, such that transfers of that content are functionally similar to transfers of digital content.

The final regulations do not broaden the definition of digital content beyond content protectable by copyright law. Section 1.861-18, as in effect before this Treasury decision, generally followed copyright law, and the Treasury Department and the IRS are of the view that it is appropriate to continue to apply this longstanding copyright law framework. This framework is not workable for non-copyrightable content given that the legal rights associated with such content generally are not the same as those associated with content protectable by copyright law. For example, in a digital transfer of property that is not protected by copyright law, the transferee may (unless otherwise restricted, such as by contract) have the unfettered ability to make and distribute copies to the public, to prepare derivative works, or to publicly display or publicly perform the property. As a result, if the framework of §1.861-18 were applied to the transaction, such a transfer would generally be characterized as a license or sale of a copyright right, regardless of whether the transferee intends to exploit those abilities or whether those powers have any value or relevance in the context of the transaction. Therefore, the existing framework could result in a classification at odds with the economics and reality of the transaction. Further, where non-copyrightable digital property is transferred subject to contractual or other restrictions, those restrictions may not fit cleanly within the existing framework and may require a different analysis to determine the correct characterization. Accordingly, including non-copyrightable content would require a different set of rules that are beyond the scope of §1.861-18.

One comment noted that under the proposed regulations, an online database that allows customers on-demand access to a collection of non-copyrightable content such as recipes or court opinions is a cloud transaction. *See* §1.861-19(d)(8) (Example 8). This is because the definition of a cloud transaction in proposed §1.861-19(b) refers to on-demand network access to computer hardware, digital content, or "other similar resources." The comment suggested that the inclusion of "other similar resources" in the definition of cloud transaction may provide a road map for expanding the definition of digital content in proposed §1.861-18. The Treasury Department and the IRS disagree. The cloud transaction definition includes access to non-copyrightable content because curation of such content is a common business model that, unlike the framework of §1.861-18, does not depend on whether the content is copyrightable because there is no transfer to the customer.

The final regulations therefore do not adopt these comments and continue to characterize digital content transactions based on the distinction between a transfer of a copyrighted article and a transfer of copyright rights, which depends on whether the customer receives copyright rights as part of the transfer. The Treasury Department and the IRS may, however, consider these comments for possible future guidance specific to types of digital property that are not protectable by copyright law. The final regulations do provide, however, that digital content includes content that is not protected by copyright law solely because the creator dedicated the content to the public domain. The regulations include this refinement because monetization of such content generally also involves digital content that is protected by copyright law and therefore fits within the framework of §1.861-18. *See* §1.861-18(a)(2).

B. *Provision of know-how relating to development of digital content*

Section 1.861-18(b)(1)(iv), as in effect before this Treasury decision, provided that one of the categories of transactions relating to computer programs was "[t]he provision of know-how relating to computer programming techniques." Section 1.861-18(e) provided that the provision of information with respect to computer programs will be treated as the provision of know-how for purposes of §1.861-18 only if the information (1) relates to computer programming techniques; (2) is furnished under conditions preventing unauthorized disclosure, specifically contracted for between the parties; and (3) is considered property subject to trade secret protection. The proposed regulations would modify §1.861-18(b)(1)(iv) and (e)(1) by replacing "computer programming techniques" with "development of digital content," but would not otherwise change §1.861-18(b)(1)(iv) and (e)(1).

One comment asked for confirmation that the changes to §1.861-18(b)(1)(iv) and (e)(1) would not change the scope of §1.861-18(b)(1)(iv), and that §1.861-18(b)(1)(iv) in the final regulations describes only know-how transferred under terms that constitute a license for United States Federal tax purposes. The Treasury Department and the IRS confirm that §1.861-18(b)(1)(iv) in the proposed and final regulations is intended to describe the same type of know-how covered by §1.861-18(b)(1)(iv) as in effect before this Treasury decision, except that know-how may relate to any development of digital content and not merely computer programming techniques. The Treasury Department and the IRS have determined that §1.861-18(b)(1)(iv) and (e)(1) are sufficiently clear in this regard and that additional guidance on the treatment of such know-how is unnecessary.

C. *Rights to prepare derivative digital content*

Section 1.861-18(c)(2)(ii), as in effect before this Treasury decision, provided that one of the copyright rights referred to in that paragraph was the right to prepare derivative computer programs based upon a copyrighted computer program. The proposed regulations would replace the references to computer programs with references to digital content but would not otherwise change §1.861-18(c)(2)(ii). One comment recommended that the right to prepare derivative digital content based upon digital content should be treated as a copyright right only if it is coupled with the right to distribute the derivative digital content to the public. The comment expressed the belief that this change would be consistent with one of the underlying policies of these regulations, which is to treat as a license a transaction in which the transferee exercises a copyright right to exploit the rights in the market, and to treat as a sale or lease a transaction in which the transferee consumes the digital content. The comment also suggested that this change would address the ambiguity in copyright law as to what modifications of a copyrighted work are necessary to create a derivative work, and whether, for example, rights to modify software during installation or customization would constitute rights to create a derivative work.

The final regulations do not adopt this comment. The preamble to Treasury Decision 8785 (which promulgated §1.861-18 in 1998) stated in response to similar comments to the proposed regulations (REG-251520-96) that were finalized in Treasury Decision 8785 that the right to make copies (which must be coupled with the right to distribute the copies to the public to constitute a copyright right under the regulations, despite such a requirement not being present under copyright law) is treated differently from the other copyright rights in the context of the regulations because of the unique characteristics of computer programs, including the ease with which computer programs can be copied. However, as explained in that preamble, it is generally consistent with copyright law to treat as a copyright right a non-de minimis right to make a derivative work, regardless of whether it is coupled with the right to distribute to the public, and there is no sufficiently unique aspect of digital content that would compel a different result for purposes of §1.861-18. The Treasury Department and the IRS continue to be of the view that that the right to make a derivative work without further rights to distribute to the public should be treated as a copyright right and that the unique characteristics of digital content do not compel a different result. However, the predominant character rule in §1.861-18(b)(2) and (3) of the final regulations (discussed in Part I.A of this Summary of Comments and Explanation of Revisions) should alleviate concerns about minor customization rights caus-

ing what would otherwise be a transfer of digital content to be treated as a license of a copyright right. *See* §1.861-18(h)(18) (Example 18) of the final regulations.

D. *Right to make a public performance or public display for purposes of advertising*

Section 1.861-18(c)(2), as in effect before this Treasury decision, designated as copyright rights the right to make a public performance of a computer program and the right to display a computer program to the public. The proposed regulations would replace the references to computer programs with references to digital content, and also provide exceptions for the right to publicly perform or publicly display digital content for the purpose of advertising the sale of the digital content performed or displayed. Proposed §1.861-18(c)(2)(iii) and (iv). The preamble to the proposed regulations used an example of rights provided to a video game retailer that allow the retailer to display screenshots of a video game on television commercials promoting the game, and noted that these rights, on their own, would not be significant. Two comments agreed with the addition of the regulatory language and one of the comments suggested that the preamble example be included in the regulatory text.

The final regulations retain the exceptions for the public performance or public display of digital content for the purpose of advertising the sale of the digital content performed or displayed. *See* §1.861-18(c)(2)(iii) and (iv). The Treasury Department and the IRS have determined, however, that the language of the regulation is sufficiently clear without an example and therefore the final regulations do not include the example in the regulatory text.

E. *Copyright rights related to digital content used for cloud transactions*

One comment questioned whether the transfer of the right to use software or other digital content for a cloud transaction should be treated as the transfer of a copyright right. The comment included an example wherein A, a domestic corporation, transfers computer software to B, a foreign affiliate. B also gets the right to use the software to provide software-as-a-service transactions, but does not get the right to sell copies of the software or make derivative works. The comment stated that it appears that a copyright right has been transferred in this scenario, but that it is not clear which of the enumerated copyright rights is transferred. The comment recommend that the final regulations allow taxpayers to elect to characterize this type of transaction as a transfer of a copyright right.

The Treasury Department and the IRS agree that a transfer of digital content accompanied by the right to use the digital content to provide a cloud transaction will generally result in the transfer of the right to either publicly display or publicly perform the digital content, depending on the type of digital content and specific rights transferred. To display a work means to show a copy of it, either directly or by means of a film, slide, television image, or any other device or process or, in the case of a motion picture or other audiovisual work, to show individual images nonsequentially. 17 U.S.C. 101. To perform a work means to recite, render, play, dance, or act it, either directly or by means of any device or process or, in the case of a motion picture or other audiovisual work, to show its images in any sequence or to make the sounds accompanying it more audible. *Id*. Further, 17 U.S.C. 101 includes a "transmit clause" that provides that to publicly display or perform a work means, in relevant part, to transmit or otherwise communicate a performance or display of the work to the public, by means of any device or process, whether the members of the public capable of receiving the performance or display receive it in the same place or in separate places and at the same time or at different times. Reading these provisions of 17 U.S.C. 101, the Treasury Department and the IRS have concluded that the use of digital content to provide a cloud transaction should be treated as the exercise of a copyright right under both copyright law and the final regulations. *See American Broadcasting Companies, Inc. v. Aereo, Inc.*, 573 U.S. 431 (2014) (holding that capture of broadcast copyrighted content and retransmission to subscribers who stream the content to their personal devices was a public performance of a copyrighted work under the transmit clause of 17 U.S.C. 101). However, whether the transferred right is a right to display or a right to perform will depend on the type of digital content, the type of copyright obtained, and the manner in which the digital content is used in the cloud transaction. Due to the factual nature of these issues and the important role of copyright law in those determinations, the final regulations do not specify which copyright right has been transferred when digital content is transferred for use in a cloud transaction.

F. *Examples illustrating §1.861-18*

Several comments requested new examples describing common business models or modifications to examples provided in the proposed regulations. In response to these comments, the final regulations contain several new examples and make certain modifications to the examples in the proposed regulations. In addition, pre-existing examples that were in effect before the issuance of this Treasury decision have been modified to follow the same analytical structure as the examples added by the final regulations.

One comment requested an example of a wholesaler of computer software buying and selling a limited number of product keys. A product key is a specific software-based key for a computer program that certifies the copy of the program is original. Instead of using physical media such as a CD or DVD to install software onto a computer or other electronic device, a user can enter a product key to download the software and then install it from their computer's hard drive. A customer that purchases software through electronic channels often receives a link to download and a product key to activate the software. The comment asserted that an underlying principle of these regulations is to treat economically similar income equally, regardless of whether the income is earned through electronic means or through more conventional channels of commerce, and therefore the income earned by a wholesaler of product keys for software should be treated the same as a wholesaler of physical copies of software. The Treasury Department and the IRS agree that §1.861-18 does not characterize otherwise similar transactions differently solely because one transaction was

effected through electronic means and the other was not. *See* §1.861-18(g)(2) of the final regulations. In response to the comment, a new example added in the final regulations, §1.861-18(h)(24) (Example 24), addresses a business model in which a video game copyright owner transfers product keys to retailers, and then the retailers transfer those keys to customers. Based on the facts in the example, the transfer of product keys to the retailers is characterized as a sale of copyrighted articles, and the transfer of product keys from the retailers to customers is also classified as the sale of copyrighted articles.

Two comments asked for an example addressing a business model in which an operator of a platform offers for download digital content (for example, video games or electronic books) as an agent of the digital content developers. The platform operator receives the copyright right to make and sell digital copies of the digital content, but this right is granted only so that the platform operator can act in its capacity as an agent facilitating sales of the digital content between digital content developers and customers. As such, the comments asserted that the transaction between the platform operator and digital content developers should not be treated as the transfer of copyright rights. One of these comments also suggested several clarifying changes to proposed §1.861-18(h)(19) (Example 19) to distinguish the business model described in that example, which involves a licensed reseller that utilizes an online platform, from the agency platform operator described in the comment.

The Treasury Department and the IRS recognize that an agency platform operator business model exists, and therefore the final regulations include a new example at §1.861-18(h)(20) (Example 20) that describes a scenario in which a platform operator offers applications for sale as an agent of the application developers. The facts in Example 20 assume that the platform operator acts as an agent of the application developers under general tax principles and concludes that the characterization of the transaction between the platform operator and application developers is not a digital content transaction nor a cloud transaction. Whether a taxpayer is acting as an agent on behalf of another taxpayer is determined under general tax principles and that determination is outside the scope of these final regulations. Additionally, §1.861-18(h)(19) (Example 19) of the final regulations contains certain changes to the facts in the proposed regulations that are intended to distinguish the licensed reseller platform operator business model described in that example from the agency platform operator model described in Example 20, namely that the primary benefit or value that the distributor (Corp A) receives in the transaction in Example 19 is the right to reproduce and distribute an unlimited number of copies of the book.

One comment recommended adding an example describing a business model in which a video game that can be played on a particular game console or a computer is sold in physical copies through retailers, or digitally through the game console's store or through an Internet store for a one-time fee. The game's core functionality is accessed online and, if played on the game console, requires paying an annual or monthly subscription fee to the console maker which grants the customer access to the online functionality of the console, thereby allowing the customer to play the online component of the video game (and all other video games) on the console. This fee is charged by the console maker for purposes of using the console online, so if the game is played on a computer, there is no additional fee to access the online content. The example in the comment concluded that the purchase of the console version of the video game, whether from a retailer, the game console store, or the Internet store, is a cloud transaction because most customers purchase the game primarily to enjoy the online functionality. This comment also recommended another similar example, except the core functionality of the video game is offline content, and therefore the purchase of the video game is the sale of a copyrighted article.

The comment underscores the fact that there are many different business models and types of transactions in the video game industry. The determination of the character of each transaction will necessarily be fact-specific based on the rights obtained by the customer and, if relevant, the predominant character of the transaction. However, to address certain aspects of these scenarios, a new example at §1.861-18(h)(24) (Example 24) of the final regulations describes the purchase of a video game for a one-time fee that has online and offline functionality, and that does not require paying a periodic subscription fee that is specific to that game to access the online content. Additionally, a new example at §1.861-19(d)(11) (Example 11) of the final regulations describes the purchase of a video game for a one-time fee whose primary functionality is online and requires paying a monthly fee to the game developer to access the online content specific to the game. The examples conclude in both cases that, under the facts presented, a customer's purchase of a game has the predominant character of a sale of a copyrighted article. Neither example introduces additional complexity by describing a separate subscription fee that the customer must pay to a console maker to enable the online functionality of the console for all games played on that console. The Treasury Department and the IRS have concluded that such a fee would not be relevant to determining the character of transactions specific to the game itself under the final regulations. Such a fee is more akin to the monthly amount that a customer may pay to an Internet service provider for Internet access to play games online in general, because the fee is not specific to the game and is instead required to enable online functionality on a device that has other functions.

One comment recommended changes to the facts in §1.861-18(h)(19) through (21) (Examples 19 through 21) of the proposed regulations, which contained a restriction on the transfer of the digital content by limiting the number of devices onto which the customer could download the content. Specifically, the comment recommended modernizing these examples by replacing the "limited number of devices" restriction with more general background that explains that the user agreement and the conditions and features of the provider's website and applications adequately restrict the end-user's ability to lend or otherwise transfer the digital content. In §1.861-18(h)(19) and (21) (Examples 19 and 21) of the final regulations, the restriction on the number of devices is removed, and facts were added

to make clear that no copyright rights were granted. Proposed §1.861-18(h)(20) (Example 20), which discussed a business that offered end-users membership to a catalog of copyrighted music and required the end-users to download the songs, was removed from the final regulations because the Treasury Department and the IRS determined the facts described in the example were unrealistic.

III. *Cloud Transactions*

A. *Classification of cloud transactions*

Proposed §1.861-19(c)(1) would provide that a cloud transaction is classified solely as either a lease of property or the provision of services, based on all relevant factors. Proposed §1.861-19(c)(2) would enumerate a non-exhaustive list of potentially relevant factors, most of which come from section 7701(e) of the Code. The preamble to the proposed regulations requested comments as to whether the classification as either a lease or a service was correct, or whether cloud transactions are more properly classified in another category of income. The preamble also requested comments on realistic examples of cloud transactions that would be treated as leases under proposed §1.861-19.

Several comments recommended that all cloud transactions be classified as services because the commentators could not identify any realistic cloud transaction that could be classified as a lease. One comment requested that the final regulations include an example of a cloud transaction that would be treated as a lease, but did not suggest a scenario in which a cloud transaction would be a lease. Alternatively, the comments recommended that the final regulations include a rebuttable presumption that all cloud transactions are classified as services.

In the absence of a rule stating all cloud transactions are services, several comments expressed concerns with, and suggested modifications to, certain factors listed in proposed §1.861-19(c)(2). For example, some comments suggested that certain factors were not relevant for cloud transactions, or would generally weigh towards a lease characterization, but that overall, a cloud transaction should still be classified as the provision of services. Comments also recommended clarifying the treatment as services of related party data hosting transactions that involve cost-plus payments from a company under common control with the hosting company.

One comment suggested adding an example that commonly exists in practice that is similar to proposed §1.861-19(d)(2) (Example 2), involving the provision of designated servers to the customer, but with a shifted focus to analyze the access that a remote user may have to data and software on those servers.

Two comments expressed concerns that the proposed regulations may be used to characterize transactions of infrastructure providers, such as real estate investment trusts, who lease and otherwise make available real property and other infrastructure to cloud providers and similar tenants. These comments were concerned that the proposed regulations referenced the section 7701(e) factors to determine whether a cloud transaction was a service or a lease, and that these interpretations could affect the interpretation of the section 7701(e) factors in the context of non-cloud transactions.

The final regulations treat all cloud transactions solely as the provision of services and remove the section 7701(e) and other factors listed in the proposed regulations. Like the comments, the Treasury Department and the IRS could not identify a transaction that satisfies the definition of a cloud transaction that would be properly classified as a lease. Further, the Treasury Department and the IRS would expect future business models that meet the definition of a cloud transaction to constitute services rather than leases or other types of transactions. The services classification is appropriate because in a typical business model that includes a cloud transaction, the cloud provider retains economic control and possession over the relevant property (such as servers, software, or digital content, depending on the transaction) and the cloud transaction meets other hallmarks of a service transaction such as the provider having the ability to determine the specific property used to provide the cloud transaction and to replace such property with similar property. Note, however, that business models may include transactions involving computer hardware, such as a server, that is located at the customer's premises, and such a transaction may fall outside the definition of a cloud transaction (for example, because there is no on-demand network access provided in that transaction) and would therefore be classified under section 7701(e) and general tax principles. The Treasury Department and the IRS have also concluded that a more definite rule for characterization based on the definition of a cloud transaction will allow for better compliance and tax administration than the factors test in the proposed regulations. Because the final regulations classify all cloud transactions as the provision of services, examples applying the factors from the proposed regulations to determine whether a cloud transaction is a service or a lease have been removed (and no example concluding that the cloud transaction is a lease has been added).

Finally, one comment recommended expanding the characterization of cloud transactions to include licenses for transactions in which non-de minimis copyright rights are transferred. The comment described an example where an owner of digital content (a movie) streams that digital content to a movie theater and grants the movie theater the right to show the streamed content to customers. The comment concluded that the transaction between the content owner and the movie theater is a license. The comment expressed the belief that the manner in which digital content and accompanying public display or performance rights are delivered should not alone change the character of a transaction from a license to a service or lease.

The final regulations do not adopt this comment. In the scenario posited by the comment, the movie theater would be much more likely to download or otherwise obtain a copy of the movie than to stream the movie simultaneously with displaying the movie to customers, given the possibility of buffering or other technology issues that might occur while streaming and negatively impact the movie theater's customers. However, a somewhat similar scenario could occur if a bar or similar establishment streams music, sporting events, or other content as entertainment for customers eating or drinking at the establishment. While the agreement

with the streaming service may grant the bar the right to perform or to display the streamed content to its customers, if there is no transfer of digital content (that is, no option to download of digital content), the transaction falls outside the digital content rules in §1.861-18 and may be properly characterized as a cloud transaction. Whether there is a transfer of a copyright right that is not described in §1.861-18(c)(2) would depend on copyright law. As described in Part I.B of this Summary of Comments and Explanation of Revisions, a fundamental requirement for a digital content transaction such as a license of copyright rights, as opposed to a cloud transaction involving digital content, is that the former involves a transfer of the digital content to the customer. If, however, the theater or the bar has the choice to download or stream the content, then §1.861-18, including the predominant character rule, would apply to the transaction.

B. *Inclusion of common cloud business models*

One comment suggested that the final regulations explicitly include as cloud transactions certain common cloud-based business models, namely: (1) advertising models where customers obtain "free" services and advertisers pay for access to those customers; (2) marketplace sites and apps that function as sales agents; (3) gig-economy sites and apps that put service providers and customers together; (4) job recruiting sites and apps that find candidates for employers; (5) travel sites and apps that act like sales agents for hotels, flights, etc.; and (6) game sites that allow users access to a range of games for a subscription price.

The final regulations do not adopt this comment, though some similar examples are included in §1.861-18(h). Although each of the comment's suggested scenarios include services or goods accessed through the Internet, whether each scenario is a cloud transaction (as defined by §1.861-19(b)) is fact-specific and cannot be determined solely on the basis of the type of offering provided. Section 1.861-19(b) defines a cloud transaction as a transaction through which a person obtains on-demand network access to computer hardware, digital content (as defined in §1.861-18(a)(2)), or other similar resources. The first scenario, involving customers' "free" access to content that is funded by advertising, is similar to §1.861-18(h)(22) (Example 22) of the final regulations. The example addresses the transfer of content to the platform by content creators (a digital content transaction) and the access to the content by customers (a cloud transaction). However, the example does not address the transaction between the advertisers and the platform because while the ads are viewable online, the advertising services are likely not cloud transactions because there is likely no on-demand network access to computer hardware, digital content, or similar resources provided by the platform to the advertisers (though specific fact patterns may differ). The second scenario, involving marketplace sites and apps that function as sales agents, may result in a transaction that has a digital content transaction element and a cloud transaction element if the marketplace site or app is used to transfer digital content to customers. *See* §1.861-18(h)(20) (Example 20). Similarly, the sixth scenario, involving game sites allowing access to a range of games for a subscription price, may require a predominant character analysis to determine whether the primary benefit to the customer (or a typical customer) is the download of games or access to play the games online. *See* §1.861-18(h)(24) (Example 24). In the remaining scenarios proposed by the comment, the website or app may provide a service, but it is likely that the service would not be a cloud transaction because the recipient of the service does not receive on-demand network access to computer hardware, digital content, or similar resources. The framework of the final regulations should be applied to the facts of each specific transaction rather than making generalizations about broad categories of content offerings.

C. *Examples illustrating §1.861-19*

Many comments requested modifications to the examples provided in proposed §1.861-19, or new examples describing common business models. In response to these comments, the final regulations contain several new examples and make certain modifications to the pre-existing examples. The final regulations also remove examples illustrating the proposed regulations' application of factors to distinguish between the characterization of a cloud transaction as a service or a lease because the final regulations characterize all cloud transactions as services.

Proposed §1.861-19(d)(11) (Example 11) would describe a scenario in which a taxpayer operates an online database of industry-specific materials that utilizes a proprietary search engine. Certain materials in the database constitute digital content. The example concluded that the taxpayer's provision of on-demand access to its computer hardware and software is a cloud transaction. One comment requested clarification that the characterization of this transaction would not be different if the online database contained no copyrightable materials. In the final regulations, the analysis of this example (which has been redesignated §1.861-19(d)(8) (Example 8)) explains that the cloud transaction is access to the search engine and online database, rather than online access to the digital content, and therefore the conclusion that the transaction is a cloud transaction would not change if none of the content in the database was copyrightable. This conclusion is consistent with §1.861-19(b)'s definition of a cloud transaction as a transaction through which a person obtains on-demand network access to computer hardware, digital content (as defined in §1.861-18(a)(2)), or other similar resources. In this case, the content accessed would be an "other similar resource."

Two comments expressed concern that certain jurisdictions around the world treat income earned by a reseller of services, such as software-as-a-service, as royalties subject to withholding. These comments asked for an example in the final regulations addressing a reseller of services that concludes the reseller's income is services income. In response to these comments, section 1.861-19(d)(10) (Example 10) of the final regulations addresses a reseller of software-as-a-service and concludes the transaction between the reseller and its customers is a cloud transaction classified as the provision of services.

Proposed §1.861-19(d)(9) (Example 9) would describe a scenario in which a

taxpayer maintains a catalogue of videos and music that it streams to customers in exchange for a monthly fee. To better reflect current and developing business practices, comments recommended adding a fact to this example that customers have the ability to download the digital content for offline viewing, and that such ability is de minimis in the context of the overall transaction. Proposed §1.861-19(d)(9) (Example 9) is redesignated §1.861-19(d)(7) (Example 7) of the final regulations, and the ability to download the digital content has been added to the facts in the example. As discussed in Part I.A of this Summary of Comments and Explanation of Revisions, a predominant character rule in the final regulations replaced the de minimis rule in the proposed regulations. Under the facts described in Example 7 of the final regulations, the predominant character of the transaction is a cloud transaction.

IV. *Sourcing Rules*

A. *Source rule for sales of copyrighted articles transferred through an electronic medium*

1. In General

Section 1.861-18(f)(2), as in effect before this Treasury decision, provided that income from sales of copyrighted articles is sourced under sections 861(a)(6), 862(a)(6), 863, 865(a), (b), (c), or (e), as appropriate. Proposed §1.861-18(f)(2)(ii) would provide that when a copyrighted article is sold and transferred through an electronic medium, the sale is deemed to have occurred at the location of download or installation onto the end-user's device used to access the digital content for purposes of §1.861-7(c). If information about the location of download or installation was not available, proposed §1.861-18(f)(2)(ii) would provide that the sale is deemed to have occurred at the location of the customer, as determined based on the taxpayer's recorded sales data for business or financial reporting purposes.

Comments observed practical challenges with applying a rule based on the location of download or installation, including that: (i) data privacy laws may prevent taxpayers from collecting or retaining this information, (ii) Internet Protocol (IP) addresses may be unreliable because virtual private networks may obscure an end-user's IP address, (iii) it would be burdensome and expensive for taxpayers to collect new data on the location of download or installation, (iv) there may be difficulties in determining the location of download or installation onto an end-user's device when software is sold through multi-level distribution channels, and (v) it may be difficult to identify the end-user. One comment suggested that the final regulations provide examples that illustrate the application of the download test in various circumstances.

Instead of endorsing the proposed rule, most comments addressing this topic recommended a rule that uses the billing address of the first unrelated purchaser to determine the location of the sale. Some comments observed that the billing address of the purchaser is information sellers already collect and is a more reliable indicator of where the purchaser will use the digital content. Several comments suggested that taxpayers be permitted to elect to use the location of download or installation instead of the billing address of the purchaser if the taxpayer has access to that information. Some comments recommended permitting taxpayers to elect to use the location of actual use of the digital content, such as when an employer purchases digital content that is used by an employee not located in the same jurisdiction as the employer.

Finally, another comment recommended that the rule in §1.861-7(c) (which provides that the place of sale is the place where the rights, title, and interest of the seller in the property are transferred to the buyer (the title passage rule)) should be retained for purposes of sourcing sales of copyrighted articles transferred through an electronic medium.

The final regulations adopt these comments in part. Consistent with the proposed regulations, §1.861-18(f)(2)(ii) of the final regulations moves away from the "title passage" rule for sales of copyrighted articles transferred through an electronic medium. One reason for the change is that the title passage rule allowed taxpayers to artificially elect the source of income from sales of copyrighted articles through an electronic medium using contractual terms that had no real-world impact due to the nature of digital content. A digital download is an almost instantaneous transfer that occurs with limited risk of loss; even when a file is corrupted in the download or installation process, a noncorrupted copy can be provided to the customer at virtually no cost to the seller, and the precise location of the corruption is typically not relevant. In contrast, a contractual agreement as to when and where title passes for physical property moved through physical distribution chains has real-world impact because the property may be lost or become damaged in transit and the location of title passage determines whether the seller or buyer bears the burden of that loss. Because the nature of the supply chain means that the seller retains risk of loss until a successful download, §1.861-18(f)(2)(ii) treats the sale as having occurred at the customer's location, using the customer's billing address as a proxy. The Treasury Department and IRS generally agree that a billing address is more administrable than the location of download or installation as a suitable proxy for the place of sale of electronically transferred copyrighted articles (subject to the anti-abuse rule discussed below).

The Treasury Department and IRS disagree, however, that the billing address of a subsequent unrelated purchaser of the same copyrighted article should be the general rule for sales between related parties, given the focus of the statutory sourcing provisions on place of sale. *See* sections 861 through 865. It would also be complex and potentially inaccurate to attempt to determine whether every sale is intended for a related or unrelated purchaser. Therefore, §1.861-18(f)(2)(ii) of the final regulations provides that when a copyrighted article is sold and transferred through an electronic medium, the sale is deemed to have occurred at the location of the billing address of the purchaser for purposes of §1.861-7(c), regardless of whether that purchaser is a related or unrelated party. This billing address rule also resolves the issue raised by comments regarding who the end-user is in certain transactions because the sourcing rule is based on the immediate purchaser in the transaction. *See* §1.861-18(h)(25) (Example 25).

The final regulations also do not provide for an election to treat the sale of a copyrighted article as occurring at the location of download or installation. As noted earlier in this part, one of the reasons for moving away from "title passage" for sales of copyrighted articles transferred through an electronic medium was that it allowed sellers the ability to artificially elect the source of the income. Consistent with this concern about electivity, the final regulations provide a single, administrable rule that applies to all sales (subject to the anti-abuse rule).

The final regulations also add a new anti-abuse rule for any case in which the sales transaction is arranged in a particular manner for a principal purpose of tax avoidance. *See* §1.861-18(f)(2)(ii) and (h)(26) (Example 26). In such cases, the foregoing billing address rule will not be applied, and instead all relevant facts and circumstances of the transaction will be considered to treat the sale as having occurred where the substance of the transaction occurred. This anti-abuse rule replaces the anti-abuse rule in §1.861-7(c) with respect to sales of copyrighted articles sold and transferred through an electronic medium.

Finally, several comments asked for clarification that this source rule applies solely for purposes of the title passage rule of §1.861-7(c). The Treasury Department and the IRS have concluded that these comments were already addressed in proposed §1.861-18(f)(2)(ii) by the language that limited application of the rule "for purposes of §1.861-7(c)," and the final regulations retain this language.

2. Coordination with Section 863(b)

Some comments recommended allowing taxpayers to elect to apply a billing address source rule for sales of digital content where section 863(b) may otherwise apply. Section 863(b) provides, in part, that the gains, profits, and income from the sale or exchange of inventory property produced (in whole or in part) by the taxpayer within the United States and sold or exchanged without the United States, or produced (in whole or in part) by the taxpayer without the United States and sold or exchanged within the United States, shall be allocated and apportioned between sources within and without the United States solely on the basis of the production activities with respect to the property.

The final regulations do not adopt the comment recommending allowing taxpayers to elect to apply a billing address source rule for sales of digital content where section 863(b) would apply. When section 863(b) applies, property produced and sold by a taxpayer must be sourced "solely on the basis of the production activities with respect to the property." There is nothing to suggest that the billing address of the customer is relevant to this statutory rule based on place of production, and so the final regulations do not adopt this comment.

3. Interaction with Rules for Sourcing Leases and Licenses of Digital Content

One comment supported the location of download or installation rule for determining the place of sale for copyrighted articles, and recommended the final regulations explicitly adopt a uniform rule for sourcing income from sales, leases, and licenses of digital content based on the location of the end-user. The comment also recommended allowing taxpayers to rely on recorded sales data to determine the location of the end-user for purposes of determining place of use for leases and licenses of digital content.

The final regulations do not adopt this comment. Section 1.861-18(f)(2)(ii) clarifies how the place of sale of digital content is determined for purposes of sections 861 through 865. Those sections contain different rules for determining the source of income from leases and licenses, for which the place of transfer is not the relevant statutory rule (generally, the determination is based on where the property subject to the lease or license is used, or where the possessor of the interest has the right to use the property). *See* sections 861(a)(4), 862(a)(4). Section 1.861-18(f)(2)(ii) looks to the customer's billing address for purposes of determining the place of sale for purposes of §1.861-7(c). While that may sometimes also be the location in which the digital content is used, that is not necessarily the case. For example, where copyright rights are transferred in a transaction that is classified as a license, the copyright rights may be used in multiple locations, and not just the location of the customer's billing address. Similarly, not all income from sales is sourced to the place where the sale occurred. In those cases, the statute provides the relevant determination, such as the place of production in section 863(b) or the residence of the seller in section 865(a). The location of download or installation is not necessarily indicative of any of those things, and the Treasury Department and the IRS only intend for the rule in §1.861-18(f)(2)(ii) to be used to determine the place where the sale occurred for purposes of statutory sourcing rules that rely on that determination. Therefore, §1.861-18(f)(2)(ii) of the final regulations is not extended to provide a sourcing rule for all sales, licenses, and leases of digital content.

Finally, a comment suggested that the regulations clarify that a license of copyright rights from a copyright owner to a distributor is sourced under section 861(a)(4) or 862(a)(4). Because §1.861-18(f)(2), as in effect before this Treasury decision, already provides that income derived from licensing copyright rights is sourced under section 861(a)(4) or 862(a)(4), no changes have been made in response to this comment.

B. *Source rule for gross income from a cloud transaction*

Proposed §1.861-19 would not provide a source rule for cloud transactions. As such, the proposed regulations indicated that existing law, regulations, and IRS guidance regarding sourcing services and leases would apply to sourcing cloud transactions. Numerous comments were received regarding whether a specific source rule for cloud transactions would be appropriate and several of these comments included suggestions for such a rule.

The Treasury Department and the IRS are of the view that that there would be benefits for taxpayer compliance and administrability if gross income from cloud transactions were sourced using a uniform rule. Thus, the Treasury Department and the IRS are issuing proposed regulations (REG-107420-24) published elsewhere in this same issue of the ***Federal Register*** (90 FR 3075) that provide

rules for determining the source of gross income from a cloud transaction.

C. *Removal of Example 5 from §1.937-3(e)*

The proposed regulations would have removed Examples 4 and 5 from §1.937-3(e). Section 937 provides residence and source rules involving territories. Examples 4 and 5 of §1.937-3(e) relate to the sourcing of income from digital content transactions and cloud transactions, respectively. One comment suggested that the proposal to remove Example 5 was premature because the proposed regulations did not include a source rule for cloud transactions. The final regulations do not accept this comment. As discussed in Part IV.B of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS are issuing a companion notice of proposed rulemaking addressing the source of income from cloud transactions concurrent with these final regulations. Therefore, to avoid potentially inconsistent inferences, the final regulations remove both Examples 4 and 5 of §1.937-3(e).

V. *Comments Outside the Scope of this Treasury Decision*

The preamble to Treasury Decision 8785, which promulgated §1.861-18 in 1998, stated that the Treasury Department and the IRS were considering whether to issue guidance regarding whether transactions in copyrighted articles are transactions in tangible property, and whether transactions in copyright rights are transactions in intangible property, in each case for purposes of section 482. The proposed regulations did not contain further guidance on this topic.

One comment to the proposed regulations recommended that the Treasury Department and the IRS reconsider this matter and issue guidance on this topic because the characterization of a transfer of digital content as tangible or intangible property is important for purposes of sections 250, 367(d), and 482. The Treasury Department and IRS have determined that guidance on whether the categories of transactions in §1.861-18 are considered tangible or intangible property for purposes of such Code sections is outside the scope of these regulations.

One comment suggested that section 904 should be amended as it relates to certain sales income earned by U.S. residents to prevent "cross-crediting" of high-taxed income and zero- or low-taxed income within the same foreign tax credit basket under section 904(d)(1). The comment noted that such "cross-crediting" results in the U.S. partially or fully bearing the cost of the high tax rates in some foreign jurisdictions because a credit related to the high-taxed income may offset U.S. tax on the income from low-tax jurisdictions. Amendments to section 904 are outside the scope of this Treasury Decision.

Two comments suggested changes to the regulations under section 250 pertaining to foreign-derived intangible income (FDII). One comment requested that the Treasury Department and the IRS introduce a rule under §1.250(b)-4 stating that intangible property used in providing a service that is a cloud transaction within the meaning of §1.861-19 is, for purposes of section 250, used at the location of the employees engaged in, and tangible property used in, providing the cloud transaction service. That comment also suggested adding a de minimis rule under §1.250(b)-4 providing that any de minimis use of intangible property is disregarded in a cloud transaction. A second comment noted that the characterization of a cloud transaction would impact whether income is eligible for the FDII deduction because there are different rules for establishing "foreign use" for services and lease transactions. That comment also suggested that the "foreign use" rule for intangible property should replicate the rule governing foreign use of general property. These comments are outside the scope of this Treasury Decision, but were considered in finalizing the section 250 regulations. *See* T.D. 9901 (85 FR 43042, July 15, 2020).

VI. *Final Regulations Apply Only for Certain International Provisions of the Code*

Section 1.861-18, as in effect before this Treasury decision, applied only to certain listed international provisions of the Code. When §1.861-18 was promulgated in 1998, the preamble stated that the Treasury Department and the IRS were considering whether the principles of §1.861-18 should apply to other provisions of the Code. The proposed regulations retained the scope of §1.861-18 by applying only to certain listed international provisions of the Code, although additional sections of the Code were added to the scope of the proposed regulations due to changes in law between 1998 and the date of the proposed regulations. Proposed §1.861-19 would also apply only to the same listed international provisions of the Code.

The Treasury Department and the IRS received comments recommending expanding the scope of the final regulations to apply for all purposes of the Code, particularly with respect to §1.861-18 for which all comments received on this topic recommended expansion to all purposes of the Code. Multiple comments expressed that the framework of the proposed regulations provides sensible rules and certainty with respect to transactions involving digital content. One comment also expressed concern that limiting the scope of the final regulations to only international provisions of the Code could lead to the same transaction being characterized differently depending on which Code section was applied. Another comment expressed the belief that both taxpayers and the IRS will utilize the guidance in the final regulations by analogy even if the final regulations apply only to international provisions of the Code, and that it would be better to make it clear that the final regulations apply to all provisions of the Code so that taxpayers and the IRS will not have to go through the rigors of trying to convince the other party that the final regulations are relevant in a particular case.

Unlike §1.861-18, some comments recommended that §1.861-19 not be applied beyond the scope provided in the proposed regulations. These comments expressed concern that the preamble to §1.861-19 referenced section 7701(e) (pertaining to the treatment of certain contracts as leases rather than service contracts), and recommended against any guidance providing that section 7701(e) could apply throughout the Code, including Subchapter M. One comment explained that the extent to which the provision of services affects the definition of "rents from real prop-

erty” for real estate investment trust purposes is addressed not only in Subchapter M and the regulations thereunder, but also in numerous items of IRS sub-regulatory guidance and private letter rulings specifically interpreting Subchapter M. The comments recommended adding an explicit disclaimer in the preamble and the text of the final regulations that any purported interpretation and application of section 7701(e) principles in the final regulations do not apply outside the intended scope of the final regulations, and therefore do not apply to lease-versus-service determinations under other provisions of chapter 1 of the Code. As discussed under Part III.A of this Summary of Comments and Explanation of Revisions, the final regulations treat all cloud transactions as the provision of services, and accordingly remove the section 7701(e) factors from the regulatory text.

More broadly, the Treasury Department and the IRS continue to study issues related to applying the final regulations to all provisions of the Code. Concurrently with the issuance of the final regulations, the Treasury Department and the IRS are issuing a Notice (**Notice 2025-6**) requesting comments regarding issues to consider in deciding whether to apply the characterization rules in §§1.861-18 and 1.861-19, as amended and added, respectively, by the final regulations to all provisions of the Code.

VII. *Change in Method of Accounting*

The proposed regulations would treat a change in method of accounting that a taxpayer made in order to comply with the proposed regulations as a change initiated by the taxpayer. Accordingly, the change in method of accounting would have to be implemented under the rules of §1.446-1(e) and the applicable administrative procedures that govern voluntary changes in method of accounting under section 446(e).

Two comments suggested that if a taxpayer must change its method of accounting in order to comply with the final regulations, then such change should be eligible for automatic consent.

The final regulations do not adopt these comments. The Treasury Department and the IRS generally do not anticipate taxpayers needing to change methods of accounting as a result of the final regulations. Additionally, in light of the aforementioned Notice requesting comments on applying the characterization rules in §§1.861-18 and 1.861-19, as amended and added, respectively, by the final regulations for all purposes of the Code, the Treasury Department and IRS have determined that it is important to ensure that any accounting method changes due to these regulations are consistent with the appropriate treatment of the transactions at issue under all appropriate Code or regulation sections.

VIII. *Applicability Date*

The proposed regulations were proposed to apply to transactions entered into pursuant to contracts entered into in taxable years beginning on or after the date of publication of final regulations.

Comments recommended the final regulations apply to transactions entered into in taxable years beginning on or after the date that final regulations are published, regardless of the date of the contracts pursuant to which such transactions were entered into. One comment noted that it would be difficult to trace particular transactions to contracts that were entered into in taxable years that begin on or after the date of publication of final regulations. Other comments noted that the proposed applicability date may result in different rules applying to similar transactions of the same taxpayer long after these regulations are finalized.

One comment suggested allowing taxpayers to elect application of the final regulations to taxable years ending after the date of publication of the proposed regulations. Another comment recommended that taxpayers be allowed to elect to apply the final regulations to transactions taking place before the effective date of the final regulations.

In response to these comments, the final regulations generally apply to taxable years beginning on or after the date of publication of this Treasury decision in the ***Federal Register***. However, taxpayers may elect to apply all of the rules of the final regulations to taxable years beginning on or after August 14, 2019 and all subsequent taxable years as long as all related persons (within the meaning of sections 267(b) and 707(b)) also apply all of the rules of the final regulations to taxable years beginning on or after August 14, 2019 and all subsequent taxable years, the period of limitations on assessment for each taxable year of the taxpayer and all related parties (within the meaning of sections 267(b) and 707(b)) is open under section 6501, and the taxpayer would not be required under this section to change its method of accounting as a result of such election.

Special Analyses

I. *Regulatory Planning and Review—Economic Analysis*

Pursuant to the Memorandum of Agreement, Review of Treasury Regulations under Executive Order 12866 (June 9, 2023), tax regulatory actions issued by the IRS are not subject to the requirements of section 6 of Executive Order 12866, as amended. Therefore, a regulatory impact assessment is not required.

II. *Paperwork Reduction Act*

The Paperwork Reduction Act of 1995 (44 U.S.C. 3501-3520) (PRA) generally requires that a Federal agency obtain the approval of the Office of Management and Budget (OMB) before collecting information from the public, whether such collection of information is mandatory, voluntary, or required to obtain or retain a benefit. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

The collections of information in these final regulations contain reporting and recordkeeping requirements that are necessary to ensure the correct classification of digital content transactions and cloud transactions. The collections will be used by the IRS for tax compliance purposes.

The final regulation mentions a reporting requirement where a taxpayer may be required to change its method of accounting. For PRA purposes, Form 3115, Application for Change in Accounting Method, is already approved by OMB under Con-

trol Numbers 1545-0047 for tax-exempt entities, 1545-0074 for individuals, 1545-0123 for business filers and 1545-0092 for trust and estate filers.

The recordkeeping requirements include that entities keep records of their transactions to substantiate the transaction classification. These recordkeeping requirements are considered general tax records under §1.6001-1(e). For PRA purposes, general tax records are already approved by OMB under 1545-0047 for tax-exempt entities, 1545-0074 for individuals, 1545-0123 for business filers and 1545-0092 for trust and estate filers.

These final regulations are not creating new information collections or changing information collections already approved by OMB.

III. *Regulatory Flexibility Act*

The Regulatory Flexibility Act requires consideration of the regulatory impact on small businesses. It is hereby certified that these final regulations will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act (5 U.S.C. chapter 6).

Although data are not readily available to estimate the number of small entities that would be affected by the final regulations, the Treasury Department and the IRS project that any economic impact of the regulations would be minimal for businesses regardless of size. These final regulations generally provide clarification of definitions regarding how transactions are classified, and thus are not expected to have an impact on burden for large or small businesses. The Treasury Department and the IRS project that any economic impact would be small because current industry practice is generally consistent with the principles underlying the final regulations.

IV. *Section 7805(f)*

Pursuant to section 7805(f) of the Code, the proposed regulations (REG-130700-14) preceding these final regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on the impact on small businesses and no comments were received.

V. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or Tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. The final regulations do not include any Federal mandate that may result in expenditures by State, local, or Tribal governments, or by the private sector in excess of that threshold.

VI. *Executive Order 13132: Federalism*

Executive Order 13132 (entitled "Federalism") prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statutes, or preempts State law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. The final regulations do not have federalism implications, do not impose substantial direct compliance costs on State and local governments, and do not preempt State law within the meaning of the Executive order.

Drafting Information

The principal authors of these final regulations are Christopher E. Fulle and Michelle L. Ng of the Office of the Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, the Treasury Department and the IRS amend 26 CFR part 1 as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.861-7 is amended by revising paragraph (c) to read as follows:

§1.861-7 Sale of personal property.

* * * * *

(c) *Country in which sold*. For purposes of part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder, a sale of personal property is consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss. However, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the foregoing rules will not be applied. In such cases, all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred. For determining the place of sale of copyrighted articles transferred through an electronic medium, see §1.861-18(f)(2)(ii).

* * * * *

Par. 3. Section 1.861-18 is amended by:

a. Revising the section heading;

b. Revising paragraphs (a), (b), (c)(1), (c)(2)(i) through (iv), (c)(3), (d), (e), (f)(1) through (3), (g)(2), (g)(3)(i) and (ii), and (h) through (j); and

c. Removing paragraph (k).

The revisions read as follows:

§1.861-18 Classification of, and source of gross income from, digital content transactions.

(a) *General*—(1) *Scope*. This section provides rules for classifying digital content transactions (as defined in paragraph (b)(1) of this section) for purposes of

subchapter N of chapter 1 of the Internal Revenue Code, sections 59A, 245A, 250, 267A, 367, 404A, 482, 679, 1059A, chapters 3 and 4, sections 842 and 845 (to the extent involving a foreign person), and transfers to foreign trusts not covered by section 679.

(2) *Digital content*—(i) *Digital content defined*. For purposes of this section, digital content means a computer program or any other content, such as books, movies, and music, in digital format that is—

(A) Protected by copyright law; or

(B) Not protected by copyright law solely—

(*1*) Due to the passage of time; or

(*2*) Because the creator dedicated the content to the public domain.

(ii) *Computer program defined*. For purposes of this section, a computer program is a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result and includes any media, user manuals, documentation, data base, or similar item if the media, user manuals, documentation, data base, or other similar item is incidental to the operation of the computer program.

(b) *Categories of transactions*—(1) *General*. A transaction that constitutes a transfer of digital content, or the provision of services or of know-how with respect to digital content (each a digital content transaction), is treated as being solely one of the following—

(i) A transfer of a copyright right in the digital content;

(ii) A transfer of a copy of the digital content (a copyrighted article);

(iii) The provision of services for the development or modification of the digital content; or

(iv) The provision of know-how relating to development of digital content.

(2) *Transaction with multiple elements*. Taking into account the overall transaction and the surrounding facts and circumstances, a transaction that has multiple elements, one or more of which would be a digital content transaction if considered separately, is classified in its entirety as a digital content transaction under one of the categories described in paragraph (b)(1) of this section if the predominant character of the transaction is described in one of the categories in that paragraph.

(3) *Determination of predominant character*—(i) *General rule*. For purposes of paragraph (b)(2) of this section and §1.861-19(c)(2), the predominant character of a transaction is determined by ascertaining the primary benefit or value received by the customer in the transaction.

(ii) *Special rule*. If the primary benefit or value received by the customer in the transaction is not reasonably ascertainable, the predominant character of a transaction is instead determined by ascertaining the primary benefit or value received by a typical customer in a substantially similar transaction as determined under paragraphs (b)(3)(ii)(A) and (B) of this section.

(A) The primary benefit or value received by a typical customer is determined by data on how a typical customer uses or accesses the digital content. See paragraph (h)(17) of this section (*Example 17*).

(B) If data described in paragraph (b)(3)(ii)(A) of this section is not available, then the predominant character of a transaction subject to the special rule in paragraph (b)(3)(ii) of this section is determined by examining other factors that are indicative of the primary benefit or value received by a typical customer, including the following—

(*1*) How the transferor or provider markets the transaction;

(*2*) The relative development costs to the transferor or provider of each element of the transaction; and

(*3*) The relative price paid in an uncontrolled transaction for one or more elements compared to the total contract price of the transaction in question.

(iii) *Identification and development of data*. A transferor or provider must use reasonable efforts to identify the data specified in paragraphs (b)(3)(i) and (ii)(A) of this section, or if necessary, to apply the factors relevant to paragraph (b)(3)(ii)(B) of this section. However, a transferor or provider is not required to develop any of the data specified in those paragraphs that it does not develop in the course of business.

(c) * * *

(1) *Transfers involving transfers of copyright rights*. A digital content transaction involves a transfer of a copyright right if, as a result of the transaction, a person acquires one or more of the rights described in paragraphs (c)(2)(i) through (iv) of this section.

(2) * * *

(i) The right to make copies of the digital content for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease or lending;

(ii) The right to prepare derivative digital content based upon the digital content;

(iii) The right to make a public performance of digital content, other than a right to publicly perform digital content for the purpose of advertising the sale of the digital content performed; or

(iv) The right to publicly display digital content, other than a right to publicly display digital content for the purpose of advertising the sale of the digital content displayed.

(3) *Copyrighted articles*. A copyrighted article includes a copy of digital content from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device. The copy of the digital content may be fixed in any medium.

(d) *Provision of services*. The determination of whether a transaction involving newly developed or modified digital content involves the provision of services described in paragraph (b)(1) of this section is based on all the facts and circumstances of the transaction, including, as appropriate, the intent of the parties (as evidenced by their agreement and conduct) as to which party is to own the copyright rights in the digital content and how the risks of loss are allocated between the parties. See paragraph (h)(15) of this section (*Example 15*).

(e) *Provision of know-how*. The provision of information with respect to digital content involves the provision of know-how for purposes of this section only if the information is—

(1) Information relating to the development of digital content;

(2) Furnished under conditions preventing unauthorized disclosure, specifically contracted for between the parties; and

(3) Considered property subject to trade secret protection.

(f) * * *

(1) *Transfers of copyright rights*. The determination of whether a transfer of a copyright right is a sale or exchange of property is made on the basis of whether, taking into account all facts and circum-

stances, there has been a transfer of all substantial rights in the copyright. A transfer of a copyright right that does not constitute a sale or exchange because not all substantial rights have been transferred will be classified as a license. For this purpose, the principles of sections 1222 and 1235 apply. Income derived from the sale or exchange of a copyright right will be sourced under section 865(a), (c), (d), (e), or (h), as appropriate. Income derived from the licensing of a copyright right will be sourced under section 861(a)(4) or 862(a)(4), as appropriate.

(2) *Transfers of copyrighted articles*—(i) *Classification*. The determination of whether a transfer of a copyrighted article is a sale or exchange is made on the basis of whether, taking into account all facts and circumstances, the benefits and burdens of ownership have been transferred. A transfer of a copyrighted article that does not constitute a sale or exchange because insufficient benefits and burdens of ownership of the copyrighted article have been transferred, such that a person other than the transferee is properly treated as the owner of the copyrighted article, will be classified as a lease.

(ii) *Source*. Income from transactions that are classified as sales or exchanges of copyrighted articles will be sourced under section 861(a)(6), 862(a)(6), 863, or 865(a), (b), (c), or (e), as appropriate. When a copyrighted article is sold and transferred through an electronic medium, the sale is deemed to have occurred at the location of the billing address of the purchaser for purposes of §1.861-7(c). However, in any case in which the sales transaction is arranged in a particular manner for a principal purpose of tax avoidance, the foregoing rules will not be applied. In such a case, all of the facts and circumstances relevant to the transaction, such as the place where the copyrighted article will be used, the place where negotiations and the execution of the agreement occurred, and the terms of the agreement, will be considered, and the sale will be treated as having occurred where the substance of the sale occurred. Income derived from leasing a copyrighted article will be sourced under section 861(a)(4) or 862(a)(4), as appropriate.

(3) *Special circumstances of digital content*. In connection with determinations under this paragraph (f), consideration must be given as appropriate to the special characteristics of digital content in transactions that take advantage of these characteristics (such as the ability to make perfect copies at minimal cost). For example, a transaction in which a person acquires a copy of digital content on a disk subject to a requirement that the disk be destroyed after a specified period is generally the equivalent of a transaction subject to a requirement that the disk be returned after such period. Similarly, a transaction in which the digital content deactivates itself after a specified period is generally the equivalent of a transaction subject to a requirement that the disk be returned after a specified period.

(g) * * *

(2) *Means of transfer not to be taken into account*. The rules of this section shall be applied irrespective of the physical or electronic or other medium used to effectuate a digital content transaction.

(3) * * *

(i) *In general*. For purposes of paragraph (c)(2)(i) of this section, a transferee of digital content shall not be considered to have the right to distribute copies of the digital content to the public if it is permitted to distribute copies of the digital content to only either a related person, or to identified persons who may be identified by either name or by legal relationship to the original transferee. For purposes of this subparagraph, a related person is a person who bears a relationship to the transferee specified in section 267(b)(3), (10), (11), or (12), or section 707(b)(1)(B). In applying section 267(b), 267(f), 707(b)(1)(B), or 1563(a), "10 percent" shall be substituted for "50 percent."

(ii) *Use by individuals*. The number of employees of a transferee of digital content who are permitted to use the digital content in connection with their employment is not relevant for purposes of this paragraph (g)(3). In addition, the number of individuals with a contractual agreement to provide services to the transferee of digital content who are permitted to use the digital content in connection with the performance of those services is not relevant for purposes of this paragraph (g)(3).

(h) *Examples*. The examples in this paragraph (h) illustrate the provisions of this section. Unless otherwise specified, assume that Corp A is a domestic corporation, the digital content described in each example does not contain any online functionality, and all facts in each example occur as part of a single transaction.

(1) *Example 1: Sale of a computer program on a disk*—(i) *Facts*. Corp A owns the copyright in a computer program, Program X. It copies Program X onto disks. The disks are placed in boxes covered with a wrapper on which is printed what is generally referred to as a shrink-wrap license. The license is stated to be perpetual. Under the license no reverse engineering, decompilation, or disassembly of the computer program is permitted. The transferee receives, first, the right to use the program on two of its own computers (for example, a laptop and a desktop) provided that only one copy is in use at any one time, and second, the right to make one copy of the program on each machine as an essential step in the utilization of the program. The transferee is permitted by the shrink-wrap license to sell the copy so long as it destroys any other copies it has made and imposes the same terms and conditions of the license on the purchaser of its copy. These disks are made available for sale to the general public in Country Z. In return for valuable consideration, P, a Country Z resident, receives one such disk.

(ii) *Analysis*. (A) Under paragraph (b)(1) of this section, the transfer of a disk containing a copy of Program X from Corp A to P is a digital content transaction with one element, which is the transfer of a copy of Program X. Therefore, the transaction is treated solely as a transfer of a copyrighted article under paragraph (b)(1)(ii) of this section. Under paragraph (g)(1) of this section, the label license is not determinative.

(B) Taking into account all of the facts and circumstances, P is properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a sale of a copyrighted article rather than the grant of a lease.

(2) *Example 2: Sale of a computer program via download from the Internet*—(i) *Facts*. The facts are the same as those in paragraph (h)(1) of this section (*Example 1*), except that instead of selling disks, Corp A decides to make Program X available, for a fee, on a World Wide Web home page on the Internet. P, the Country Z resident, in return for payment made to Corp A, downloads Program X (via modem) onto the hard drive of his computer. As part of the electronic communication, P signifies his assent to a license agreement with terms identical to those in *Example 1*, except that in this case P may make a back-up copy of the program on to a disk.

(ii) *Analysis*. (A) Under paragraph (b)(1) of this section, the digital transfer of a copy of Program X from Corp A to P is a digital content transaction with one element, which is the transfer of a copy of Program X. Therefore, the transaction is treated solely as a transfer of a copyrighted article under paragraph (b)(1)(ii) of this section. Although P did not buy a physical copy of the disk with the program on it, paragraph (g)(2) of this section provides that the means of transferring the program is irrelevant.

(B) As in paragraph (h)(1) of this section (*Example 1*), P is properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a sale of a copyrighted article rather than the grant of a lease.

(3) *Example 3*: *Lease of a computer program with requirement to return disk*—(i) *Facts*. The facts are the same as those in paragraph (h)(1) of this section (*Example 1*), except that Corp A only allows P, the Country Z resident, to use Program X for one week. At the end of that week, P must return the disk with Program X on it to Corp A. P must also destroy any copies made of Program X. If P wishes to use Program X for a further period he must enter into a new agreement to use the program for an additional charge.

(ii) *Analysis*. (A) Under paragraph (b)(1) of this section, the transfer of a disk with a copy of Program X from Corp A to P is a digital content transaction with one element, which is the transfer of a copy of Program X. Therefore, the transaction is treated solely as a transfer of a copyrighted article under paragraph (b)(1)(ii) of this section.

(B) Taking into account all of the facts and circumstances, P is not properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a lease of a copyrighted article rather than a sale. Taking into account the special characteristics of digital content as provided in paragraph (f)(3) of this section, the result would be the same if P were required to destroy the disk at the end of the one-week period instead of returning it since Corp A can make additional copies of the program at minimal cost.

(4) *Example 4: Lease of a computer program with electronic lock*—(i) *Facts*. The facts are the same as those in paragraph (h)(2) of this section (Example 2), where P, the Country Z resident, receives Program X from Corp A's home page on the Internet, except that P may only use Program X for a period of one week at the end of which an electronic lock is activated and the program can no longer be accessed. Thereafter, if P wishes to use Program X, it must return to the home page and pay Corp A to send an electronic key to reactivate the program for another week.

(ii) *Analysis*. (A) Under paragraph (b)(1) of this section, the digital transfer of a copy of Program X from Corp A to P is a digital content transaction with one element, which is the transfer of a copy of Program X. Therefore, the transaction is treated solely as a transfer of a copyrighted article under paragraph (b)(1)(ii) of this section.

(B) As in paragraph (h)(3) of this section (*Example 3*), P is not properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a lease of a copyrighted article rather than a sale. While P does retain Program X on its computer at the end of the one-week period, as a legal matter P no longer has the right to use the program (without further payment) and, indeed, cannot use the program without the electronic key. Functionally, Program X is no longer on the hard drive of P's computer. Instead, the hard drive contains only a series of numbers which no longer perform the function of Program X. Although in *Example 3*, P was required to physically return the disk, taking into account the special characteristics of digital content as provided in paragraph (f)(3) of this section, the result in this paragraph (h)(4) (*Example 4*) is the same as in *Example 3*.

(5) *Example 5*: *Sale of copyright rights to a computer program*—(i) *Facts*. Corp A transfers a disk containing Program X to Corp B, a Country Z corporation, and grants Corp B an exclusive license for the remaining term of the copyright to copy and distribute an unlimited number of copies of Program X in the geographic area of Country Z, prepare derivative works based upon Program X, make public performances of Program X, and publicly display Program X. Corp B will pay Corp A a royalty of $y a year for three years, which is the expected period during which Program X will have commercially exploitable value (a period shorter than the copyright term). Corp A has ascertained that the primary benefit or value from the transaction to Corp B is derived from the four legal rights obtained in Program X from Corp A and not from the receipt of a copy of Program X. The transfer of a copy of Program X is merely the means by which Corp A provides Corp B access to Program X in order to exercise its copyright rights.

(ii) *Analysis*. (A) The transaction between Corp A and Corp B has multiple elements. One element is the transfer of a disk with a copy of Program X, which would be a digital content transaction described under paragraph (b)(1)(ii) of this section (transfer of a copyrighted article) if considered separately. Another element is the grant of the right to make an unlimited number of copies of Program X and distribute those copies to the public, the right to prepare derivative works based upon Program X, the right to make public performances of Program X, and the right to publicly display Program X, which would be described under paragraphs (b)(1)(i) and (c)(2) of this section (transfer of a copyright right) if considered separately.

(B) Because the transaction has multiple elements, one or more of which would be a digital content transaction if considered separately, paragraph (b)(2) of this section provides that the transaction is classified within a single category under paragraph (b)(1) of this section if its predominant character is described in that paragraph. Pursuant to paragraph (b)(3)(i) of this section, the predominant character of the transaction is based on the primary benefit or value of the transaction to the customer, if it is reasonably ascertainable. The predominant character of this transaction is therefore the transfer of copyright rights because the primary benefit or value received by Corp B from the transaction is the ability to exercise the copyright rights described in paragraph (c)(2) of this section. Therefore, this transaction is classified solely as a transfer of copyright rights described in paragraph (b)(1)(i) of this section.

(C) Applying the all substantial rights test under paragraph (f)(1) of this section, Corp A will be treated as having sold copyright rights to Corp B. Corp B has acquired all of the copyright rights in Program X, has received the right to use them exclusively within Country Z, and has received the rights for the remaining life of the copyright in Program X. The fact that the payments cease before the copyright term expires is not controlling. Under paragraph (g)(1) of this section, the fact that the agreement is labelled a license is not controlling nor is the fact that Corp A receives a sum labelled a royalty. (The result in this case would be the same if the copy of Program X to be used for the purposes of reproduction were transmitted electronically to Corp B, as a result of the application of the rule of paragraph (g)(2) of this section.)

(6) *Example 6: License of copyright right to make copies of a computer program and distribute to the public*—(i) *Facts*. Corp A transfers a disk containing Program X to Corp B, a Country Z corporation, and grants Corp B the non-exclusive right to reproduce and distribute for sale to the public an unlimited number of disks containing Program X at its factory in Country Z in return for a payment related to the number of disks copied and sold. The term of the agreement is two years, which is less than the remaining life of the copyright. Corp A has ascertained that the primary benefit or value from the transaction to Corp B is derived from the right to reproduce and distribute Program X and not from the receipt of a copy of Program X. The transfer of a copy of Program X is merely the means by which Corp A provides Corp B access to Program X in order to exercise its copyright rights.

(ii) *Analysis*. (A) The transaction between Corp A and Corp B has multiple elements. One element is the transfer of a disk with a copy of Program X, which would be described under paragraph (b)(1)(ii) of this section (transfer of a copyrighted article) if considered separately. Another element is the grant of the right to reproduce and distribute for sale to the public an unlimited number of disks containing Program X, which would be described under paragraphs (b)(1)(i) and (c)(2)(i) of this section (transfer of a copyright right) if considered separately.

(B) Because the transaction has multiple elements, one or more of which would be a digital content transaction if considered separately, paragraph (b)(2) of this section provides that the transaction is classified within a single category under paragraph (b)(1) of this section if its predominant character is described in that paragraph. Pursuant to paragraph (b)(3) of this section, the predominant character of the transaction is based on the primary benefit or value of the transaction to the customer, if it is reasonably ascertainable. The predominant character of this transaction is therefore the transfer of a copyright right because the primary benefit or value received by Corp B is the right to reproduce and distribute for sale to the public copies of Program X. Therefore, this transaction is classified solely as a transfer of copyright rights described in paragraph (b)(1)(i) of this section.

(C) Taking into account all of the facts and circumstances, there has been a license of Program X to Corp B. Under paragraph (f)(1) of this section, there has not been a transfer of all substantial rights in the copyright to Program X because Corp A has the right to enter into other licenses with respect to the copyright of Program X, including licenses in Country Z (or even to sell that copyright, subject to Corp B's interest). Corp B has acquired no right itself to license the copyright rights in Program X. Finally, the term of the license is for less than the remaining life of the copyright in Program X.

(7) *Example 7: Sale of disks containing copies of a computer program to a distributor*—(i) *Facts*. Corp C, a distributor, enters into an agreement with Corp A to purchase as many copies of Program X on disk as it may from time-to-time request. Corp C will then sell these disks to retailers. The disks are shipped in boxes covered by shrink-wrap licenses (identical to the license described in paragraph (h)(1) of this section (*Example 1*)).

(ii) *Analysis*. (A) Under paragraph (b)(1) of this section, the transfers of disks with copies of Program X from Corp A to Corp C are digital content transactions with one element, which is the transfer of copies of Program X. Therefore, the transactions are

classified solely as the transfer of copyrighted articles under paragraph (b)(1)(ii) of this section. The use of the term license is not dispositive under paragraph (g)(1) of this section.

(B) Taking into account all of the facts and circumstances, Corp C is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, there has been a sale of copyrighted articles.

(8) *Example 8: License to a computer manufacturer of copyright rights to make and load copies of a computer program onto the hard drive of computers*—(i) *Facts*. Corp A transfers a disk containing Program X to Corp D, a foreign corporation engaged in the manufacture and sale of personal computers in Country Z. Corp A grants Corp D the non-exclusive right to copy Program X onto the hard drive of an unlimited number of computers, which Corp D manufactures, and to distribute those copies (on the hard drive) to the public. The term of the agreement is two years, which is less than the remaining life of the copyright in Program X. Corp D pays Corp A an amount based on the number of copies of Program X it loads on to computers. Corp A has ascertained that the primary benefit or value from the transaction to Corp D is the ability to copy and distribute Program X onto computers manufactured by Corp D, not from the receipt of a copy of Program X. The transfer of a copy of Program X is merely the means by which Corp A provides Corp D access to Program X in order to exercise its right to make and distribute copies.

(ii) *Analysis*. (A) The transaction between Corp A and Corp D has multiple elements. One element is the transfer of a disk with a copy of Program X, which would be described in paragraph (b)(1)(ii) of this section (transfer of a copyrighted article) if considered separately. Another element is the grant of the non-exclusive right to copy Program X onto the hard drive of an unlimited number of computers and distribute those copies (on the hard drive) to the public, which would be described in paragraphs (b)(1)(i) and (c)(2)(i) of this section (transfer of a copyright right) if considered separately.

(B) Because the transaction has multiple elements, one or more of which would be a digital content transaction if considered separately, paragraph (b)(2) of this section provides that the transaction is classified within a single category under paragraph (b)(1) of this section if its predominant character is described in that paragraph. Pursuant to paragraph (b)(3) of this section, the predominant character of the transaction is based on the primary benefit or value of the transaction to the customer, if it is reasonably ascertainable. The predominant character of this transaction is therefore the transfer of copyright rights because the primary benefit or value received by Corp D is the right to copy Program X onto the hard drive of an unlimited number of computers and sell those copies (on the hard drive) to the public. Therefore, this transaction is classified solely as a transfer of copyright rights described in paragraph (b)(1)(i) of this section.

(C) Taking into account all of the facts and circumstances, there has been a license of Program X to Corp D. Under paragraph (f)(1) of this section, there has not been a transfer of all substantial rights in the copyright to Program X because Corp A has the right to enter into other licenses with respect to the copyright of Program X, including licenses in Country Z (or even to sell that copyright, subject to Corp D's interest). Corp D has acquired no right itself to license the copyright rights in Program X. Finally, the term of the license is for less than the remaining life of the copyright in Program X. The result would be the same if Corp D included with the computers it sells a copy of Program X on a disk.

(9) *Example 9: Sale of disks containing a copy of computer program to a computer manufacturer*—(i) *Facts*. The facts are the same as those in paragraph (h)(8) of this section (*Example 8*), except that Corp D, the Country Z corporation, receives physical disks. The disks are shipped in boxes covered by shrink-wrap licenses (identical to the licenses described in paragraph (h)(1) of this section (*Example 1*)). The terms of these licenses do not permit Corp D to make additional copies of Program X. Corp D uses each individual disk only once to load a single copy of Program X onto each separate computer. Corp D transfers the disk with the computer when it is sold.

(ii) *Analysis*. (A) Under paragraph (b)(1) of this section, the transfers of disks with copies of Program X from Corp A to Corp D are digital content transactions with one element, which is the transfer of copies of Program X. Therefore, the transaction is classified solely as the transfer of copyrighted articles under paragraph (b)(1)(ii) of this section. Corp D acquires the disks without the right to reproduce and distribute publicly further copies of Program X.

(B) Taking into account all of the facts and circumstances, Corp D is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, the transaction is classified as the sale of a copyrighted article. The result would be the same if Corp D used a single physical disk to copy Program X onto each computer, and transferred an unopened box containing Program X with each computer, if Corp D were not permitted to copy Program X onto more computers than the number of individual copies purchased.

(10) *Example 10: Sale of a computer program with right to load onto multiple employee workstations*—(i) *Facts*. Corp A transfers a disk containing Program X to Corp E and grants Corp E the right to load Program X onto 50 individual workstations for use only by Corp E employees at one location in return for a one-time per-user fee (generally referred to as a site license or enterprise license). If additional workstations are subsequently introduced, Program X may be loaded onto those machines for additional one-time per-user fees. The license which grants the rights to operate Program X on 50 workstations also prohibits Corp E from selling the disk (or any of the 50 copies) or reverse engineering the program. The term of the license is stated to be perpetual.

(ii) *Analysis*. (A) It must be determined whether the transfer from Corp A to Corp E of a disk containing a copy of Program X and the right to load Program X onto 50 individual workstations is a transaction with multiple elements. There is at least one element, which is the transfer of a disk containing a copy of Program X, which either is a digital content transaction under paragraph (b)(1) of this section or would be a digital content transaction if considered separately. If there is no additional element, then the transaction is classified as a transfer of a copyrighted article pursuant to paragraph (b)(1)(ii) of this section. If there is a second element, then paragraph (b)(2) of this section applies and the transaction is classified within a single category under paragraph (b)(1) of this section if its predominant character is described in that paragraph. The grant of a right to copy, unaccompanied by the right to distribute those copies to the public, is not the transfer of a copyright right described in paragraph (c)(2) of this section. Therefore, there is no second element in this transaction and it is classified solely as the transfer of copyrighted articles (50 copies of Program X).

(B) Taking into account all of the facts and circumstances, Corp E is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, there has been a sale of copyrighted articles rather than the grant of a lease. Notwithstanding the restriction on sale, other factors such as, for example, the risk of loss and the right to use the copies in perpetuity outweigh, in this case, the restrictions placed on the right of alienation.

(C) The result would be the same if Corp E were permitted to copy Program X onto an unlimited number of workstations used by employees of either Corp E or other persons that had a relationship to Corp E specified in paragraph (g)(3) of this section.

(11) *Example 11: Sale of a computer program with right to make available to multiple employees via local area network*—(i) *Facts*. The facts are the same as those in paragraph (h)(10) of this section (*Example 10*), except that Corp E, the Country Z corporation, acquires the right to make Program X available to workstation users who are Corp E employees by way of a local area network (LAN). The number of users that can use Program X on the LAN at any one time is limited to 50. Corp E pays a one-time fee for the right to have up to 50 employees use the program at the same time.

(ii) *Analysis*. Under paragraph (g)(2) of this section the mode of utilization is irrelevant. Therefore, as in paragraph (h)(10) of this section (*Example 10*), this is a digital content transaction with a single element that is classified as the transfer of a copyrighted article pursuant to paragraph (b)(1)(ii) of this section. Under the benefits and burdens test of paragraph (f)(2) of this section, this transaction is a sale of copyrighted articles. The result would be the same if an unlimited number of Corp E employees were permitted to use Program X on the LAN or if Corp E were permitted to copy Program X onto LANs maintained by persons that had a relationship to Corp E specified in paragraph (g)(3) of this section.

(12) *Example 12: Lease of a computer program with right to receive upgrades and technical support services*—(i) *Facts*. The facts are the same as in paragraph (h)(11) of this section (*Example 11*), except that instead of paying a one-time fee, Corp E pays a monthly fee to Corp A calculated with reference to the permitted maximum number of users (which can be changed) and the computing power of Corp E's server. In return for this monthly fee, Corp E receives the right to receive upgrades of Program X when they become available. The agreement may be terminated by either party at the end of any month. When the disk containing the upgrade is received, Corp E must return the disk containing the earlier version of Program X to Corp A. If the contract is terminated,

Corp E must delete (or otherwise destroy) all copies made of the current version of Program X. The agreement also requires Corp A to provide technical support in the form of troubleshooting and configuration assistance to Corp E, but the agreement does not allocate the monthly fee between the right to use Program X, the right to receive upgrades of Program X, and the technical support services. The amount of technical support that Corp A will provide to Corp E is not foreseeable when the contract is entered into but is expected to be minimal. Corp A has ascertained that the primary benefit or value to Corp E from the transaction is the right to use Program X on the LAN (without the ability to exercise any of the rights described in paragraphs (c)(2)(i) through (iv) of this section), not the receipt of technical support services with respect to Program X.

(ii) *Analysis*. (A) The transaction between Corp A and Corp E has multiple elements. One element is the transfer of a disk with a copy of Program X, which would be described in paragraph (b)(1)(ii) of this section (transfer of a copyrighted article) if considered separately. Another element is the provision of technical support services, which are not services for the development or modification of Program X described in paragraph (d) of this section because Corp E has received no copyright rights with respect to Program X. Thus, the technical support services would not be described in any of the categories in paragraph (b)(1) of this section if considered separately.

(B) Because the transaction has multiple elements, one or more of which would be a digital content transaction if considered separately, paragraph (b)(2) of this section provides that the transaction is classified within a single category under paragraph (b)(1) of this section if its predominant character is described in that paragraph. Pursuant to paragraph (b)(3) of this section, the predominant character of the transaction is based on the primary benefit or value of the transaction to the customer. The predominant character of this transaction is therefore the transfer of a copyrighted article because the primary benefit or value received by Corp E is the right to use Program X. Accordingly, this transaction is classified solely as a transfer of a copyrighted article described in paragraph (b)(1)(ii) of this section.

(C) Taking into account all facts and circumstances, under the benefits and burdens test Corp E is not properly treated as the owner of the copyrighted article. Corp E does not receive the right to use Program X in perpetuity, but only for so long as it continues to make payments. Corp E does not have the right to purchase Program X on advantageous (or, indeed, any) terms once a certain amount of money has been paid to Corp A or a certain period has elapsed (which might indicate a sale). Once the agreement is terminated, Corp E will no longer possess any copies of Program X, current or superseded. Therefore, under paragraph (f)(2) of this section there has been a lease of a copyrighted article.

(13) *Example 13: Sale of a computer program along with right to receive upgrades*—(i) *Facts*. The facts are the same as those in paragraph (h)(12) of this section (*Example 12*), except that, while Corp E must return copies of Program X as new upgrades are received, if the agreement terminates, Corp E may keep the latest version of Program X (although Corp E is still prohibited from selling or otherwise transferring any copy of Program X).

(ii) *Analysis*. For the reasons stated in paragraph (h)(10)(ii)(B) of this section (*Example 10*), the transfer of the program will be treated as a sale of a copyrighted article rather than as a lease.

(14) *Example 14: Sale of a modified computer program*—(i) *Facts*. Corp G enters into a contract with Corp A for Corp A to modify Program X so that it can be used at Corp G's facility in Country Z. Under the contract, Corp G is to acquire one copy of the program on a disk and the right to use the program on 5,000 workstations. The contract requires Corp A to rewrite elements of Program X so that it will conform to Country Z accounting standards and states that Corp A retains all copyright rights in the modified Program X. The agreement between Corp A and Corp G is otherwise identical as to rights and payment terms as the agreement described in paragraph (h)(10) of this section (*Example 10*).

(ii) *Analysis*. (A) It must be determined whether the transfer of disks with modified copies of Program X from Corp A to Corp G is a transaction with multiple elements. There is at least one element, the transfer of copies of Program X, which either is a digital content transaction under paragraph (b)(1) of this section or would be a digital content transaction if considered separately. If there is no additional element, then the transaction is classified as a transfer of a copyrighted article pursuant to paragraph (b)(1)(ii) of this section. If there is a second element, then paragraph (b)(2) of this section applies and the transaction is classified within a single category under paragraph (b)(1) of this section if its predominant character is described in that paragraph. Pursuant to paragraph (d) of this section, the modifications made by Corp A before transferring Program X to Corp G do not constitute the provision of services for the development or modification of digital content because Corp A retains all copyright rights with respect to the modified software. Therefore, there is no second element in this transaction and it is classified solely as the transfer of copyrighted articles.

(B) Taking into account all facts and circumstances, Corp G is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, there has been the sale of a copyrighted article rather than the grant of a lease.

(15) *Example 15: Provision of services for development of a computer program*—(i) *Facts*. Corp H enters into a license agreement for a new computer program. Program Q is to be written by Corp A. Corp A and Corp H agree that Corp A is writing Program Q for Corp H and that, when Program Q is completed, the copyright in Program Q will belong to Corp H. Corp H gives instructions to Corp A programmers regarding program specifications. Corp H agrees to pay Corp A a fixed monthly sum during development of the program. If Corp H is dissatisfied with the development of the program, it may cancel the contract at the end of any month. In the event of termination, Corp A will retain all payments, while any procedures, techniques or copyrightable interests will be the property of Corp H. All of the payments are labelled royalties. There is no provision in the agreement for any continuing relationship between Corp A and Corp H, such as the furnishing of updates of the program, after completion of the modification work.

(ii) *Analysis*. Under paragraph (b)(1) of this section, the provision of computer program development services by Corp A to Corp H is a digital content transaction with one element, which is the provision of services for the development or modification of digital content. Under paragraph (d) of this section, the transaction between Corp A and Corp H involves the provision of services for the development of a computer program because Corp H bears all of the risks of loss associated with the development of Program Q and is the owner of all copyright rights in Program Q. Taking into account all of the facts and circumstances, Corp A is treated as providing services to Corp H described in paragraph (b)(1)(iii) of this section. Under paragraph (g)(1) of this section, the fact that the agreement is labelled a license is not controlling (nor is the fact that Corp A receives a sum labelled a royalty).

(16) *Example 16: Provision of know-how by computer programmers*—(i) *Facts*. Corp A and Corp I, a Country Z corporation, agree that a development engineer employed by Corp A will travel to Country Z to provide know-how relating to certain techniques not generally known to computer programmers, which will enable Corp I to more efficiently create computer programs. These techniques represent the product of experience gained by Corp A from working on many computer programming projects, and are furnished to Corp I under nondisclosure conditions. Such information is property subject to trade secret protection.

(ii) *Analysis*. The provision of know-how with respect to computer programming techniques by Corp A's development engineer to Corp I is described in paragraph (e) of this section. Therefore, the transaction is a digital content transaction with one element, which is the provision of know-how. The transaction is classified solely as the provision of know-how pursuant to paragraph (b)(1)(iv) of this section.

(17) *Example 17: Sale of development program in transaction with multiple elements*—(i) *Facts*. Corp A transfers a disk containing Program Y to Corp E in exchange for a single fixed payment. Program Y is a computer program development program, which is used to create other computer programs, consisting of several components, including libraries of reusable software components that serve as general building blocks in new software applications. Because a computer program created with the use of Program Y will not operate unless the libraries are also present, the license agreement between Corp A and Corp E grants Corp E the right to distribute copies of the libraries with any program developed using Program Y. The license agreement is otherwise identical to the license agreement in paragraph (h)(1) of this section (*Example 1*). Corp A cannot reasonably ascertain the primary benefit or value of the transaction to Corp E. A customer like Corp E derives two benefits from this or a substantially similar transaction, the first of which is the ability to use Program Y to develop new software and the second of which is the right to utilize the libraries and reusable software components in Program Y in distributed programs. Corp A possesses data arising from market research and customer surveys indicating that customers utilize Program Y primarily for its computer program development features and do not make significant

use of the libraries of reusable software components. The libraries and reusable software components are not significant components of any overall new program created by using Program Y.

(ii) *Analysis*. (A) The transaction between Corp A and Corp E has multiple elements. One element is the transfer of a disk with a copy of Program Y, which would be described in paragraph (b)(1)(ii) of this section (transfer of a copyrighted article) if considered separately. Another element is the grant of the right to distribute copies of the libraries of reusable software components with any program developed using Program Y, which would be described in paragraphs (b)(1)(i) and (c)(2)(i) of this section (transfer of a copyright right) if considered separately.

(B) Because the transaction has multiple elements, one or more of which would be a digital content transaction if considered separately, paragraph (b)(2) of this section provides that the transaction is classified within a single category under paragraph (b)(1) of this section if its predominant character is described in that paragraph. Pursuant to paragraph (b)(3)(i) of this section, the predominant character of a transaction is generally based on the primary benefit or value of the transaction to the customer. If the primary benefit or value is not reasonably ascertainable, paragraph (b)(3)(ii) of this section provides that the predominant character of a transaction may be determined based on the primary benefit or value to a typical customer of a substantially similar transaction. This primary benefit or value to a typical customer can be identified through actual data about use or access pursuant to paragraph (b)(3)(ii)(A) of this section, or if that data is not available, by other evidence indicative of the primary benefit or value to a typical customer pursuant to paragraph (b)(3)(ii)(B) of this section. Although there are two benefits in this type of transaction, Corp A possesses data indicating that a typical customer primarily uses Program Y because of its computer program development features, rather than the right to distribute reusable components. This is reinforced by the fact that programs created using Program Y do not contain libraries of reusable software components as significant components. These facts indicate that the primary benefit or value to a typical customer arises from the ability to use Program Y, rather than the right to distribute reusable components. Therefore, the predominant character of this transaction is the transfer of a copy of Program Y, and this transaction is thus classified solely as the transfer of a copyrighted article described in paragraph (b)(1)(ii) of this section.

(C) Taking into account all the facts and circumstances, Corp E is properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been the sale of a copyrighted article rather than the grant of a lease.

(18) *Example 18: Sale of a computer program with right to make modifications*—(i) *Facts*. Corp A transfers a disk containing Program X to Corp E. The disk contains both the object code and the source code to Program X, and the license agreement grants Corp E the right to modify the source code to correct minor errors and make minor adaptations to Program X so it will function on Corp E's computer; as well as the right to recompile the modified source code. The license does not grant Corp E the right to distribute the modified Program X to the public. The license is otherwise identical to the license agreement in paragraph (h)(1) of this section (*Example 1*). Corp A has ascertained that the primary benefit or value received by Corp E from the transaction is the core functionality of Program X rather than the limited rights to modify the source code.

(ii) *Analysis*. (A) The transaction between Corp A and Corp E has multiple elements. One element is the transfer of a disk with a copy of Program X, which would be described in paragraph (b)(1)(ii) of this section (transfer of a copyrighted article) if considered separately. Another element is the grant of the right to modify the source code to Program X and recompile the modified source code to create new code to correct minor errors, and to make minor adaptations to Program X, which would be described in paragraphs (b)(1)(i) and (c)(2)(ii) of this section (transfer of a copyright right) if considered separately.

(B) Because the transaction has multiple elements, one or more of which would be a digital content transaction if considered separately, paragraph (b)(2) of this section provides that the transaction is classified within a single category under the categories described under paragraph (b)(1) of this section if its predominant character is described in that paragraph. Pursuant to paragraph (b)(3) of this section, the predominant character of the transaction is based on the primary benefit or value of the transaction to the customer, if it is reasonably ascertainable. Since the primary benefit or value received by Corp E is the core functionality of Program X, rather than the limited rights to modify the source code, the predominant character of this transaction is the transfer of a copyrighted article. Therefore, this transaction is classified solely as a transfer of a copyrighted article under paragraph (b)(1)(ii) of this section.

(C) Taking into account all the facts and circumstances, Corp E is properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been the sale of a copyrighted article rather than the grant of a lease.

(19) *Example 19: License to website operator to make and sell copies of electronic books via download*—(i) *Facts*. Corp A operates a website that offers electronic books for download onto customers' computers or other electronic devices. The books offered are protected by copyright law. In a transaction between Corp A and a content owner, Corp A receives from the content owner a digital master copy of a book, which Corp A downloads onto its server. Corp A receives the non-exclusive right to reproduce an unlimited number of copies of the book for purposes of distribution and sale to the public. Corp A pays the content owner a specified amount for each copy sold to a customer. Corp A may not transfer any of the rights it receives from the content owner. The term of the agreement Corp A has with the content owner is shorter than the remaining life of the copyright. The content owner has ascertained that the primary benefit or value Corp A receives in the transaction is the right to reproduce and distribute an unlimited number of copies of the book and not the transfer of a copy of the book. In a separate transaction, Corp A charges a customer a fixed fee for each book purchased. When purchasing a book from Corp A on Corp A's website, the customer must acknowledge the terms of a license agreement with the content owner that states that the customer may download and view the electronic book in perpetuity but may not reproduce, distribute, or sell copies of it. Once the customer downloads the book from Corp A's server onto a device, the customer may access and view the book from that device, which does not need to be connected to the Internet for the customer to view the book. The customer owes no additional payment to Corp A for the ability to view the book in the future.

(ii) *Analysis*. (A) Notwithstanding the license agreement between each customer and the content owner granting the customer rights to use the book, the relevant transactions are the transfer of a master copy of the book along with the grant from the content owners to Corp A of the right to reproduce and sell to the public copies of the books, and the transfers of copies of the books by Corp A to customers. Although the content owner is identified as a party to the license agreement memorializing the customer's rights with respect to the book, each customer obtains those rights directly from Corp A, not from the content owner. Under paragraph (b)(1) of this section, the download of a copy of a book by a customer is a digital content transaction with one element, which is the transfer of a digital copy of a book. Therefore, the transaction is treated solely as a transfer of a copyrighted article under paragraph (b)(1)(ii) of this section. Under the benefits and burdens test of paragraph (f)(2) of this section, the transaction is classified as a sale and not a lease, because the customer receives the right to view the book in perpetuity on its device.

(B) The transaction between the content owner and Corp A has multiple elements. One element is the transfer of a master copy of the book, which would be described in paragraph (b)(1)(ii) of this section (transfer of a copyrighted article) if considered separately. Another element is the grant of the right to reproduce and sell an unlimited number of copies to customers, which would be described in paragraphs (b)(1)(i) and (c)(2)(i) of this section (transfer of a copyright right) if considered separately. Because the transaction has multiple elements, one or more of which would be a digital content transaction if considered separately, paragraph (b)(2) of this section provides that the transaction is classified within a single category under the categories described under paragraph (b)(1) of this section if its predominant character is described in that paragraph. Pursuant to paragraph (b)(3) of this section, the predominant character of the transaction is based on the primary benefit or value of the transaction to the customer, if it is reasonably ascertainable. Since the primary benefit or value Corp A receives in the transaction is the right to reproduce and distribute an unlimited number of copies, the predominant character of this transaction is the transfer of a copyright right. Therefore, this transaction is classified solely as a transfer of copyright rights described in paragraph (b)(1)(i) of this section.

(C) Taking into account all of the facts and circumstances, there has been a license of books to Corp A. Under paragraph (f)(1) of this section, there has not been a transfer of all substantial rights in the copyright rights to the books because each content owner has the right to enter into other licenses with respect to the copyright of their book. Corp A has

acquired no right itself to license the copyrights in the books. Finally, the terms of the licenses are for less than the remaining lives of the copyrights in the books.

(20) *Example 20: Internet platform operator as agent for application developers*—(i) *Facts*. Corp A operates a platform on the Internet that offers applications for download onto a customer's mobile phone. Under general tax principles, Corp A and an application developer establish an agency relationship whereby Corp A acts as the agent to offer the application for sale to customers on behalf of the application developer. The applications are protected by copyright law. Under the agreement between Corp A and the application developer, Corp A agrees to provide the application developer with platform and agency services to facilitate the sale of the application to customers. Corp A also provides the application developer with hosting services to host the application on Corp A's servers for download by the customers. Corp A receives a digital master copy of the application along with a non-exclusive right to make copies of the application and allow customers to download copies of the application from Corp A's platform. Corp A has ascertained that the primary benefit or value from the transaction received by the application developer is the platform and agency services that Corp A provides. Corp A receives the right to make copies of the application merely to perform its activities as an agent on behalf of the application developer. When purchasing an application on Corp A's platform, the customer must acknowledge the terms of a license agreement with the application developer that states that the customer may use the application but may not reproduce or distribute copies of it. In addition, the agreement provides that the customer may download the application onto only one mobile phone at a time. A customer does not need to be connected to the Internet to access the application. The customer owes no additional payment to Corp A or the application developer for the ability to use the application in perpetuity. Corp A retains a fixed percentage of each purchase price of the application and remits the remaining balance to the application developer.

(ii) *Analysis*. (A) The transaction between Corp A and the application developer has multiple elements. One element is the transfer of a master copy of an application by the application developer to Corp A, which would be described in paragraph (b)(1)(ii) of this section (transfer of a copyrighted article) if considered separately. Another element is the transfer of the right to make and distribute copies of the application by the application developer to Corp A, which would be described in paragraphs (b)(1)(i) and (c)(2) of this section (transfer of a copyright right) if considered separately. A third element is the platform and agency services provided by Corp A to the application developer, which would not be described in this section if considered separately. A fourth element is the hosting services provided by Corp A to the application developer, which would be described in §1.861-19 if considered separately. Under the facts and circumstances, although Corp A receives a copy of the application and the right to make and distribute copies of the application, Corp A receives this copy and right merely to facilitate the sale of applications on behalf of the application developer.

(B) Because the transaction has multiple elements, one or more of which would be a digital content transaction if considered separately, paragraph (b)(2) of this section provides that the transaction is classified within a single category under the categories described under paragraph (b)(1) of this section if its predominant character is described in that paragraph. Pursuant to paragraph (b)(3) of this section, the predominant character of the transaction is based on the primary benefit or value of the transaction to the customer, if it is reasonably ascertainable. Since the primary benefit or value the application developer receives in the transaction is the platform and agency services, the predominant character of this transaction is the platform and agency services and not a digital content transaction nor a cloud transaction.

(C) The transfer of a copy of an application from the application developer to a customer is a digital content transaction with one element, which is the transfer of a copy of a digital program. Therefore, the transaction is treated solely as a transfer of a copyrighted article under paragraph (b)(1)(ii) of this section. Under the benefits and burdens test of paragraph (f)(2) of this section, this transaction is a sale of a copyrighted article because a customer has the right to use the application in perpetuity.

(21) *Example 21: Movies and TV shows available for stream, rent, or purchase*—(i) *Facts*. Corp A offers a catalog of movies and TV shows, all of which are subject to copyright protection. Corp A gives customers several options for viewing the content, each of which has a separate price. A "streaming" option allows a customer to view the video, which is hosted on Corp A's servers, while connected to the Internet for as many times as the customer wants during a limited period. A "rent" option allows a customer to download the video to its computer or other electronic device (which does not need to be connected to the Internet for viewing) and watch the video as many times as the customer wants for a limited period, after which an electronic lock is activated and the customer may no longer view the content. A "purchase" option allows a customer to download the video and view it as many times as the customer chooses with no end date. Under all three options, the customer may view the video but may not reproduce or distribute copies of it, prepare derivative works based on it, or publicly display it.

(ii) *Analysis*. (A) With respect to the "rent" option, under paragraph (b)(1) of this section the download of a video by a customer is a digital content transaction with one element, which is the transfer of a copy of the video. Therefore, the transaction is treated solely as the transfer of a copyrighted article under paragraph (b)(1)(ii) of this section. Although a customer will retain a copy of the content at the end of the payment term, the customer cannot access the content after the electronic lock is activated. The activation of the electronic lock is the equivalent of having to return the copy. Therefore, the transaction is classified as a lease of a copyrighted article under paragraph (f)(2) of this section because the customer's right to view the videos is for a limited period.

(B) With respect to the "purchase" option, under paragraph (b)(1) of this section the download of a video by a customer is a digital content transaction with one element, which is the transfer of a copy of the video. Therefore, the transaction is treated solely as the transfer of a copyrighted article under paragraph (b)(1)(ii) of this section. The transaction is classified as a sale of a copyrighted article under paragraph (f)(2) of this section because the customer receives the right to view the videos in perpetuity.

(C) With respect to the "streaming" option, the transaction is Corp A's grant of the right to its customers to view the movies or shows while connected to the Internet for a limited period. There is no transfer of any copyright rights described in paragraph (c)(2) of this section. There is also no transfer of a copyrighted article because the content is not downloaded by a customer, but rather, is accessed through an on-demand network. The transaction also does not constitute the provision of services for the development of digital content or the provision of know-how under paragraph (b)(1) of this section. Therefore, the transaction is not a digital content transaction described in paragraph (b)(1) of this section. Instead, the transaction is a cloud transaction that is classified under §1.861-19. See §1.861-19(b).

(22) *Example 22: Website offering third-party videos via stream*—(i) *Facts*. Corp A operates a website that allows customers to stream videos that third-party content creators upload to Corp A's website. Corp A has advertising contracts with third-party advertisers pursuant to which Corp A earns advertising revenue when a customer views a video. Customers can either stream videos for free with advertisements or can pay a subscription fee to stream videos without advertisements. Under the contract between Corp A and content creators, content creators retain all ownership rights in their videos and must own or have the necessary rights to publish their videos. The contract also states that content creators grant Corp A a non-exclusive license to use, reproduce, distribute, and display their videos in connection with Corp A's website, and grant customers a non-exclusive license to view the videos. These licenses terminate within a commercially reasonable time after a content creator removes or deletes a video from Corp A's website. Content creators have ascertained that the primary benefit or value Corp A receives from transactions with content creators is the right to use, reproduce, distribute, and display their videos. Corp A pays content creators a percentage of advertising revenue generated from the videos and a percentage of subscription fees.

(ii) *Analysis*. (A) The transaction between Corp A and the content creators has multiple elements. One element is the uploading of a video by a content creator, which would be described in paragraph (b)(1)(ii) of this section (transfer of a copyrighted article) if considered separately. Another element is the grant by content creators to Corp A of the right to use, reproduce, distribute, and display their videos, which would be described in paragraph (b)(1)(i) of this section (transfer of a copyright right) if considered separately. Content creators are not providing content development services to Corp A under paragraph (d) of this section because content creators own the copyright rights in the videos.

(B) Because the transaction has multiple elements, one or more of which would be a digital content transaction if considered separately, paragraph (b)(2) of this section provides that the transaction

is classified within a single category under the categories described under paragraph (b)(1) of this section if its predominant character is described in that paragraph. Pursuant to paragraph (b)(3) of this section, the predominant character of the transaction is based on the primary benefit or value of the transaction to the customer. The predominant character of the transaction is therefore the transfer of copyright rights because the primary benefit or value received by Corp A is the right to use, reproduce, distribute, and display videos. Accordingly, this transaction is characterized solely as a transfer of a copyright right as described in paragraphs (b)(1)(i) of this section.

(C) Taking into account all of the facts and circumstances, there has been a license of videos to Corp A. Under paragraph (f)(1) of this section, there has not been a transfer of all substantial rights in the copyright rights to the videos because each content owner has the right to enter into other licenses with respect to the copyright of their videos. Corp A has acquired no right itself to license the copyrights in the videos. Finally, the terms of the licenses are for less than the remaining lives of the copyrights in the videos.

(D) For both the free streaming and subscription streaming transactions between Corp A and customers, there is no transfer of any copyright rights described in paragraph (c)(2) of this section. There is also no transfer of a copyrighted article, because the content is not downloaded by a customer, but rather is accessed through an on-demand network. The transactions also do not constitute the provision of services for the development of digital content or the provision of know-how under paragraph (b)(1) of this section. Therefore, paragraph (b)(1) of this section does not apply to such transactions. Instead, both transactions are cloud transactions that are classified under §1.861-19. See §1.861-19(b).

(23) *Example 23: Sale of computer programs electronically through a reseller*—(i) *Facts*. Corp A owns the copyright to software (Program S). Corp A hosts Program S on its servers. Corp A grants Corp B, a foreign corporation wholly owned by Corp A, the right to distribute copies of Program S (without the right to reproduce copies of Program S) to Corp B's customers that are located in Corp B's country. Under the agreement between Corp A and Corp B, Corp B pays Corp A a fixed fee for each copy of Program S that Corp A delivers to a customer. In separate transactions, customers pay Corp B for the right to receive digital copies of Program S that they may then use in perpetuity without further payment. Corp B is responsible for managing the purchase/sale interaction with Corp B's customers, including invoicing and collections. Corp A is responsible for creating and delivering the digital copies of Program S to Corp B's customers from Corp A's servers. Corp B does not perform any functions to provide access to Program S.

(ii) *Analysis*. (A) Although there is a single contract between Corp A and Corp B that grants a legal right to Corp B with respect to Program S, that right (the right to distribute) is not a copyright right described in paragraphs (b)(1)(i) and (c)(2) of this section. Instead, the transactions between Corp A and Corp B and then Corp B and its customers are functionally and economically equivalent to back-to-back transfers of copyrighted articles. The transfers are only superficially different from those described in paragraph (h)(24) of this section (*Example 24*) where the reseller acquires product keys and sells them on to customers. Therefore, each sale of a copy of Program S by Corp B to a customer should be viewed as a transfer of a copyrighted article from Corp A to Corp B and then from Corp B to the customer.

(B) The transaction between Corp A and Corp B is a digital content transaction with a single element that is classified as a transfer of a copyrighted article described in paragraph (b)(1)(ii) of this section. There are no additional elements because Corp B's receipt of the right to distribute copies of Program S (without the right to make copies) is not a copyright right described in paragraph (c)(2) of this section. Under the benefits and burdens test of paragraph (f)(2) of this section, the transfer is classified as the sale of a copyrighted article.

(C) The transaction between Corp B and a customer is a digital content transaction with a single element that is classified as a transfer of a copyrighted article described in paragraph (b)(1)(ii) of this section. Under the benefits and burdens test of paragraph (f)(2) of this section, this transaction is a sale of a copyrighted article because the customer has the right to use the application in perpetuity.

(24) *Example 24: Sale of video games with online and offline functionality through retailers using digital keys*—(i) *Facts*. Corp A owns the copyright in a computer program (Program Y). Corp A creates digital keys that allow for the download of one copy of Program Y from Corp A's website. Corp A sells these digital keys to retailers for a one-time fee per key, and the retailers do not use Program Y, but instead sell them in separate transactions to customers for a one-time fee per key. Corp A ascertains that the primary benefit or value to retailers from the purchase of digital keys from Corp A is the right to further transfer the digital keys to customers. The retailers cannot reasonably ascertain the primary benefit or value that their specific customers derive from Program Y, nor is there data available to the retailers about how their customers typically use Program Y. Program Y is a video game that contains online and offline features, both of which can be played without paying an additional game-specific cost after paying the one-time fee to purchase a key. The offline feature is comprised of a single-player story that does not require any Internet connection to play. The online feature is comprised of the ability to play competitive matches against other players that are hosted on servers owned by Corp A. The competitive matches require an ongoing connection to the Internet to play. Neither the customers nor the retailer receives any copyright rights described in paragraph (c)(2) of this section with respect to Program Y. Customers can use Program Y in perpetuity. Program Y is primarily marketed as a single-player game in television and online advertising, with only brief mentions of the multiplayer mode in print advertising. The development cost for Program Y was allocated 40% to developing the single-player content, 20% to developing the multiplayer content, and 40% to developing content that is used by both types of content (e.g., cost of developing the game engine).

(ii) *Analysis*. (A) The transaction between Corp A and a retailer has multiple elements. One element is the transfer of a key with the right to download a copy of Program Y for use to play the offline story, which would be a digital content transaction described in paragraph (b)(1)(ii) of this section (transfer of a copyrighted article) if considered separately. Another element is the transfer of the same key with a copy of Program Y providing on-demand network access to digital content in the form of competitive multiplayer functionality, which would be a cloud transaction described in §1.861-19(b) if considered separately.

(B) Because the transaction has multiple elements, one of which would be a digital content transaction if considered separately and one of which would be a cloud transaction if considered separately, paragraph (b)(2) of this section provides that the transaction is classified within a single category under paragraph (b)(1) of this section if its predominant character is described in that paragraph, or the transaction is classified solely as a cloud transaction if its predominant character is a cloud transaction pursuant to §1.861-19(c)(2). Pursuant to paragraph (b)(3)(i) of this section, the predominant character of the transaction is based on the primary benefit or value of the transaction to the customer, if it is reasonably ascertainable. The predominant character of this transaction is therefore the transfer of copyrighted articles because the primary benefit or value received by a retailer is the right to further transfer the same copyrighted articles to customers in the form of digital keys. The retailers do not have any intent to utilize the cloud functionality of the digital keys, although they do have the right to do so. Therefore, this transaction is classified solely as a transfer of copyrighted articles described in paragraph (b)(1)(ii) of this section.

(C) Under the benefits and burdens test of paragraph (f)(2) of this section, the transfer between Corp A and a retailer is classified as the sale of a copyrighted article because the retailer has the right to use, or sell, Program Y in perpetuity without further payment.

(D) The transfer of a key (with the right to download a copy of Program Y) by a retailer to a customer also contains the same two elements as each transaction between Corp A and a retailer. However, a retailer cannot reasonably ascertain the primary benefit or value derived by a specific customer from Program Y. In such situations, paragraph (b)(3)(ii) of this section provides that the predominant character of a transaction may be determined based on the primary benefit or value to a typical customer of a substantially similar transaction. This primary benefit or value to a typical customer can be identified through actual data about use or access pursuant to paragraph (b)(3)(ii)(A) of this section, or if that data is not available, by using other evidence indicative of the primary benefit or value to a typical customer pursuant to paragraph (b)(3)(ii)(B) of this section. Because the retailers do not have available data about how customers use Program Y, they may use the marketing with respect to Program Y to determine that its predominant character is that of a transfer of a copyrighted article described in paragraph (b)(1)(ii) of this section. The relative development costs of the offline and online components of the game could also be used if they are known to a retailer. Therefore, the transfer between a retailer and a customer

of a digital key containing the right to download a copy of Program Y is classified solely as a transfer of a copyrighted article.

(E) Under the benefits and burdens test of paragraph (f)(2) of this section, the transfer between a retailer and a customer is classified as the sale of a copyrighted article because the customer has the right to use Program Y in perpetuity without further payment.

(25) *Example 25: Source of income from the sale of a copyrighted article transferred through an electronic medium*—(i) *Facts*. Corp A is the parent company of a world-wide group of affiliated companies. Corp B is a foreign corporation wholly owned by Corp A. In the ordinary course of business, Corp B acts as a procurement hub for Corp A's affiliated companies. In this role, Corp B regularly purchases products that will be distributed amongst Corp A's affiliated companies to be used by them in their respective businesses. Corp B purchases digital copies of a computer program (Program Y) from Corp C, an unrelated company. Corp B may use Program Y in perpetuity without further payment. Corp B receives no copyright rights in Program Y. Corp B does not use Program Y, and instead distributes all of its copies of Program Y to various affiliates. Corp C sources income from the sale of Program Y using sections 861(a)(6) and 862(a)(6).

(ii) *Analysis*. (A) Under paragraph (b)(1) of this section, the transfer of Program Y from Corp C to Corp B is a digital content transaction with one element, which is the transfer of a copy of Program Y. Therefore, the transaction is treated solely as a transfer of a copyrighted article under paragraph (b)(1)(ii) of this section. Taking into account all of the facts and circumstances, there have been sales of copies of Program Y to Corp B under paragraph (f)(2) of this section.

(B) Income from the sale of Program Y by Corp C is sourced pursuant to sections 861(a)(6) and 862(a)(6) to the place where the sale occurred. Pursuant to paragraph (f)(2)(ii) of this section, a transfer of a copyrighted article through an electronic medium is treated as occurring at the billing address of the purchaser, in this case Corp B, unless the sales transaction is arranged for a principal purpose of tax avoidance. In this case, the sale is treated as occurring at the billing address of Corp B, and Corp C's income is foreign source, even though Corp B will not use Program Y, because Corp B regularly purchases products that will be distributed amongst its affiliates to be used in their respective businesses, and therefore there is no evidence that Corp B was used by Corp A to purchase Program Y with a principal purpose of tax avoidance.

(26) *Example 26: Application of anti-abuse rule for sale of a copyrighted article transferred through an electronic medium*—(i) *Facts*. Corp A is the parent company of a world-wide group of affiliated companies. Corp B is a foreign affiliate of Corp A. In the ordinary course of business, Corp B does not act as a procurement hub regularly purchasing products for use by Corp A's affiliated companies. Corp A negotiates an agreement with Corp C, an unrelated company, to purchase digital copies of a computer program (Program Y) for use in Corp A's business. The agreement grants Corp A the right to use Program Y in perpetuity for a one-time payment. Corp C requests that Corp B be the purchaser of the copies of Program Y even though Corp B will not use Program Y and is not otherwise involved in the transaction between Corp A and Corp C for a principal purpose of tax avoidance. Corp A agrees, and Corp B purchases the copies of Program Y and subsequently distributes them to Corp A. Corp C sources income from the sale of Program Y using sections 861(a)(6) and 862(a)(6).

(ii) *Analysis*. (A) Under paragraph (b)(1) of this section, the transfer of Program Y from Corp C to Corp B is a digital content transaction with one element, which is the transfer of a copy of Program Y. Therefore, the transaction is classified solely as a transfer of a copyrighted article under paragraph (b)(1)(ii) of this section. Taking into account all of the facts and circumstances, there have been sales of copies of Program Y to Corp B under paragraph (f)(2) of this section.

(B) Income from the sale of Program Y by Corp C is sourced pursuant to sections 861(a)(6) and 862(a)(6) to the place where the sale occurred. Pursuant to paragraph (f)(2)(ii) of this section, a transfer of a copyrighted article through an electronic medium is treated as occurring at the billing address of the purchaser, in this case Corp B, unless the sales transaction is arranged for a principal purpose of tax avoidance. In this case, Corp B does not regularly purchase products that will be used by other companies within Corp A's group of affiliated companies, and Corp B was instead used as the purchaser of Program Y on behalf of Corp A with a principal purpose of tax avoidance. Therefore, the place where the sale occurred must be determined based on all relevant facts and circumstances. Corp A negotiated the purchase, and the software will be used by Corp A in its business. As a result, under paragraph (f)(2)(ii) of this section, the sale is treated as occurring at the location of Corp A and the income derived by Corp C from the sale is U.S. source.

(C) The same result would apply if, instead of using Corp B for the purchase, Corp A made the purchase but rented a P.O. Box outside the United States to serve as the billing address for the transaction with a principal purpose of tax avoidance.

(i) *Applicability date*—(1) *In general*. This section applies to taxable years beginning on or after January 14, 2025.

(2) *Early application*. A taxpayer can apply this section to taxable years beginning on or after August 14, 2019 and all subsequent taxable years not described in paragraph (i)(1) of this section (early application years) if—

(i) The taxpayer also applies §1.861-19 to the early application years;

(ii) This section and §1.861-19 are applied to the early application years by all persons related to the taxpayer (within the meaning of sections 267(b) and 707(b));

(iii) The period of limitations on assessment for each early application year of the taxpayer and all related parties (within the meaning of sections 267(b) and 707(b)) is open under section 6501; and

(iv) The taxpayer would not be required under this section to change its method of accounting as a result of such election.

(j) *Change in method of accounting required by this section*. In order to comply with this section, a taxpayer may be required to change its method of accounting. If so required, the taxpayer must secure the consent of the Commissioner in accordance with the requirements of §1.446-1(e) and the applicable administrative procedures for obtaining the Commissioner's consent under section 446(e) for voluntary changes in methods of accounting.

Par. 4. Section 1.861-19 is added to read as follows:

§1.861-19 Classification of cloud transactions.

(a) *In general*. This section provides rules for classifying cloud transactions (as defined in paragraph (b) of this section). The rules of this section apply for purposes of Internal Revenue Code sections 59A, 245A, 250, 267A, 367, 404A, 482, 679, and 1059A; subchapter N of chapter 1; chapters 3 and 4; and sections 842 and 845 (to the extent involving a foreign person), and apply with respect to transfers to foreign trusts not covered by section 679.

(b) *Cloud transaction defined*. A cloud transaction is a transaction through which a person obtains on-demand network access to computer hardware, digital content (as defined in §1.861-18(a)(2)), or other similar resources. A cloud transaction does not include network access to download digital content for storage and use on a person's computer or other electronic device.

(c) *Classification of cloud transactions*—(1) *In general*. A cloud transaction is classified as the provision of services.

(2) *Transaction with multiple elements*. Taking into account the overall transaction and the surrounding facts and circumstances, a transaction that has multiple elements, one or more of which would be a cloud transaction if considered separately, is classified in its entirety as a cloud transaction if the predominant character of the transaction as determined under §1.861-18(b)(3) is a cloud transaction.

(d) *Examples*. The examples in this paragraph (d) illustrate the provisions of this section. Unless otherwise specified, assume that Corp A is a domestic corporation, no rights described in §1.861-18(c)(2) (copyright rights) are transferred as part of the transactions described, and all facts in each example occur as part of a single transaction.

(1) *Example 1*: *Computing capacity*—(i) *Facts*. Corp A operates data centers on its premises in various locations. Corp A provides Corp B computing capacity on Corp A's servers in exchange for a monthly fee based on the amount of computing power made available to Corp B. Corp B provides its own software to run on Corp A's servers.

(ii) *Analysis*. The provision of on-demand network computing capacity by Corp A to Corp B is a cloud transaction with one element. Therefore, the transaction is treated solely as a cloud transaction under paragraph (b) of this section and is classified as the provision of services under paragraph (c)(1) of this section.

(2) *Example 2*: *Computing capacity on dedicated on-premises servers*—(i) *Facts*. The facts are the same as in paragraph (d)(1)(i) of this section (the facts in *Example 1*), except that, in order to offer more security to Corp B, Corp A provides Corp B computing capacity exclusively through designated servers, which are owned and operated by Corp A and located at Corp B's facilities. Corp A agrees not to use the designated server for any other customer for the duration of its arrangement with Corp B. Although the server is located at Corp B's facilities, Corp B accesses the server through Corp A's network and the monthly fee is based on the amount of computing power made available to Corp B.

(ii) *Analysis*. As in paragraph (d)(1) of this section (*Example 1*), the transaction between Corp A and Corp B is the provision of on-demand network computing capacity and is therefore a cloud transaction with one element. Therefore, the transaction is treated solely as a cloud transaction under paragraph (b) of this section and is classified as the provision of services under paragraph (c)(1) of this section. If the transaction between Corp A and Corp B involved only the provision of a server by Corp A for use by Corp B, and not on-demand network access to computing capacity, the transaction would not be a cloud transaction and this section would not apply.

(3) *Example 3*: *Access to software development platform and website hosting*—(i) *Facts*. Corp A provides Corp B a software platform that Corp B uses to develop and deploy websites with a range of features, including blogs, message boards, and other collaborative knowledge bases. The software development platform consists of an operating system, web server software, scripting languages, libraries, tools, and back-end relational database software and allows Corp B to use in its websites certain visual elements subject to copyrights held by Corp A. The software development platform is hosted on servers owned by Corp A and located at Corp A's facilities. Corp B's finished websites are also hosted on Corp A's servers. Corp B accesses the software development platform via a standard web browser. Corp B has no ability to alter the software code. A small amount of copyrighted scripting code is downloaded onto Corp B's computers to facilitate secure logins and access to the software development platform. All other functions of the software development platform execute on Corp A's servers, and no portion of the core software code is ever downloaded by Corp B or Corp B's customers. Corp A has ascertained that the primary benefit or value to Corp B from the transaction is the right to use the software development platform. Corp B pays Corp A a monthly fee for the platform and website hosting.

(ii) *Analysis*. (A) There is one transaction with multiple elements between Corp A and Corp B. One element is Corp A's provision to Corp B of on-demand network access to the software platform, which would be a cloud transaction described in paragraph (b) of this section if considered separately. Another element is Corp A's hosting of Corp B's finished websites, which would be a cloud transaction described in paragraph (b) of this section if considered separately. A third element is the grant by Corp A to Corp B of the right to use in Corp B's websites certain visual elements subject to copyrights held by Corp A, which would be a transfer of copyright rights under §1.861-18(b)(1)(i) if considered separately. A fourth element is the download of scripting code by Corp B, which would be a transfer of a copyrighted article under §1.861-18(b)(1)(ii) if considered separately.

(B) Because the transaction has multiple elements, one or more of which would be a cloud transaction if considered separately, paragraph (c)(2) of this section provides that the transaction is classified as a cloud transaction if its predominant character is a cloud transaction. Pursuant to §1.861-18(b)(3), the predominant character of the transaction is based on the primary benefit or value of the transaction to the customer, if it is reasonably ascertainable. The predominant character of this transaction is therefore a cloud transaction because the primary benefit or value received by Corp B is the right to use the software development platform. Accordingly, this transaction is classified solely as a cloud transaction described in paragraph (b) of this section and is classified as the provision of services under paragraph (c)(1) of this section.

(4) *Example 4*: *Access to online software via an application*—(i) *Facts*. Corp A provides Corp B word processing, spreadsheet, and presentation software and allows employees of Corp B to access the software over the Internet through a web browser or an application ("app") that can be downloaded from Corp A's servers onto a computer or mobile device. Corp B's employees usually download Corp A's app onto their mobile devices. To access the full functionality of the app, the device must be connected to the Internet. Only a limited number of features on the app are available without an Internet connection. Corp B has no ability to alter the software code. The software is hosted on servers owned by Corp A and located at Corp A's facilities and is used concurrently by other Corp A customers in addition to Corp B. Corp B pays a monthly fee based on the number of employees with access to the software. Users have the option to save files either online using the storage provided by Corp B, or offline on their own hard drives. Corp B's employees can also download updates to the app as part of the monthly fee arrangement. Upon termination of the arrangement, Corp A activates an electronic lock preventing Corp B's employees from further utilizing the app, and Corp B's employees are no longer able to access the software via a web browser. Corp A has ascertained that the primary benefit or value to Corp B from the transaction is the right to access Corp A's software over the Internet, whether via web browser or after downloading the app.

(ii) *Analysis*. (A) There is one transaction with multiple elements between Corp A and Corp B. One element is Corp A's provision to Corp B of on-demand network access to Corp A's computer hardware and software resources for the purpose of fully utilizing Corp A's software, which would be a cloud transaction described in paragraph (b) of this section if considered separately. Another element is the download of Corp A's app by Corp B employees, which would be a transfer of a copyrighted article under §1.861-18(b)(1)(ii) if considered separately.

(B) Because the transaction has multiple elements, one or more of which would be a cloud transaction if considered separately, paragraph (c)(2) of this section provides that the transaction is classified as a cloud transaction if its predominant character is a cloud transaction. Pursuant to §1.861-18(b)(3), the predominant character of the transaction is based on the primary benefit or value of the transaction to the customer, if it is reasonably ascertainable. The predominant character of this transaction is therefore a cloud transaction because the primary benefit or value received by Corp B is the right to access Corp A's software over the Internet. Accordingly, this transaction is classified solely as a cloud transaction described in paragraph (b) of this section and is classified as the provision of services under paragraph (c)(1) of this section.

(5) *Example 5*: *Access to offline software with limited online functions*—(i) *Facts*. Corp A provides Corp B word processing, spreadsheet, and presentation software that is functionally similar to the software in paragraph (d)(4) of this section (*Example 4*). The software is made available for access over the Internet but only to download the software from servers owned by Corp A onto a computer or mobile device in the form of an app. The downloaded software contains all the core functions of the software. Employees of Corp B can use the software on their computers or mobile devices regardless of whether their computer or mobile device is online. When online, the software provides a few ancillary functions that are not available offline, such as access to document templates and data collection for diagnosing problems with the software. Whether working online or offline, Corp B employees can store their files only on their own computer or mobile device, and not on Corp A's data storage servers. Corp B's employees can also download updates to the software as part of the monthly fee arrangement. Upon termination of the arrangement, an electronic lock is activated so that the software can no longer be accessed. Corp A has ascertained that the primary benefit or value to Corp B from the transaction is the right to download and use Corp A's software offline.

(ii) *Analysis*. (A) The transaction between Corp A and Corp B contains multiple elements. One element is the transfer of a copy of Corp A's software via download, which would be a transfer of

a copyrighted article described under §1.861-18(b)(1)(ii) if considered separately. Another element is the provision of online ancillary functionality of the software, which would be a cloud transaction described in paragraph (b) of this section if considered separately.

(B) Because the transaction has multiple elements, one or more of which would be a cloud transaction if considered separately, paragraph (c)(2) of this section provides that the transaction is classified as a cloud transaction if its predominant character is a cloud transaction. Pursuant to §1.861-18(b)(3), the predominant character of the transaction is based on the primary benefit or value of the transaction to the customer, if it is reasonably ascertainable. The predominant character of this transaction is therefore the transfer of a copyrighted article because the primary benefit or value received by Corp B is the right to download and use Corp A's software offline. Accordingly, this transaction is classified solely as a transfer of a copyrighted article described in §1.861-18(b)(1)(ii). The provision of the software constitutes a lease of a copyrighted article under §1.861-18 because access to the app is terminated when the monthly fee is no longer paid, even though Corp B employees retain the locked files on their devices. See §1.861-18(h)(4).

(6) *Example 6*: *Data storage, separate from access to offline software*—(i) *Facts*. The facts are the same as in paragraph (d)(5)(i) of this section (the facts in *Example 5*), except that Corp A also provides on-demand network data storage to Corp B on Corp A's servers in exchange for a monthly fee based on the amount of data storage used by Corp B. Under the data storage terms, Corp B employees may store files created by Corp B employees using Corp A's software or other software. Although Corp A's word processing software is compatible with Corp A's data storage systems, the core functionality of Corp A's software is not dependent on Corp B's purchase of the storage plan. Corp A's provision of software and data storage capacity constitute separate transactions.

(ii) *Analysis*. (A) As explained in paragraph (d)(5)(ii) of this section, Corp B's download of fully functional software, along with on-demand network access to certain limited online features, does not constitute a cloud transaction, but rather constitutes a lease of a copyrighted article under §1.861-18.

(B) The provision of on-demand network data storage by Corp A to Corp B is a cloud transaction with one element. Therefore, the transaction is treated solely as a cloud transaction under paragraph (b) of this section and is classified as the provision of services under paragraph (c)(1) of this section.

(7) *Example 7*: *Streaming and temporary download of digital content using third-party servers*—(i) *Facts*. Corp A offers via stream or temporary download digital content in the form of videos and music to customers from servers located in data centers owned and operated by Data Center Operator. Each customer uses a computer or other electronic device to access unlimited streaming or temporary downloads of video and music in exchange for payment of a flat monthly fee to Corp A. The customer may select from among the available content the particular video or song to be streamed or downloaded. Corp A continually updates its content catalog, replacing content with higher quality versions and adding new content at no additional charge to the customer. It also provides additional functionality such as various methods of filtering and sorting the library, a watchlist, and recommendations based on a customer's preferences. Content that is streamed to the customer is not stored locally on the customer's computer or other electronic device and therefore can be played only while the customer's computer or other electronic device is connected to the Internet. Content that is temporarily downloaded is stored on the customer's computer or other electronic device for 1 week and therefore can be played while the customer's computer or other electronic device is not connected to the Internet. Corp A cannot reasonably ascertain the primary benefit or value that its specific customers derive from accessing Corp A's catalog of digital content. Data collected by Corp A indicates that the vast majority of customers stream digital content rather than temporarily download the content. Corp A pays Data Center Operator a fee based on the amount of data storage used and computing power made available in connection with Corp A's content offerings.

(ii) *Analysis*. (A) The provision of data storage and computing power by Data Center Operator to Corp A is a cloud transaction with one element. Therefore, the transaction is treated solely as a cloud transaction under paragraph (b) of this section, and is classified as the provision of services under paragraph (c)(1) of this section.

(B) A transaction between Corp A and a customer has two elements. One element is streaming access to a curated and routinely updated library of digital content, which would be a cloud transaction described in paragraph (b) of this section if considered separately. Another element is the transfer of a copy of digital content via temporary download, which would be a transfer of a copyrighted article under §1.861-18(b)(1)(ii) if considered separately.

(C) Because the transaction has multiple elements, one or more of which would be a cloud transaction if considered separately, paragraph (c)(2) of this section provides that the transaction is classified as a cloud transaction if its predominant character is a cloud transaction. Pursuant to §1.861-18(b)(3), the predominant character of the transaction is based on the primary benefit or value of the transaction to the customer if it is reasonably ascertainable. However, Corp A cannot reasonably ascertain the primary benefit or value derived by a specific customer from Corp A's offering. In such situations, §1.861-18(b)(3)(ii) provides that the predominant character of a transaction may be determined based on the primary benefit or value to a typical customer of a substantially similar transaction. This primary benefit or value to a typical customer can be identified through actual data about use or access pursuant to §1.861-18(b)(3)(ii)(A), or if that data is not available, by using other evidence indicative of the primary benefit or value to a typical customer pursuant to §1.861-18(b)(3)(ii)(B). Because Corp A has data that shows the typical customer streams digital content rather than temporarily downloading it, the primary benefit or value received by a typical customer is streaming access to digital content. Therefore, the predominant character of the transaction is a cloud transaction. Under paragraph (c)(1) of this section, the cloud transaction is classified as the provision of services.

(8) *Example 8*: *Access to online database*—(i) *Facts*. Corp A offers an online database of industry-specific materials. Customers access the materials through Corp A's website, which aggregates and organizes information topically and hosts a proprietary search engine. Corp A hosts the website and database on its own servers and provides multiple customers access to the website and database concurrently. Most materials in Corp A's database are publicly available by other means, but Corp A's website offers an efficient way to locate and obtain the information on demand. Certain materials in Corp A's database constitute digital content within the meaning of §1.861-18(a)(2), and Corp A pays the copyright owners a license fee for using them. Each customer may download any of the materials to its own computer and keep such materials without further payment. The customer pays Corp A a fee based on the number of searches or the amount of time spent on the website, and such fee is not dependent on the amount of materials the customer downloads. The fee that the customer pays is substantially higher than the stand-alone charge for accessing the same digital content outside of Corp A's system. Corp A cannot reasonably ascertain the primary benefit or value that a specific customer derives from accessing Corp A's database. Corp A does not have data indicating whether the typical customer downloads materials from the database. Corp A markets its website and online database as user-friendly and an efficient way to find relevant materials because of its proprietary search engine. Developing the proprietary search engine was the largest cost Corp A incurred in creating its website and online database.

(ii) *Analysis*. (A) The transaction between Corp A and a customer has multiple elements. One element is Corp A's provision to a customer of access to Corp A's website and online database, which is a cloud transaction described in paragraph (b) of this section if considered separately. Another element is the transfer of digital content via download, which is the transfer of a copyrighted article under §1.861-18 if considered separately.

(B) Because the transaction has multiple elements, one or more of which would be a cloud transaction if considered separately, paragraph (c)(2) of this section provides that the transaction is classified as a cloud transaction if its predominant character is a cloud transaction. Pursuant to §1.861-18(b)(3), the predominant character of the transaction is based on the primary benefit or value of the transaction to the customer, if it is reasonably ascertainable. However, Corp A cannot reasonably ascertain the primary benefit or value derived by a specific customer from access to Corp A's database. In such situations, §1.861-18(b)(3)(ii) provides that the predominant character of a transaction may be determined based on the primary benefit or value to a typical customer of a substantially similar transaction. This primary benefit or value to a typical customer can be identified through actual data about use or access pursuant to §1.861-18(b)(3)(ii)(A), or if that data is not available, by using other evi-

dence indicative of the primary benefit or value to a typical customer pursuant to §1.861-18(b)(3)(ii)(B). That Corp A focuses on its proprietary search engine when marketing its website and database, as well as the facts that the search engine was the most expensive cost incurred by Corp A in creating its website and database, and that customers pay a substantially higher fee to access Corp A's system than they would otherwise pay to access the content outside of Corp A's system, indicates that the primary benefit or value received by a typical customer is the right to use the search engine. Therefore, under paragraph (c)(2) of this section, the predominant character of the transaction between Corp A and a customer is a cloud transaction. Under paragraph (c)(1) of this section the cloud transaction is classified as the provision of services.

(9) *Example 9*: *Temporary or perpetual access to a single movie via stream or download*—(i) *Facts*. Corp A hosts movies on its website and allows customers to view a single movie for a limited period or perpetually for a one-time fee, with perpetual viewing rights costing a higher fee. Corp A does not charge customers a separate fee for access to the website. In addition, Corp A's website provides recommendations for movies based on a customer's search for a particular title and/or the customer's purchase history. Customers have no ability to alter the servers, website, or movies available on the website. The movies in Corp A's database constitute digital content within the meaning of §1.861-18(a)(2), and Corp A pays the copyright owners a license fee for using them. Corp A allows customers to view the movies by either streaming the movies from Corp A's servers, or by downloading the movies onto the customer's computer or other electronic device. The file size of movies offered by Corp A is generally large and so customers may be expected to download movies only in certain situations such as when traveling without Internet access. Upon the expiration of the rental period, customers will no longer have access to stream the movies, and any movie that was downloaded onto a customer's computer or other electronic device will auto-delete from the customer's computer or other electronic device. Whether a customer chooses to view the movie via stream or download, Corp A charges the same one-time fee. Corp A cannot reasonably ascertain the primary benefit or value that a specific customer derives from accessing Corp A's website. Corp A maintains aggregate data on whether a given movie is viewed via stream or download, and this data shows that most movies are viewed by streaming, even in the case where a customer pays for the right to view a movie in perpetuity.

(ii) *Analysis*. (A) A transaction between Corp A and a customer contains multiple elements. One element is Corp A's provision to a customer of access to Corp A's website in order to view a movie via stream, which is a cloud transaction described in paragraph (b) of this section if considered separately. Another element is Corp A's provision to a customer of access to Corp A's website in order to download a movie, which is the transfer of a copyrighted article under §1.861-18 if considered separately.

(B) Because the transaction has multiple elements, one or more of which would be a cloud transaction if considered separately, paragraph (c)(2) of this section provides that the transaction is classified as a cloud transaction if its predominant character is a cloud transaction. Pursuant to §1.861-18(b)(3), the predominant character of the transaction is based on the primary benefit or value of the transaction to the customer, if it is reasonably ascertainable. However, Corp A cannot reasonably ascertain the primary benefit or value derived by a specific customer from access to Corp A's database. In such situations, §1.861-18(b)(3)(ii) provides that the predominant character of a transaction may be determined based on the primary benefit or value to a typical customer of a substantially similar transaction. This primary benefit or value to a typical customer can be identified through actual data about use or access pursuant to §1.861-18(b)(3)(ii)(A), or if that data is not available, by using other evidence indicative of the primary benefit or value to a typical customer pursuant to §1.861-18(b)(3)(ii)(B). Corp A has data that shows that the typical customer views movies by streaming rather than download. Accordingly, under paragraph (c)(2) of this section, the predominant character of the transaction is a cloud transaction because the primary benefit or value a typical customer receives is access to stream movies on Corp A's website. Under paragraph (c)(1) of this section, the cloud transaction is classified as the provision of services.

(10) *Example 10*: *Reseller of software as a service*—(i) *Facts*. Corp A owns the copyright to software (Program S). Corp A hosts Program S on its servers. Customers access Program S only through an Internet connection. Corp A grants Corp B, a foreign corporation wholly owned by Corp A, the right to sell access to Program S to Corp B's customers that are located in Corp B's country. Corp B is responsible for managing the purchase/sale interaction with Corp B's customers, including invoicing and collections. Corp A is responsible for providing customers with access to Program S. Corp B does not perform any functions to provide access to Program S.

(ii) *Analysis*. (A) The transaction between Corp A and Corp B is treated as Corp A providing on-demand access to Program S to Corp B even though Corp B resells that access. This transaction is a cloud transaction with one element. Under paragraph (c)(1) of this section, the cloud transaction is classified as the provision of services. The transaction does not involve the transfer of any copyright rights described in §1.861-18(c)(2), and therefore is governed solely by this section.

(B) The transaction between Corp B and its customers is the provision of on-demand access to Program S by Corp B, which is a cloud transaction with one element. Under paragraph (c)(1) of this section, the cloud transaction is classified as the provision of services. The transaction does not involve the transfer of any copyright rights described in §1.861-18(c)(2), and therefore is governed solely by this section.

(11) *Example 11*: *Computer game with online functionality and in-game purchases*—(i) *Facts*. Corp A owns the copyright to a computer game (Game X). Customers can purchase Game X for a one-time fee and download it onto their computers. A customer may play certain aspects of Game X while not connected to the Internet, but most of the core functionality of Game X is available only when the customer is connected to the Internet, including the ability to play with other customers. In order to access the additional online functionality specific to Game X, customers must pay a monthly fee to Corp A. The additional functionality of Game X is hosted on servers owned by Corp A. Customers may also pay a one-time fee to access an in-game item that can be utilized only when playing Game X online.

(ii) *Analysis*. (A) There are three transactions between Corp A and a customer. The first transaction is the transfer of a copy of Game X, which is a digital content transaction with one element because a customer receives from Corp A access only to offline content in exchange for purchasing a copy of the game. Therefore, this transaction is treated solely as a transfer of a copyrighted article under §1.861-18.

(B) The second transaction between Corp A and a customer is the payment of a monthly fee to play Game X online on Corp A's servers, which is a cloud transaction with one element. Therefore, this transaction is treated solely as a cloud transaction, and is classified as the provision of services under paragraph (c)(1) of this section.

(C) The third transaction between Corp A and a customer is the payment of a one-time fee in exchange for an in-game item. Because a customer can utilize the item only when playing Game X through an Internet connection, the transaction is a cloud transaction with one element. Therefore, this transaction is treated solely as a cloud transaction, and is classified as the provision of services under paragraph (c)(1) of this section.

(e) *Applicability date*—(1) *In general*. This section applies to taxable years beginning on or after January 14, 2025.

(2) *Early application*. A taxpayer can apply this section to taxable years beginning on or after August 14, 2019 and all subsequent taxable years not described in paragraph (e)(1) (early application years) if—

(i) The taxpayer also applies §1.861-18 to the early application years;

(ii) This section and §1.861-18 are applied to the early application years by all persons related to the taxpayer (within the meaning of sections 267(b) and 707(b));

(iii) The period of limitations on assessment for each early application year of the taxpayer and all related parties (within the meaning of sections 267(b) and 707(b)) is open under section 6501; and

(iv) The taxpayer would not be required under this section to change its method of accounting as a result of such election.

(f) *Change in method of accounting required by this section*. In order to comply with this section, a taxpayer may be required to change its method of accounting. If so required, the taxpayer must secure the consent of the Commissioner

in accordance with the requirements of §1.446-1(e) and the applicable administrative procedures for obtaining the Commissioner's consent under section 446(e) for voluntary changes in methods of accounting.

§1.937-3 [Amended]

Par. 5. Section 1.937-3 is amended by removing *Examples 4* and *5* from paragraph (e).

Douglas W. O'Donnell,
Deputy Commissioner.

Approved: December 18, 2024.

Aviva R. Aron-Dine,
Deputy Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register January 10, 2025, 8:45 a.m., and published in the issue of the Federal Register for January 14, 2025, 90 FR 2977)

Part III

Request for Comments on Applying the Characterization Rules in §§1.861-18 and 1.861-19 to All Provisions of the Internal Revenue Code

Notice 2025-6

SECTION 1. PURPOSE

The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) have published Treasury Decision 10022 containing final regulations (2025 final regulations) that provide rules for characterizing digital content and cloud transactions. [T.D. 10022, 90 FR 2977 (January 14, 2025).] The 2025 final regulations apply solely to certain enumerated international provisions of the Internal Revenue Code (the Code).[1] This notice requests comments on any potential implications if the characterization rules currently contained in §§1.861-18 and 1.861-19, as amended and added, respectively, by the 2025 final regulations, were to apply to all provisions of the Code, including the need for additional guidance, and seeks specific comments on the possible impacts and guidance that may be necessary with respect to certain identified provisions. Comments received in response to this notice will help inform the Treasury Department and the IRS's decision regarding whether to apply the characterization rules currently contained in §§1.861-18 and 1.861-19 to all provisions of the Code and what further guidance, if any, should be issued if the regulations were revised in this manner.

SECTION 2. BACKGROUND

In 1998, in response to rapid technological advances including the growth of transactions in digitized information,[2] the Treasury Department and the IRS published Treasury Decision 8785, which contains the original final regulations in §1.861-18 (1998 final regulations) that set forth a framework for characterizing transactions involving computer programs. T.D. 8785, 63 FR 52971 (Oct. 2, 1998). This framework is based on copyright law, but takes into account the unique features of digitized information. REG-251520-96, 61 FR 58152, 58153 (Nov. 13, 1996) ("Although the proposed regulations are guided by copyright law principles in determining whether a copyright right or a copyrighted article has been transferred, the regulations depart in some cases from a strict reliance on copyright law in order to take into account the special nature of computer programs and to treat functionally equivalent transactions in the same way."). The 1998 final regulations broadly group computer program transactions into one of the following categories: transfers of copyright rights, transfers of a copy of the program (a copyrighted article), services for the development or modification of the program, or the provision of know-how relating to computer programming techniques.

The 1998 final regulations focus on the distinction between transfers of the copyright itself and transfers of a copyrighted article with a substance-over-form characterization approach that looks to the underlying rights granted to the transferee. Where a transfer conveys a commercial exploitation right included in the list of enumerated copyright rights (such as the right to make copies of the program for purposes of distribution to the public), the transaction is treated as a transfer of copyright rights. However, if a copy of a program is transferred without one of the enumerated copyright rights (merely granting a right to the transferee to use the copy on its own computer, for example), the transaction is treated as a transfer of a copyrighted article.

The 1998 final regulations further characterize transfers of copyright rights and copyrighted articles as complete or partial transfers. For a transfer of a copyright right, if all substantial rights to the underlying copyright right are transferred, the transfer is classified as a sale or exchange of the copyright right under the principles of §§1222 and 1235. If less than all substantial rights are transferred, the transaction is classified as a license. For a transfer of a copyrighted article, if the benefits and burdens of ownership have been transferred, the transaction is classified as a sale of the copyrighted article. If insufficient benefits and burdens of ownership of the copyrighted article have been transferred, the transaction is classified as a lease. *See, e.g.*, *Grodt & McKay Realty, Inc. v. Comm'r*, 77 T.C. 1221, 1237–38 (1981); *Torres v. Comm'r*, 88 T.C. 702, 720–27 (1987); *Estate of Thomas v. Comm'r*, 84 T.C. 412, 431–40 (1985).

The 1998 final regulations apply solely for purposes of subchapter N of chapter 1 of the Code, §§367, 404A, 482, 551, 679, 1059A, chapter 3, chapter 5, §§842 and 845 (to the extent involving a foreign person), and transfers to foreign trusts not covered by §679. The preamble to the 1998 final regulations states that while such regulations apply only to cross-border transactions involving computer programs, the Treasury Department and the IRS may consider whether to apply the principles of the regulations to all transactions in digitized information as part of a separate guidance project.

In general, the 2025 final regulations maintain the basic framework from the 1998 final regulations for characterizing transfers of content as primarily copyright rights or copyrighted articles (and subcategorizing as sales or licenses of copyright rights, or sales or leases of copyrighted articles). The 2025 final regulations extend the characterization framework of the 1998 final regulations to transactions involving digital content, which is generally defined as a computer program or any other content protected by copyright law, not just transactions involving computer programs. The 2025

[1] Unless otherwise specified, all "section" or "§" references are to sections of the Code or the Income Tax Regulations (26 CFR part 1).

[2] *See* Treasury Department, "Selected Tax Policy Implications of Global Electronic Commerce," Nov. 1996, at 27-28.

final regulations also include §1.861-19, which provides that cloud transactions (generally defined as transactions through which a person obtains on-demand network access to computer hardware, digital content, or other similar resources) are characterized as the provision of services. Further, the 2025 final regulations implement a predominant character rule for characterizing digital content and cloud transactions.

The 2025 final regulations continue to apply only to certain listed international Code provisions, with updates to eliminate references to repealed §551 and chapter 5, and to add references to §§59A, 245A, 250, and 267A, and chapter 4. The 2025 final regulations retain this limited scope although the Treasury Department and the IRS received several comments recommending that the regulations apply to all provisions of the Code in response to the proposed regulations preceding the 2025 final regulations. As noted in the preamble to the 2025 final regulations, however, the Treasury Department and the IRS continue to study whether the characterization rules currently contained in §§1.861-18 and 1.861-19 should apply to all provisions of the Code. To inform their consideration of and decision on the issue, section 3 of this notice solicits comments.

SECTION 3. REQUEST FOR COMMENTS

The Treasury Department and the IRS request comments regarding any consequences or interactions that would result if the characterization rules currently contained in §§1.861-18 and 1.861-19, as amended and added, respectively, by the 2025 final regulations, were to apply to all provisions of the Code. Comments are requested on any specific areas that would be affected, with examples where appropriate. Comments are also requested on any guidance that would be needed, including what approach such guidance should take. In addition to general comments, the Treasury Department and the IRS request comments, with examples, regarding the desirability and effects, if any, of applying the characterization rules currently contained in §§1.861-18 and 1.861-19 on the rules in the following areas, including whether further guidance in these areas would be necessary and, if so, what the approach of the guidance should be:

- Section 167(f)
- Section 168(g)(1)(B)
- Section 178
- Section 197
- Section 263
- Section 451
- Sections 263A and 471
- Sections 856 through 859
- Sections 1001 and 1011
- Sections 1221 and 1222
- Section 1241

SECTION 4. SUBMISSION OF COMMENTS

.01 Written comments should be submitted by **[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE INTERNAL REVENUE BULLETIN]**. Consideration will be given, however, to any written comment submitted after **[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE INTERNAL REVENUE BULLETIN]**, if such consideration will not delay the issuance of guidance. The subject line for the comments should include a reference to Notice 2025-6. Comments may be submitted in one of two ways:

(1) Electronically via the Federal eRulemaking Portal at www.regulations.gov (type IRS-2025-6 in the search field on the regulations.gov homepage to find this notice and submit comments). Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn.

(2) Alternatively, by mail to: Internal Revenue Service, CC:PA:01:PR (Notice 2025-6, Room 5203, P.O. Box 7604, Ben Franklin Station, Washington, D.C., 20044.

.02 All commenters are strongly encouraged to submit comments electronically. The Treasury Department and the IRS will publish for public availability any comment submitted electronically and on paper to its public docket on www.regulations.gov.

SECTION 5. DRAFTING AND CONTACT INFORMATION

The principal author of this notice is Michelle L. Ng of the Office of the Associate Chief Counsel (International). Other personnel from the Treasury Department and the IRS participated in its development. For further information regarding this notice, call the contact number at (202) 317-6989 (not a toll-free number).

Domestic Content Bonus Credit Amounts under the Inflation Reduction Act of 2022: First Updated Elective Safe Harbor modifying Notice 2024-41

Notice 2025-08

SECTION 1. PURPOSE

This notice provides an updated elective safe harbor for the domestic content bonus credit (First Updated Elective Safe Harbor) that modifies the safe harbor provided in IRS Notice 2024-41, 2024-24 I.R.B. 1615 (Notice 2024-41), including the table provided in section 4.04(1)-(3) (Table 1), in the five ways described below in section 3 of this notice. Table 1 provided the Assigned Cost Percentages for each Manufactured Product and Manufactured Product Component to provide taxpayers clarity in applying the new elective safe harbor (New Elective Safe Harbor) outlined in Notice 2024-41. Taxpayers, including entities that make elective payment elections under § 6417 of the Internal Revenue Code (Code),[1] may elect to use the First Updated Elective Safe Harbor in lieu of

[1] *Unless otherwise specified, all "section" or "§" references are to sections of the Code or the Income Tax Regulations (26 CFR part 1).*

the Domestic Manufactured Products and Components Cost and Total Manufactured Products Cost provisions of the Adjusted Percentage Rule in section 3.03(2)(b) and (c) of Notice 2023-38, 2023-22 I.R.B. 872 (Notice 2023-38), which require taxpayers to use the manufacturer's direct costs of producing Manufactured Products and Manufactured Product Components in an Applicable Project.[2] Taxpayers who elect to use the First Updated Elective Safe Harbor for any Applicable Project must use one of the respective tables provided below in sections 5-7 of this notice subject to the conditions described in section 8 of this notice, also provided below.

SECTION 2. BACKGROUND

Public Law 117-169, 136 Stat. 1818 (August 16, 2022), commonly known as the Inflation Reduction Act of 2022 (IRA), amended §§ 45 and 48 to provide a domestic content bonus credit amount for certain qualified facilities or energy projects placed in service after December 31, 2022, and added new §§ 45Y and 48E, which include a domestic content bonus credit amount for certain investments in qualified facilities or energy storage technologies placed in service after December 31, 2024.

.01 *Notice 2023-38.* On May 12, 2023, the Treasury Department and the IRS released Notice 2023-38, which states that the Treasury Department and the IRS intend to propose regulations for rules that taxpayers must satisfy to qualify for the domestic content bonus credit amounts under §§ 45, 45Y, 48, and 48E. Notice 2023-38 also describes a safe harbor regarding the classification of certain Applicable Project Components in representative types of qualified facilities, energy projects, or energy storage technologies.

.02 *Notice 2024-41*. On May 24, 2024, the Treasury Department and the IRS released Notice 2024-41, which, among other things, modified the existing domestic content safe harbor in Notice 2023-38 by (i) expanding the non-exclusive list of Applicable Projects in "Table 2--Categorization of Applicable Project Components" from Notice 2023-38 to include hydropower and pumped hydropower storage facilities; (ii) replacing "Utility scale photovoltaic system" with "Ground-mount and rooftop photovoltaic system"; and (iii) including certain Manufactured Product Components for previously listed Applicable Projects.

Notice 2024-41 further provided an elective safe harbor in Table 1 of section 4.04(1)-(3) that taxpayers may use to classify the identified Applicable Project Components. Table 1 also provided the Assigned Cost Percentages for each of the identified Manufactured Products and Manufactured Product Components that may be found in the identified Applicable Projects, which include solar photovoltaic (PV) systems, land-based wind facilities, and battery energy storage technologies. The Assigned Cost Percentage for each of the identified Manufactured Products and Manufactured Product Components in Table 1 was obtained from DOE for purposes of calculating the Domestic Cost Percentage and satisfying the Adjusted Percentage Rule and will be accepted by the IRS for those Manufactured Products and Manufactured Product Components for taxpayers that are eligible to rely on Notice 2024-41. Finally, Notice 2024-41 provided requirements for taxpayers that elect to use the New Elective Safe Harbor to classify the identified Applicable Project Components listed in Table 1 and to calculate the Domestic Cost Percentage.

SECTION 3. OVERVIEW OF MODIFICATIONS TO NOTICE 2024-41

The First Updated Elective Safe Harbor modifies Notice 2024-41 in five ways.

First, section 5 of this notice provides several modifications to Notice 2024-41, including expanding the Solar PV Table of Table 1 into two distinct tables, one for Photovoltaic (PV) Ground-mount (Tracking and Fixed) Applicable Projects and one for PV Rooftop (MLPE and String) Applicable Projects, and providing updated associated cost percentages for each table (Updated Assigned Cost Percentages for PV Solar)[3], including those within the new columns in each table that provide a second set of associated cost percentages for employing PV modules that incorporate crystalline silicon photovoltaic (c-Si PV) cells and wafers that are manufactured in the United States. See sections 5.05 and 5.06 of this notice. The Updated Assigned Cost Percentages for PV Solar provided in the new columns specific to projects that use c-Si PV cells made with domestically produced wafers increase accuracy beyond Table 1 by accounting for the expected significant cost premium this type of cell would carry. There are no additional associated cost percentages for other types of PV cells because DOE assesses that the existing cost percentages, as updated in this notice, adequately capture the costs of other types of PV cells.

Second, section 6 of this notice modifies the Land-Based Wind Table from Table 1 by renaming the term (i) "Steel or iron rebar in foundation," which is listed as an Applicable Project Component in Table 1, to "Steel or iron reinforcing products in foundation," and (ii) the term "Material," which is listed as a Manufactured Product Component in Table 1, to "Preform." Regarding the associated cost percentages for land-based wind components, the First Updated Elective Safe Harbor's values (Updated Assigned Cost Percentages for Land-Based Wind) are the same values as the Assigned Cost Percentages for the Land-Based Wind Table in Table 1. This notice uses the same values because DOE, using analysis from the national laboratories, found only minor changes in the component cost data underlying the Assigned Cost Percentages for the Land-Based Wind Table in Table 1. For this reason, DOE did not independently publish updates to this data.

[2] *Unless otherwise specified, capitalized terms used throughout this notice are defined in Notice 2023-38 and Notice 2024-41. The term "Applicable Project" includes a qualified facility described in § 45Y(b)(1)(C) or § 48E(b)(3)(B)(i).*

[3] *For purposes of the First Updated Elective Safe Harbor, the Updated Assigned Cost Percentages for PV Solar, defined in section 3 of this notice, the associated cost percentages for the Land-Based Wind, which are the same cost values as the Assigned Cost Percentages provided in Notice 2024-41, and the Updated Assigned Cost Percentages for BESS, defined in section 7 below, are collectively defined as the Updated Assigned Cost Percentages.*

Third, section 7 of this notice provides several modifications to Notice 2024-41, including providing updated assigned cost percentages for the Manufactured Products and Manufactured Product Components relating to the Battery Electric Storage System (BESS) (Updated Assigned Cost Percentages for BESS), which Table 1 provided as the Assigned Cost Percentages for the (3) Battery Electric Storage System (BESS). Like the Assigned Cost Percentages, the Updated Assigned Cost Percentages apply to both grid-scale BESS and distributed BESS Applicable Projects.

Fourth, section 4 of the First Updated Elective Safe Harbor provides that a taxpayer with a qualified facility under § 45 or energy project under § 48 that is placed in service after December 31, 2022, and that meets the 80/20 Rule, or a qualified facility under §§ 45Y or 48E or energy storage technology under § 48E that is placed in service after December 31, 2024, and that meets the 80/20 Rule, may use the classifications and cost percentages in Table 1 or the First Updated Elective Safe Harbor (as applicable) to qualify for the domestic content bonus credit amount.

Fifth, the First Updated Elective Safe Harbor provides updated definitions for representative types of Applicable Projects and definitions for certain Applicable Project Components and Manufactured Product Components.

SECTION 4. CLARIFICATION ON APPLICATION OF TABLES

A taxpayer may elect to use the classifications and cost percentages in Table 1 of Notice 2024-41 or the First Updated Elective Safe Harbor (as applicable) to qualify for the domestic content bonus credit amount for Applicable Projects of the specific types identified in Table 1 or the First Updated Elective Safe Harbor that are eligible for a credit under sections 45, 45Y, 48, or 48E by virtue of the 80/20 Rule. For example, as provided for in Notice 2023-38, an Applicable Project that is eligible for a credit under sections 45, 45Y, 48, or 48E by virtue of the 80/20 Rule is eligible for a domestic content bonus credit amount if the new property in the Applicable Project meets the Domestic Content Requirement and the taxpayer complies with the requirements described in the notice. To determine the Domestic Cost Percentage for such an Applicable Project, the taxpayer may use the classifications and cost percentages in Table 1 or the First Updated Elective Safe Harbor (as applicable). Only new U.S. Manufactured Products and U.S. Components of the Applicable Project that are listed in Table 1 of Notice 2024-41 or of this First Updated Elective Safe Harbor (as applicable) would be considered in the calculation of the Domestic Cost Percentage (with no changes to those tables' percentages). All other Manufactured Products or Manufactured Product Components, including the used property in an Applicable Project that qualifies as originally placed in service by virtue of the 80/20 Rule, will be treated as foreign-sourced Manufactured Products or Manufactured Product Components solely for purposes of calculating the Domestic Cost Percentage when applying the New Elective Safe Harbor in Notice 2024-41, and for applying the First Updated Elective Safe Harbor in this notice, and must take a zero value consistent with section 4.03(3) in Notice 2024-41 and section 8.03(3) of this notice. In such cases, new property may be considered in the calculation of the Domestic Content Percentage if it meets the definition of a U.S. Manufactured Product (as defined in section 3.03(1) of Notice 2023-38, including being produced in the United States), or a U.S. Component (as defined in section 3.03(2)(b) in Notice 2023-38, including being mined, produced, or manufactured in the United States). Furthermore, to meet the Domestic Content Requirement, such Applicable Projects must also satisfy the Steel or Iron Requirement with respect to only new Applicable Project Components that are specified as subject to the Steel or Iron Requirement in Table 1 of Notice 2024-41 or this First Updated Elective Safe Harbor (as applicable).

The modification to Notice 2024-41 described in this section does not extend a taxpayer's ability to rely on Notice 2024-41, as described in section 11 of this notice.

SECTION 5. MODIFICATIONS TO TABLE 1 FOR SOLAR PV; GROUND-MOUNT AND ROOFTOP

.01 *Modifications to Table 1 for Solar PV; Expanded Tables*. The First Updated Elective Safe Harbor modifies Table 1 for Solar PV in section 4.04(1) of Notice 2024-41 by expanding it into two distinct tables to provide the Updated Assigned Cost Percentages for PV Solar for both types of ground-mount photovoltaic systems and both types of rooftop photovoltaic systems. See tables in sections 5.05 and 5.06 of this notice. DOE calculated the Updated Assigned Cost Percentages for PV Solar using its new ground-mount and rooftop PV component costs for 2024, which DOE derived from cost data from a variety of sources, including datasets of system characteristics, price indices, U.S. survey data from the government (for example, the U.S. Bureau of Labor Statistics, Department of Labor) and private sector, public filings from corporations, and comprehensive interviews of manufacturers, installers, developers, and owners of the representative technologies. In addition, DOE used data collected from three different national laboratories to generate the Updated Assigned Cost Percentages for PV Solar, rather than a single national laboratory survey that DOE relied upon for the methodology used to generate the Assigned Cost Percentages in Table 1.

.02 *Addition of New Columns*. The First Updated Elective Safe Harbor further modifies Table 1 for Solar PV in section 4.04(1) of Notice 2024-41 by adding a new column with a second set of Updated Assigned Cost Percentages for each type of ground-mount PV system and each type of rooftop PV system. This alternative set of Updated Assigned Cost Percentages can be used if a PV system has PV modules that incorporate c-Si PV cells and wafers manufactured within the United States. These additional Updated Assigned Cost Percentages were incorporated to reflect the significant cost premium this type of cell would carry relative to other types of domestic cells, such as those with foreign wafers or domestic thin-film cells. These new columns include values based on DOE's estimates of underlying direct costs for a domestically produced mod-

ule containing c-Si PV cells made from domestically produced c-Si wafers. The Updated Assigned Cost Percentages for PV Solar are from DOE's Quarterly Solar Industry Update (publication pending), which are derived from a DOE-led effort that uses data collected from national laboratories.

The Treasury Department and the IRS, in consultation with DOE, implemented the updates described after review of the comments received in response to the request for comments made in Notice 2024-41, which highlighted the expected cost premium incurred from procuring domestically produced c-Si PV cells made with domestically produced silicon wafers. Based on this review and consultation with DOE, the Treasury Department and the IRS concluded that, due to the expected cost premium associated with domestically produced silicon wafers, Table 1 could misrepresent the expected costs of domestically produced c-Si PV cells made with these wafers, thereby reducing Table 1's accuracy. This inaccuracy could risk under-crediting a component whose value is, to a significant extent, created domestically, while over-crediting other components within the table.

Given these considerations, the Treasury Department and the IRS, in consultation with DOE, have determined that it is appropriate to provide taxpayers the option of using a cost safe harbor that more specifically reflects the cost of c-Si PV cells produced with domestically produced wafers.

.03 *Renaming of Certain Components*. The First Updated Elective Safe Harbor further modifies Table 1 for Solar PV in section 4.04(1) of Notice 2024-41 by renaming the following Applicable Project Components and Manufactured Product Components. With respect Applicable Project Components: (i) "Pile or ground screw" is renamed "Steel pile or steel ground screw" for consistency with the description of other items categorized as a steel/iron product, and (ii) "Steel or iron rebar in foundation" is renamed "Steel or iron reinforcing products in foundation" to better reflect its function and to clarify that non-rebar steel or iron reinforcement is also covered.

With respect to Manufactured Product Components: (i) "Climate Control" is renamed "Thermal Management System"; (ii) "Enclosure" is renamed "Enclosure & Skids" for the Inverter Applicable Project Component of both types of ground-mount photovoltaic systems; (iii) "Fasteners" is renamed "Structural Fasteners"; (iv) "Slew Drive" is renamed "Drive System"; and (v) "Motor" is renamed "Actuator" to better reflect each Manufactured Product Component's function by providing specificity.

.04 *Redefining, Recategorizing, and Reclassifying Certain Components*. The following changes were made after consultation with DOE and review of stakeholder feedback: First, the First Updated Elective Safe Harbor revises the definition of: (i) "Ground-mounted PV (fixed-tilt)" to clarify that it includes canopy steel racking structures and structures floating on a body of water; (ii) "Ground-mounted PV (tracker)" to clarify that it includes structures floating on a body of water; and (iii) "Rooftop PV (MLPE)" to clarify that it refers to a system where the microinverters or DC-optimizers regulate the DC electricity from each of its solar PV modules independently before the electricity is converted into alternating current electricity.

Second, the First Updated Elective Safe Harbor clarifies that the Manufactured Product Component "Electrical Parts" for ground-mount PV systems includes the following components that are not on printed circuit board (PCB) assemblies: control transformers, capacitors, inductors, bus/cables, circuit protection.

Third, as provided in the table in section 5.06 of this notice, the First Updated Elective Safe Harbor removes "Electrical Parts for rooftop PV systems," and adds their costs to "Printed Circuit Board Assemblies" (DC-DC) and "Printed Circuit Board Assemblies" (DC-AC).[4]

Fourth, for "Solar PV Rooftop", the First Updated Elective Safe Harbor categorizes DC-to-DC and DC-to-AC "Printed Circuit Board Assemblies" as separate Manufactured Products Components, and the domestic "Printed Circuit Board Assemblies" that perform both functions (that is, convert both DC to DC and DC to AC) can get credit for each cost percentage.[5]

Fifth, "Adhesives," which is listed as a Manufactured Product Component for PV Solar in Table 1, is removed from the First Updated Elective Safe Harbor to avoid redundancy and confusion because "Pottants" and "Edge Seals," which are listed as Manufactured Product Components within the First Updated Elected Safe Harbor, are also adhesives. As such, to reflect the removal of "Adhesives" within the Updated Assigned Cost Percentages for PV Solar, the Treasury Department and the IRS, in consultation with DOE, increased the associated cost percentage for both "Pottants" and "Edge Seals". See tables in section 5.05 and 5.06 of this notice.

.05 *Updated Table for Solar PV Ground-Mount*

[4] *The abbreviated terms "DC" and "AC" are generally industry accepted terms meaning "Direct Current" and "Alternating Current," respectively.*

[5] *Larger inverters, such as those in most ground-mount applications, have fundamentally different architectures than smaller inverters. As such, DOE assessed that a similar change would not improve the accuracy of the cost percentages for ground-mount PV systems.*

APC	*MPC*	**Ground-mount (Tracking)**	**Ground- mount (Tracking) with Domestic c-Si PV Cells & Domestic Wafers**	**Ground-mount (Fixed)**	**Ground- mount (Fixed) with Domestic c-Si PV Cells & Domestic Wafers**
PV module	Cells	38.0	51.6	53.2	66.6
	Frame/Backrail	6.0	4.7	8.5	6.1
	Front Glass	6.0	4.7	8.4	6.1
	Encapsulant	3.8	3.0	5.4	3.8
	Backsheet/Backglass	3.8	3.0	5.4	3.8
	Junction Box	1.0	0.8	1.4	1.0
	Edge Seals	0.3	0.2	0.4	0.3
	Pottants	0.3	0.2	0.4	0.3
	Bus Ribbons	1.5	1.2	2.1	1.5
	Bypass Diodes	0.4	0.3	0.6	0.4
	Production[6]	**4.7**[7]	**3.7**[7]	**6.7**[7]	**4.8**[7]
Inverter	Printed Circuit Board Assemblies	2.4	1.7	3.1	2.2
	Electrical Parts	0.8	0.6	1.1	0.8
	Thermal Management System	0.5	0.4	0.7	0.5
	Enclosure & Skids	0.6	0.5	0.9	0.6
	Production	**1.2**[7]	**0.9**[7]	**1.7**[7]	**1.2**[7]
PV Tracker	Torque tube	11.0	8.6	-	-
	Structural Fasteners	0.4	0.3	-	-
	Drive System	1.9	1.5	-	-
	Dampers	0.5	0.4	-	-
	Actuator	2.8	2.2	-	-
	Controller	0.7	0.6	-	-
	Rails	2.0	1.6	-	-
	Production	**9.4**[7]	**7.3**[7]	**-**	**-**
Steel photovoltaic module racking	-	-	-	Steel/Iron Product	Steel/Iron Product
Steel pile or Steel ground screw	-	Steel/Iron Product	Steel/Iron Product	Steel/Iron Product	Steel/Iron Product
Steel or Iron reinforcing products in foundation	-	Steel/Iron Product	Steel/Iron Product	Steel/Iron Product	Steel/Iron Product
Total	-	**100**	**100**	**100**	100

[6] *Although "Production" is listed under the column for Manufactured Product Components (MPCs), it is not an MPC. "Production" refers to the production cost of the relevant Applicable Project Component (APC) that is a Manufactured Product and can only be included in the Domestic Cost Percentage if all of the Manufactured Product Components of that Manufactured Product APC are domestically produced. See section 3.03(2) of Notice 2023-38.*

[7] *Consistent with Notice 2023-38, the direct cost of producing a Manufactured Product counts toward the Domestic Cost Percentage only if all its Manufactured Product Components are domestically produced.*

.06 *Updated Table for Solar PV Rooftop*

APC	*MPC*	*Rooftop (MLPE)*	**Rooftop (MLPE) with Domestic c-Si PV cells & Domestic Wafers**	*Rooftop (String)*	**Rooftop (String) with Domestic c-Si PV cells & Domestic Wafers**
PV module	Cells	31.1	43.9	38.5	52.1
	Frame/Backrail	4.9	4.0	6.1	4.8
	Front Glass	4.9	4.0	6.1	4.7
	Encapsulant	3.1	2.5	3.9	3.0
	Backsheet/Backglass	3.1	2.5	3.9	3.0
	Junction Box	0.8	0.6	1.0	0.8
	Edge Seals	0.2	0.2	0.3	0.2
	Pottants	0.2	0.2	0.3	0.2
	Bus Ribbons	1.2	1.0	1.5	1.2
	Bypass Diodes	0.3	0.3	0.4	0.3
	Production	**5.8**[8]	**4.7**[8]	**7.2**[8]	**5.6**[8]
Inverter[9]	Printed Circuit Board Assemblies (DC-DC)[10]	7.8	6.4	1.6	1.3
	Printed Circuit Board Assemblies (DC-AC)[10]	11.8	9.5	2.4	1.9
	Thermal Management System	-	-	0.5	0.4
	Enclosure	4.3	3.5	1.3	1.0
	Production	**0.9**[8]	**0.7**[8]	**0.5**[8]	**0.4**[8]
Non-Steel Roof Racking	Structural Fasteners	3.5	2.9	4.4	3.4
	Rails	15.0	12.2	18.7	14.6
	Production	**1.1**[8]	**0.9**[8]	**1.4**[8]	**1.1**[8]
Total	-	**100**	**100**	100	100

.07 *Definitions*.

(1) *Actuator. Actuator* means the component that produces the force, torque, and displacement.

(2) *Backrail*. *Backrail* means the component that secures the module laminate to its support structure. A *Backrail* can be used for the same purposes and in place of a *Frame*.

(3) *Backsheet/Backglass*. *Backsheet/Backglass* means the sheet or piece of glass on the back of solar modules that acts as an electric insulator and protects the inner components of such module from the surrounding environment.

(4) *Cells. Cells* in a PV module means the smallest semiconductor element of a solar module which performs the immediate conversion of light into electricity.

(5) *Controller. Controller* means the component that transmits operating instructions to the actuator.

(6) *Crystalline silicon cells. Crystalline silicon cells,* also referred to as c-Si cells, means a cell in a PV module, as defined in section 5.05(4) of this notice, that is made of silicon atoms connected to form a lattice.

(7) *Drive system. Drive system* means the components that transmit force, torque, or displacement from the actuator to the torque tube.

(8) *Electrical parts. Electrical parts* mean the components consisting of only control transformers, capacitors, inductors, bus/cables, and circuit protection not on printed circuit board (PCB) assemblies.

(9) *Encapsulant. Encapsulant* means the material used to adhere the cell strings between the front and rear glass (or backsheet) for the purpose of protecting against environmental stress.

(10) *Enclosure: Enclosure* means the protective structure that houses, that is, encloses, the other inverter components.

(11) *Frame. Frame* means the component that secures the module laminate to its support structure.

(12) *Front glass*: *Front glass* means the transparent, protective, structural front layer of a PV module.

[8] *Consistent with Notice 2023-38, the direct cost of producing a Manufactured Product counts toward the Domestic Cost Percentage only if all its Manufactured Product Components are domestically produced.*

[9] *For purposes of this table, module-level power electronics inverter systems, including either microinverters or direct current (DC) optimizers, are considered an inverter product.*

[10] *In instances in which a U.S. Component meets the criteria of more than one listed manufactured product component, it can claim all relevant Updated Assigned Cost Percentages.*

(13) *Ground-mounted PV (fixed-tilt)*. *Ground-mount PV (fixed-tilt)* refers to an energy system using photovoltaic solar modules to generate electricity, mounted to a non-building structure, including canopy steel racking structures, or floating on a body of water, where the PV modules are mounted at a fixed angle and orientation.

(14) *Ground-mounted PV (tracker)*. *Ground-mount PV (tracker)* refers to an energy system using photovoltaic solar modules to generate electricity, mounted to a non-building structure, or floating on a body of water, which integrates a solar tracker to rotate the solar modules.

(15) *Junction box*. *Junction box* means the component that connects PV cell strings and keeps power flowing in one direction.

(16) *Printed circuit board assemblies. Printed circuit board assemblies* means finished, fully functional printed circuit boards that have all necessary subcomponents soldered and installed on to them.

(17) *Rails. Rails,* including the components known as purlins, means the components that attach modules to torque tubes.

(18) *Rooftop PV (MLPE)*. *Rooftop PV (MLPE)* refers to an energy system using photovoltaic solar modules to generate electricity, mounted to a building structure, which integrates one or more microinverters or uses a DC-optimized inverter system such that the rooftop PV system (with its microinverter(s) or DC-optimized inverter system) regulates the DC electricity from each of its modules independently before that electricity is converted into alternating current electricity.

(19) *Rooftop PV (string inverter)*. *Rooftop PV (string inverter)* refers to an energy system using photovoltaic solar modules to generate electricity, mounted to a building structure, which integrates one or more inverters to convert direct current electricity from a string of solar panels into alternating current electricity.

(20) *Skid. Skid* means that component upon which the enclosure sits.

(21) *Structural Fasteners. Structural Fasteners* for use in ground-mount PV applications means a component that is used to connect the mechanical and drive system components of a solar tracker to the foundation of the solar tracker, to connect torque tubes to drive assemblies, or to connect segments of torque tubes to one another. *Structural Fasteners* for use in rooftop PV applications means a component that connects the rails, modules, and MLPE (if applicable) to one another.

(22) *Thermal management system. Thermal management system* means the system consisting of the heat sinks, heat pipes, fans and/or the liquid cooling systems.

(23) *Torque tubes.* For purposes of the Manufactured Product Components provided within the table under section 5.05 of this notice, *Torque tubes* means a structural support element, including longitudinal purlins that: (i) is part of a solar tracker; (ii) is of any cross-sectional shape; (iii) may be assembled from individually manufactured segments; (iv) spans longitudinally between foundation posts; (v) supports solar panels and is connected to a mounting attachment for solar panels (with or without separate module interface rails); (vi) and is rotated by means of a drive system.

(24) *Wafer*. *Wafer* means a thin slice, sheet or layer of crystalline silicon semiconductor material that comprises the substrate or absorber layer of one or more photovoltaic cells. It is manufactured by forming an ingot from molten polysilicon and then slicing it into wafers, or by depositing a thin-film semiconductor photon absorber into a sheet or layer, that is, a thin-film deposition.

SECTION 6. MODIFICATIONS TO TABLE 1 FOR LAND-BASED WIND

.01 *Modifications to Table 1 for Land-Based Wind*. The First Updated Elective Safe Harbor modifies Table 1 for Land-based Wind of section 4.04(2) of Notice 2024-41 by renaming “Steel or iron rebar in foundation,” the Applicable Project Component for wind turbine foundation steel, to “Steel or iron reinforcing products in foundation,” and further renaming “Material,” the Manufactured Product Component for wind tower flanges, to “Preform.” This first modification is made to better reflect the Applicable Project Component’s function and to clarify that non-rebar steel or iron reinforcement is also covered. The second modification is made to better reflect the manufacturing process and supply chain.

.02 *Updated Table for Land-Based Wind*.

APC	MPC	Value
Wind Turbine	Blades	31.2
	Rotor Hub	9.9
	Nacelle	47.5
	Power Converter	8.9
	Production	**0.9**[11]
Wind Tower Flanges	Preform[12]	0.8
	Production	**0.8**[11]
Tower	-	Steel/Iron Product
Steel or iron reinforcing products in foundation	-	Steel/Iron Product
Total	**-**	**100**

[11] *Consistent with Notice 2023-38, the direct cost of producing a Manufactured Product counts toward the Domestic Cost Percentage only if all its Manufactured Product Components are domestically produced.*

[12] *Flanges are typically made from single pieces of steel bar or pre-formed steel ingot; therefore the only component of a flange would be the preform.*

.03 *Definitions*.

(1) *Blades*. *Blades* means the airfoil-shaped blade that is responsible for converting wind energy to low-speed rotational energy.

(2) *Land-based wind*. *Land-based* wind means an energy system using wind turbines to generate electricity on land.

(3) *Nacelle*. *Nacelle* means the assembly of the drivetrain and other tower-top parts of a wind turbine (with the exception of the blades, rotor hub, and power converter, if located atop the tower) within their cover housing.

(4) *Power converter*. *Power converter* means the component that translates the electrical energy generated by the generator within the nacelle into a frequency and voltage compatible with use or export to the grid.

(5) *Preform*. *Preform* means the rough-formed forged metal component from which a wind tower flange is rolled and machined.

(6) *Rotor hub*. *Rotor hub* means the component to which the blades of a wind turbine are attached, which controls the pitch angle of the blades with respect to the wind and is connected to and transfers its rotation to the drivetrain within the nacelle.

SECTION 7. MODIFICATIONS TO TABLE 1 FOR BATTERY ENERGY STORAGE SYSTEMS

.01 *Modifications to Table 1 for Battery Energy Storage Systems (BESS)*.

The First Updated Elective Safe Harbor modifies Table 1 for BESS in section 4.04(3) of Notice 2024-41 by providing the Updated Assigned Cost Percentages for BESS, which DOE sourced from its new BESS component costs for 2024. DOE derived the Updated Assigned Cost Percentages for BESS from cost data from a variety of sources, including datasets of system characteristics, price indices, U.S. survey data from the government (for example, the U.S. Bureau of Labor Statistics, Department of Labor) and private sector, public filings from corporations, and comprehensive interviews of manufacturers, installers, developers, and owners of the representative technologies. In addition, DOE used data collected from three different national laboratories to generate the Updated Assigned Cost Percentages for BESS, rather than a single national laboratory survey that DOE relied upon for the methodology it used to generate the Assigned Cost Percentages in Table 1. The Updated Assigned Cost Percentages for BESS more closely reflect the direct cost methodology outlined in Notice 2023-38.

The First Updated Elective Safe Harbor further modifies the BESS table from Table 1 by: (i) renaming the following Applicable Project Components: (1) “Battery Pack” to “Battery Pack/Module,” (2) “Inverter” to “Inverter/Converter,” and (3) “Steel or iron rebar in foundation” to “Steel or iron reinforcing product foundation”; (ii) renaming the Manufactured Product Components “Enclosure,” within the Inverter/Converter row, to “Enclosure & Skids,” and “Climate Control,” within the Inverter/Converter row, to “Thermal Management System for Inverter”; (iii) recategorizing the following Manufactured Product Components: (1) “Thermal Management System” and “Battery Management System” are recategorized from the Applicable Project Component row of “Battery Pack,” in Table 1, to the Applicable Project Component row of “Battery Container/Housing”, and (2) “Battery Racks” and “Metal Enclosures” are recategorized as “Enclosures” within the Applicable Project Component row of “Battery Container/Housing”; and (iv) removing the cost values for “Electrical Parts and Thermal Management System for Inverter” (within the Inverter/Converter Applicable Project Component) from the Distributed BESS column and adding them to the Printed Circuit Board Assemblies within the same column.

The modifications described above are made for purposes of the First Updated Elective Safe Harbor to better represent the variety of the Manufactured Product Components that are used for particular functions within Applicable Project Components. Additionally, “Steel or iron reinforcing product foundation” is renamed to better reflect its function, and to clarify that non-rebar steel and iron reinforcement are also covered.

With respect to the Thermal Management Systems and Battery Management Systems referenced above, the DOE has advised that most of these systems are located in the container outside of the battery pack/module. For this reason, and because DOE’s published cost analysis is based on extensive industry feedback, updating the placement of these items within the tables provided in this notice more accurately represents the Manufactured Product Components for Battery Packs/Modules and for Battery Container/Housing. Updating the placement of these items is also more consistent with the cost breakdown within DOE’s cost analysis**.** As such, the reclassification further improves the accuracy of the associated cost percentages provided in this notice.

.02 *Updated Table for Battery Energy Storage System (BESS)*.

APC	MPC	Grid-scale BESS	Distributed BESS
Battery Pack/ Module	Cells	52.0	26.9
	Packaging	5.6	13.4
	Production	**8.0**[13]	**2.9**[13]
Inverter/ Converter	Printed Circuit Board Assemblies	1.4	5.4
	Thermal Management System for Inverter	0.4	-
	Electrical Parts	0.5	-
	Enclosure & Skids	0.4	1.0
	Production	**1.9**[13]	**4.3**[13]
Battery Container/ Housing	Enclosure	14.8	22.8
	Battery Management System	7.4	10.1
	Thermal Management System for Battery Container/ Housing	5.6	10.1
	Production	**2.0**[13]	**3.1**[13]
Steel or iron reinforcing products in foundation	-	Steel/Iron Product	-
Total	**-**	**100**	**100**

.03 *Definitions*.

(1) *Battery pack/module*. *Battery pack/module* means the packaged unit of battery cells that are configured electrically, in series or parallel, and is ready for installation in the battery container/housing without an additional manufacturing process.

(2) *Inverter/converter*. *Inverter/converter* means an end product that is suitable to convert between direct current and alternating current or direct current and direct current electricity to enable battery charge and discharge.

(3) *Battery container/housing*. *Battery container/housing* means a superstructure that houses, protects, and manages a system of multiple battery packs/modules.

(4) *Battery Management System*. *Battery Management System* means a combined system of electrical and electronic parts that serves to monitor (and may also control) the condition of the battery pack/module.

(5) *Cells*. *Cells* in a battery pack means an electrochemical cell comprised of one or more positive electrodes and one or more negative electrodes.

(6) *Distributed BESS*. *Distributed BESS* means an energy storage system for electricity generation using battery cells and battery modules, which has a nameplate capacity not greater than 1 megawatt-hour.

(7) *Electrical parts*. *Electrical parts* mean the components consisting of only control transformers, capacitors, inductors, bus/cables, and circuit protection not on printed circuit board (PCB) assemblies.

(8) *Enclosure*. *Enclosure* means a structure that houses and protects other equipment and may provide structural support to other products and components.

(9) *Grid-scale BESS*. *Grid-scale BESS* means an energy storage system for electricity generation using battery cells and battery modules, which has a nameplate capacity greater than 1 megawatt-hour.

(10) *Packaging*. *Packaging* means the materials that surround battery cells to create a battery pack/module.

(11) *Printed circuit board assemblies*. *Printed circuit board assemblies* means finished, fully functional printed circuit boards that have all necessary subcomponents soldered and installed on to them.

(12) *Thermal Management System for Inverter*. *Thermal management System for Inverter* means the primary cooling unit to optimize operation and safety, external to and/or within the Inverter/Converter (in which it is a Manufactured Product Component of the Inverter/Converter).

(13) *Thermal Management System for Battery Container/Housing*. *Thermal Management System for Battery Container/Housing* means the primary cooling unit to optimize operation and safety of the BESS (in which it is a Manufactured Product Component of the Battery Container/Housing).

SECTION 8. CONDITIONS FOR USE OF THE FIRST UPDATED ELECTIVE SAFE HARBOR

.01 *In General*. The First Updated Elective Safe Harbor applies to both the Steel or Iron Requirement and the Manufactured Products Requirement of the Domestic Content Requirement for each Applicable Project for which a taxpayer elects to have the First Updated Elective Safe Harbor apply. Notice 2023-38 requires that costs that are included in the numerator and denominator for purposes of calculating the Domestic Cost Percentage are the direct materials and direct labor costs that are paid or incurred by the manufacturer of the Manufactured Product. Taxpayers are further required to calculate the direct costs of any U.S.

[13] *Consistent with Notice 2023-38, the direct cost of producing a Manufactured Product counts toward the Domestic Cost Percentage only if all its Manufactured Product Components are domestically produced.*

Components that may have been incorporated into Non-U.S. Manufactured Products. The Treasury Department and the IRS are aware that obtaining a manufacturer's direct costs of manufacturing may require the taxpayer to gather cost data from multiple suppliers and manufacturers, including foreign manufacturers, and may present challenges for substantiation and verification.

.02 *First Updated Elective Safe Harbor*. Unless otherwise provided in this notice, a taxpayer electing to use the First Updated Elective Safe Harbor for an Applicable Project must use the Applicable Project Components, the Manufactured Product Components, and the Updated Assigned Cost Percentages listed in a table provided in sections 5-7 of this notice as the exclusive and exhaustive set of Applicable Project Components, Manufactured Product Components and Updated Assigned Cost Percentages for purposes of determining compliance with the Domestic Content Requirement for each Applicable Project for which the taxpayer makes this election. The requirements in the previous sentence apply regardless of whether property listed in a table provided in sections 5-7 of this notice is fully or fractionally owned or shared. The classifications and cost percentages provided in a tables provided in sections 5-7 of this notice will be accepted by the IRS for the identified Manufactured Products and Manufactured Product Components for purposes of determining compliance with the Steel or Iron Requirement and calculating the Domestic Cost Percentage if all other requirements in this notice and Notice 2023-38 are met.

To be eligible for the First Updated Elective Safe Harbor, Applicable Projects are not required to be made of all the Applicable Project Components provided in a table provided in sections 5-7 of this notice, and each Applicable Project Component listed is not required to be made of the full list of Manufactured Product Components provided in a table provided in sections 5-7 of this notice. Taxpayers may still elect to use the First Updated Elective Safe Harbor even if entries in a table of this notice are not used as inputs to their Applicable Projects or Manufactured Products, or if the Applicable Project contains additional inputs not listed in a table provided in sections 5-7 of this notice.

Any Applicable Project Component or Manufactured Product Component listed in a table provided in sections 5-7 of this notice that is not used as an input to the Applicable Project must be treated by the electing taxpayer as having a zero value in calculating the Domestic Cost Percentage. An Applicable Project Component or Manufactured Product Component contained in a taxpayer's Applicable Project but not listed in a table provided in sections 5-7 of this notice will not disqualify the taxpayer from using the First Updated Elective Safe Harbor. However, such unlisted items may not count toward satisfying the Adjusted Percentage Rule. The absence of a Manufactured Product or Manufactured Product Component that is listed in a table provided in sections 5-7 of this notice, or the presence of a Manufactured Product or Manufactured Product Component that is not listed in sections a table provided in 5-7 of this notice, in an Applicable Project does not affect the Assigned Cost Percentages listed in sections 5-7 for purposes of the First Updated Elective Safe Harbor.

.03 *First Updated Elective Safe Harbor Requirements*.

(1) *In general*. Unless otherwise provided, all other provisions of Notice 2023-38 apply in determining whether an Applicable Project meets the Domestic Content Requirement. For example, the Applicable Project Components that are specified as subject to the Steel or Iron Requirement in sections 5-7 of this notice must satisfy the Steel or Iron Requirement described in section 3.02 of Notice 2023-38. See sections 8.03(8) and 10 of this notice for the First Updated Elective Safe Harbor's election and certification requirements.

(2) *No Partial Safe Harbor Reliance*. Taxpayers that elect to use the First Updated Elective Safe Harbor must apply in its entirety the section of this notice that is specific to the Applicable Project for which the taxpayer makes such election. For example, if a taxpayer's Applicable Project is a land-based wind facility, the taxpayer must use the classifications for Applicable Project Components and Manufactured Product Components in section 6.02 of this notice with respect to land-based wind and must use the Updated Assigned Cost Percentages for all the Manufactured Products and Manufactured Product Components (for example, Blades, Rotor Hub, Nacelle, and Power Converter) provided in section 6.02 of this notice that are used in the taxpayer's Applicable Project without substitution.

(3) *Determining Domestic Cost Percentage*. To determine the Domestic Cost Percentage using the First Updated Elective Safe Harbor, a taxpayer must refer to the section of this notice that describes the taxpayer's Applicable Project and add up the Updated Assigned Cost Percentages for each listed U.S. Manufactured Product (as defined in section 3.03(1) of Notice 2023-38) and U.S. Component (as described in section 3.03(2)(b) of Notice 2023-38) of the taxpayer's Applicable Project. This total value is the Domestic Cost Percentage for purposes of the First Updated Elective Safe Harbor. Any Manufactured Product or Manufactured Product Component listed in a table provided in sections 5-7 of this notice that is not a part of the taxpayer's Applicable Project must take a zero value for the Updated Assigned Cost Percentage under the First Updated Elective Safe Harbor for such Manufactured Product or Manufactured Product Component, with all Updated Assigned Cost Percentages shown in sections 5-7 of this notice remaining unchanged. Any Manufactured Product or Manufactured Product Component not listed in a table provided in sections 5-7 of this notice must be disregarded for purposes of determining the Domestic Cost Percentage using the First Updated Elective Safe Harbor.

(4) *Solar PV systems with Domestic C-Si PV Cells and Domestic Wafers*. Taxpayers with ground-mount (tracking), ground-mount (fixed), rooftop (MLPE), or rooftop (string) solar PV systems may elect to use the associated cost percentages for ground-mount (tracking) with domestic c-Si PV cells and domestic wafers, ground-mount (fixed) with domestic c-Si PV cells and domestic wafers, rooftop (MLPE) with domestic c-Si PV cells and domestic wafers, or rooftop (string) with domestic c-Si PV cells and domestic wafers if all, or a portion of, the PV modules in the Applicable Project use domestically manufactured c-Si PV cells that exclusively use domestically manu-

factured wafers, as the terms are defined in section 5.07 of this notice and subject to the guidance in section 8.03(5) of this notice below.

(5) *Foreign- and Domestic-Sourced Manufactured Products and/or Manufactured Product Components*. Taxpayers who source the same type of Manufactured Product or Manufactured Product Component (that is, they are listed in the same row of a particular table in sections 5-7 of this notice) from both foreign and domestic sources (Mixed Source Item or MSI) in a particular Applicable Project described in sections 5-7 of this notice may use the First Updated Elective Safe Harbor to determine a single Updated Assigned Cost Percentage for each separate type of Mixed Source Item in the Applicable Project.

Taxpayers that elect to use the associated cost percentages for solar PV with domestic c-Si PV cells and domestic wafers where only a portion of the Applicable Project's PV cells are domestic c-Si PV cells that exclusively use domestically manufactured wafers must treat any domestically manufactured PV cells that do not exclusively use domestic wafers as though such PV cells are foreign sourced for purposes of using the cost percentages in this notice, and may not include the "Production" cost percentage for PV modules containing such cells that otherwise meet the definition of a U.S. Manufactured Product in section 3.03(2) of Notice 2023-38. Furthermore, taxpayers that elect to use the associated cost percentages for ground-mount (tracking) with domestic c-Si PV cells and domestic wafers, ground-mount (fixed) with domestic c-Si PV cells and domestic wafers, rooftop (MLPE) with domestic c-Si PV cells and domestic wafers, or rooftop (string) with domestic c-Si PV cells and domestic wafers must use the corresponding Updated Assigned Cost Percentages for all the Manufactured Products and Manufactured Product Components in the Applicable Project for purposes of determining the Domestic Cost Percentage.

For Mixed Source Items (MSI), that have a nameplate capacity, the following weighted average formula may be used to determine the Updated Assigned Cost Percentage attributable to each type of Mixed Source Item:

$$\frac{DCP_{\text{Domestic MSI}} \text{ x Nameplate Capacity}_{\text{Domestic MSI}}}{\text{Nameplate Capacity}_{\text{MSI}}}$$

For purposes of this formula:

(a) $DCP_{\text{Domestic MSI}}$ means the Updated Assigned Cost Percentage derived from the tables in this notice of the Mixed Source Item.

(b) Nameplate $\text{Capacity}_{\text{DomesticMSI}}$ means the nameplate capacity of the Mixed Source Items of the same type in the Applicable Project that is produced in the United States.

(c) Nameplate $\text{Capacity}_{\text{MSI}}$ means the total nameplate capacity of the Mixed Source Items of the same type in the Applicable Project.

For Mixed Source Items without nameplate capacities, the portion of cost percentage provided in sections 5-7 of this notice that may count toward the Domestic Cost Percentage must be calculated by using the weighted average formula described above, modified by replacing the nameplate capacity of the Mixed Source Items with the nameplate capacities of the associated Applicable Project Components with which the Mixed Source Item is directly integrated. For this purpose, Mixed Source Items without nameplate capacities must apply: the total nameplate capacity of the associated PV module(s) for the Solar PV Table; the total nameplate capacity of the associated wind turbine for land-based wind; or the total nameplate capacity of the battery pack(s) for BESS. If a type of Mixed Source Item without nameplate capacity has multiple units that are both foreign- and domestic-sourced associated and directly integrated with the same Applicable Project Component with nameplate capacity, then all such Mixed Source Items must be treated as foreign-sourced.

(6) *Production Costs*. The tables in sections 5-7 of this notice contain a line item for "Production," which, although listed under the column for Manufactured Product Components, is not a Manufactured Product Component. With the exception noted in section 8.03(5) of this notice, above, "Production" refers to the production cost of the relevant Manufactured Product and can be included in the total Domestic Cost Percentage only if all the Manufactured Product Components of a Manufactured Product are domestically produced. See Notice 2023-38, section 3.03(2). The Updated Assigned Cost Percentage attributable to production costs for a particular Manufactured Product may be used if such Manufactured Product contains Manufactured Product Components not listed in a table provided in sections 5-7 of this notice or if entries in a table provided in sections 5-7 of this notice are not a part of such Manufactured Product, so long as the remainder of the Manufactured Product Components in sections 5-7 that are a part of such Manufactured Product are mined, produced, or manufactured in the United States.

(7) *Exclusive Safe Harbor*. A taxpayer that elects to use the First Updated Elective Safe Harbor with respect to an Applicable Project must consider the steel or iron products, Manufactured Products, and Manufactured Product Components that are identified in a table provided in sections 5-7 of this notice as an exclusive and exhaustive set of steel or iron products, Manufactured Products, and Manufactured Product Components for purposes of determining compliance with the Domestic Content Requirement for that Applicable Project. The First Updated Elective Safe Harbor may still be used in instances in which a taxpayer's Applicable Project does not contain every item identified in a table in sections 5-7 of this notice, or in which a taxpayer's Applicable Project contains additional items not identified in a table provided in sections 5-7 of this notice, provided the taxpayer applies the requirements for determining Domestic Cost Percentage described in section 8.03(3)-(7) of this notice.

(8) *Certification*. Taxpayers must affirmatively elect to rely on the First Updated Elective Safe Harbor in sections 5-7 of this notice and must notify the IRS of this election by providing information on the

Domestic Content Certification Statement as described in section 10 of this notice.

.04 *Examples*

(1) Example 1.

(a) In its taxable year beginning in June 2025, Taxpayer purchases a 100-megawatt direct current (MWdc) ground-mounted PV (tracker) (Applicable Project A) from Contractor under an EPC contract, places the project in service, and makes a valid election to use the First Updated Elective Safe Harbor to qualify for the domestic content bonus credit amount under § 48. Applicable Project A is an energy project for purposes of § 48 that is comprised of five categories of Applicable Project Components identified in the table in section 5.05 in this notice for a ground-mounted PV (tracker): PV modules, inverters, PV trackers, steel piles, and steel reinforcing products in foundation. For purposes of the Adjusted Percentage Rule, the adjusted percentage is 40 percent for energy projects that are not offshore wind facilities. See § 48(a)(12)(B).

(b) In accordance with the table in section 5.05 of this notice, taxpayer identifies the steel piles and steel reinforcing products in foundation as steel or iron products and the PV modules, inverters, and PV trackers as Manufactured Products.

(c) All of the steel piles and steel reinforcing products in foundation are manufactured in the United States and meet the Steel or Iron Requirement.

(d) Two sets of PV modules are used in the Applicable Project A. One set has a capacity of 60 MWdc and are PV modules manufactured in the United States that incorporate c-Si PV cells and wafers that are manufactured in the United States, with the modules' remaining Manufactured Product Components, as identified in accordance with the table in section 5.05 of this notice, also manufactured in the United States. The remaining set has a capacity of 40 MWdc and are PV modules that are not manufactured in the United States and that have no U.S. Components. None of Applicable Project A's PV inverters are manufactured in the United States or have any U.S. Components.

(e) The PV trackers used in Applicable Project A are manufactured in the United States and have seven categories of Manufactured Product Components (torque tubes, structural fasteners, drive system, dampers, actuator, controllers, and rails) of which a portion of the torque tubes are manufactured in the United States. The PV trackers are associated and directly integrated with all the PV modules used in Applicable Project A. The torque tubes manufactured in the United States are the only torque tubes associated and directly integrated with 80 MWdc of Applicable Project A's PV modules. The remainder of torque tubes and other PV tracker components are not manufactured in the United States. The PV trackers are Non-U.S. Manufactured Products because some of their Manufactured Product Components are not produced in the United States.

(f) Applicable Project A's steel or iron products identified in the table in section 5.05 of this notice meet the Steel or Iron Requirement. The Taxpayer makes a valid election to use the associated cost percentages for ground-mount (tracking) with domestic c-Si PV cells & domestic wafers. The Taxpayer is able to do so because a portion of the PV modules in the Applicable Project use domestically manufactured crystalline silicon cells that exclusively use domestically manufactured wafers. The table in section 5.05 of this notice identifies the torque tube Manufactured Product Component of a PV tracker of a PV system as constituting 8.6% of the total cost of Manufactured Products for this type of Applicable Project. The table in section 5.05 of this notice identifies the Manufactured Product Components of a PV module as constituting 69.7% (51.6% + 4.7% + 4.7% + 3.0% + 3.0% + 0.8% + 0.2% + 0.2% + 1.2% + 0.3%) of the total cost of Manufactured Products for an Applicable Project that is a ground-mounted PV (tracker) with domestic c-Si PV cells & domestic wafers. In addition to these costs, the table in section 5.05 of this notice provides that the cost to produce PV modules for such an Applicable Project constitutes 3.7% of the total cost of Manufactured Products for such an Applicable Project. Based on a nameplate capacity weighted average of Applicable Project Component categories and Manufactured Product Component categories identified in the table in section 5.05 of this notice, the total Updated Assigned Cost Percentage attributable to the PV modules of Applicable Project A would be calculated as: (69.7% + 3.7%) x 60 / 100 = 44.0%. Based on a nameplate capacity weighted average (using the capacities of the Applicable Project Components associated with the torque tubes),the Updated Assigned Cost Percentage attributable to the torque tubes of Applicable Project A would be calculated as: 8.6% x 80 / 100 = 6.9%. Applicable Project A's overall Domestic Cost Percentage is: 44.0% + 6.9% = 50.9%. Applicable Project A satisfies the Adjusted Percentage Rule because its Domestic Cost Percentage of 50.9% exceeds the adjusted percentage that applies to Applicable Project A (40%).

(2) Example 2.

(a) Assume the same facts as in Example 1, except that the second set of PV modules used in Applicable Project A, with a capacity of 40 MWdc, are manufactured in the United States with domestically produced PV cells using foreign wafers though none of those modules' other components are produced in the United States. The taxpayer makes a valid election to use the associated cost percentages for ground-mount (tracking) with domestic c-Si PV cells & domestic wafers. The Taxpayer is able to do so because a portion of the PV modules in Applicable Project A use domestically manufactured c-Si cells that exclusively use domestically manufactured wafers. Consistent with section 8.03(5) of this notice, the 40 MW of PV modules using foreign wafers must be treated as having foreign cells and the PV modules also are Non-U.S. Manufactured Products. In this case, the Domestic Cost Percentage would be the same as in Example 1, or 50.9%, even though the second set of PV modules are manufactured in the United States and contain domestically produced PV cells. When a taxpayer elects to use the associated cost percentages for PV systems with domestic c-Si cells and domestic wafers it must treat any domestically-produced PV cells that do not exclusively use domestic wafers as not being U.S. Components, and hence must treat the modules in which those cells are used as Non-U.S. Manufactured Products for purposes of using such cost percentages.

(3) Example 3.

(a) Assume the same facts as in Example 2, except that the taxpayer does not elect to use the associated cost percentages for ground-mount (tracking) with domestic c-Si PV cells & domestic wafers.

(b) Applicable Project A's steel or iron products identified in the table in section 5.05 of this notice meet the Steel or Iron Requirement. The table in section 5.05 of this notice identifies the torque tube Manufactured Product Component of a PV tracker of a PV system that does not contain domestic c-Si cells and wafers as constituting 11.0% of the total cost of Manufactured Products for this type of Applicable Project.

The table in section 5.05 of this notice identifies the Manufactured Product Components of a PV module as constituting 61.1% (38.0% + 6.0% + 6.0% + 3.8% + 3.8% + 1.0% + 0.3% + 0.3% + 1.5% + 0.4%) of the total cost of Manufactured Products for an Applicable Project that is a ground-mounted PV (tracker). In addition to these costs, the table in section 5.05 of this notice provides that the cost to produce PV modules for such an Applicable Project constitutes 4.7% of the total cost of Manufactured Products for such an Applicable Project. Based on a nameplate capacity weighted average of Applicable Project Component categories and Manufactured Product Component categories identified in the table in section 5.05 of this notice, the total Updated Assigned Cost Percentage attributable to the first set of PV modules of Applicable Project A would be calculated as: (61.1% + 4.7%) x 60 / 100 = 39.5%. Based on a nameplate capacity weighted average of Applicable Project Component categories and Manufactured Product Component categories identified in the table in section 5.05 of this notice, the total Updated Assigned Cost Percentage attributable to the second set of PV modules of Applicable Project A would be calculated as: (38.0%) x 40 / 100 = 15.2%. Based on a nameplate capacity weighted average (using the capacities of the Applicable Project Components associated with the torque tubes), the Updated Assigned Cost Percentage attributable to the torque tubes of Applicable Project A would be calculated as: 11.0% x 80 / 100 = 8.8%. Applicable Project A's overall Domestic Cost Percentage is: 39.5% + 15.2% + 8.8% = 63.5%. Applicable Project A satisfies the Adjusted Percentage Rule because its Domestic Cost Percentage of 63.5% exceeds the adjusted percentage that applies to Applicable Project A (40%).

(4) Example 4.

(a) In its taxable year beginning June 2025, Taxpayer purchases a 100-megawatt direct current (MWdc) ground-mounted PV (tracker) (Applicable Project B) from Contractor under an EPC contract, places the project in service, and makes a valid election to use the First Updated Elective Safe Harbor to qualify for the domestic content bonus credit amount under § 48. Applicable Project B is an energy project for purposes of § 48 that is comprised of five categories of Applicable Project Components identified in the table in section 5.05 in this notice for a ground-mounted PV (tracker): PV modules, inverters, PV trackers, steel piles, and steel reinforcing products in foundation. For purposes of the Adjusted Percentage Rule, the adjusted percentage is 40 percent for energy projects that are not offshore wind facilities. See § 48(a)(12)(B).

(b) In accordance with the table in section 5.05 of this notice, taxpayer identifies the steel piles and steel reinforcing products in foundation as steel or iron products and the PV modules, inverters, and PV trackers as Manufactured Products.

(c) All of the steel piles and steel reinforcing products in foundation are manufactured in the United States and meet the Steel or Iron Requirement.

(d) Two sets of PV modules are used in the Applicable Project B. One set has a capacity of 60 MWdc and are PV modules manufactured in the United States that incorporate c-Si PV cells and wafers that are manufactured in the United States, with the modules' remaining Manufactured Product Components, as identified in accordance with the table in section 5.05 of this notice, also manufactured in the United States. The remaining set, with a capacity of 40 MWdc, is manufactured in the United States with domestically produced PV cells using foreign wafers and domestically produced front glass. None of the remaining set of modules' other Manufactured Product Components are produced in the United States. None of Applicable Project B's PV inverters are manufactured in the United States or have any U.S. Components.

(e) The PV trackers used in Applicable Project B are manufactured in the United States and have seven categories of Manufactured Product Components (torque tubes, structural fasteners, drive system, dampers, actuator, controllers, and rails) of which a portion of the torque tubes are manufactured in the United States. The PV trackers are associated and directly integrated with all the PV modules used in Applicable Project B. The torque tubes manufactured in the United States are the only torque tubes associated and directly integrated with 80 MWdc of Applicable Project B's PV modules. The remainder of torque tubes and other PV tracker components are not manufactured in the United States. The PV trackers are Non-U.S. Manufactured Products because some of their Manufactured Product Components are not produced in the United States.

(f) Applicable Project B's steel or iron products identified in the table in section 5.05 of this notice meet the Steel or Iron Requirement. The Taxpayer makes a valid election to use the associated cost percentages for ground-mount (tracking) with domestic c-Si PV cells & domestic wafers. The Taxpayer is able to do so because a portion of the PV modules in the Applicable Project use domestically manufactured crystalline silicon cells that exclusively use domestically manufactured wafers. The table in section 5.05 of this notice identifies the torque tube Manufactured Product Component of a PV tracker of a PV system as constituting 8.6% of the total cost of Manufactured Products for this type of Applicable Project. The table in section 5.05 of this notice identifies the Manufactured Product Components of a PV module as constituting 69.7% (51.6% + 4.7% + 4.7% + 3.0% + 3.0% + 0.8% + 0.2% + 0.2% + 1.2% + 0.3%) of the total cost of Manufactured Products for an Applicable Project that is a ground-mounted PV (tracker) with domestic c-Si PV cells & domestic wafers, of which front glass accounts for 4.7 percentage points. In addition to these costs, the table in section 5.05 of this notice provides that the cost to produce PV modules for such an Applicable Project constitutes 3.7% of the total cost of Manufactured Products for such an Applicable Project.

Based on a nameplate capacity weighted average of Applicable Project Component categories and Manufactured Product Component categories identified in the table in section 5.05 of this notice, the total Updated Assigned Cost Percentage attributable to the PV modules of Applicable Project B would be calculated as: [(69.7% + 3.7%) x 60 / 100] + [(4.7%) x 40 / 100] = 45.9%. Based on a nameplate capacity weighted average (using the capacities of the Applicable Project Components associated with torque tubes), the Updated Assigned Cost Percentage attributable to the torque tubes of Applicable Project B would be calculated as: 8.6% x 80 / 100 = 6.9%. Applicable Project B's overall Domestic Cost Percentage is: 45.9% + 6.9% = 52.8%. Applicable Project B satisfies the Adjusted Percentage Rule because its Domestic Cost Percentage of 52.8% exceeds the adjusted percentage that applies to Applicable Project B (40%).

SECTION 9. CERTIFICATION

An Applicable Project is eligible for a domestic content bonus credit amount if the Applicable Project satisfies the Domestic Content Requirement and the taxpayer timely submits to the IRS the certification described in section 5 of Notice 2023-38. To affirmatively elect to rely on the New Elective Safe Harbor, a taxpayer must provide on the Domestic Content Certification Statement described in section 5.01(2)(c) of Notice 2023-38 a statement that the taxpayer is relying on the First Updated Elective Safe Harbor. As provided in section 5.01(2)(b) of Notice 2023-38, the Domestic Content Certification Statement must be attached to Form 8835, *Renewable Electricity Production Credit*; Form 3468, *Investment Credit*; or other applicable form for reporting domestic content bonus credit amounts under §§ 45, 45Y, 48, or 48E filed with the taxpayer's annual return submitted to the IRS for the first taxable year in which the taxpayer reports a domestic content bonus credit amount for such Applicable Project.

SECTION 10. SUBSTANTIATION

A taxpayer reporting a domestic content bonus credit amount for meeting the Domestic Content Requirement must meet the general recordkeeping requirements under § 6001 to substantiate that the Domestic Content Requirement has been met. Section 6001 provides that every person liable for any tax imposed by the Code, or for the collection thereof, must keep such records as the Secretary of the Treasury or her delegate may from time to time prescribe. Section 1.6001-1(a) provides that any person subject to income tax must keep such permanent books of account or records as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax. Section 1.6001-1(e) provides that the books and records required by § 1.6001-1 must be retained so long as the contents thereof may become material in the administration of any internal revenue law. See also §§ 45(b)(12), 48(a)(16), 48E(a)(3)(B) (by cross-reference to § 48(a)(12)), and 45Y(f).

SECTION 11. TAXPAYER RELIANCE

To the extent reliance statements in Notice 2023-38 and Notice 2024-41 conflict with this notice, the reliance statements described below shall control.

Taxpayers may rely on the rules described in sections 3 through 6 of Notice 2023-38 for the domestic content bonus credit requirements for any Applicable Project, the construction of which begins before the date that is 90 days after the date of publication in the *Federal Register* of proposed regulations on the domestic content bonus credit requirements.

Taxpayers may rely on the two modifications[14] of Table 2 in Notice 2024-41 for any Applicable Project the construc-

[14] *The two modifications of Table 2 in Notice 2024-41 are (1) adding the Applicable Project "Hydropower Facility, or Pumped Hydropower Storage Facility" and its associated list of Applicable Project Components and categorizations and (2) replacing "Utility-scale photovoltaic system" with "Ground-mount and rooftop photovoltaic system."*

tion of which begins before the date that is 90 days after the date of publication in the *Federal Register* of proposed regulations on the domestic content bonus credit requirements.

Taxpayers may rely on Notice 2024-41, in its entirety and as modified by section 4 of this notice, for the domestic content bonus credit requirements for any Applicable Project, the construction of which begins before the date that is 90 days after the effective date of this notice.

Effective January 16, 2025, taxpayers may rely on the First Updated Elective Safe Harbor and the guidance provided in this notice for the domestic content bonus credit requirements for any Applicable Project the construction of which begins before the date that is 90 days after any future modification, update, or withdrawal of the First Updated Elective Safe Harbor.

Where taxpayers may rely on either the New Elective Safe Harbor of Notice 2024-41 or the First Updated Elective Safe Harbor in this notice, a taxpayer may apply only one of the above-referenced safe harbors, and its associated cost percentages, and use it exclusively.

Taxpayers may treat the classifications of any Applicable Project Components or Manufactured Product Components that are listed within the tables provided in sections 5-7 of this notice as also being listed in Table 2 of Notice 2023-38. To the extent Table 2 of Notice 2023-38 and the tables provided in sections 5-7 of this notice are inconsistent regarding the classification of Applicable Project Components or Manufactured Product Components, the taxpayer may elect which set of classifications to use and must consistently apply the related classifications to all the other Applicable Project Components or Manufactured Product Components of the Applicable Project.

SECTION 12. PAPERWORK REDUCTION ACT

Any collection burden associated with this notice is accounted for in Office of Management and Budget (OMB) control numbers 1545-0123 and 1545-0047. The reporting requirements from section 9 of this notice and the recordkeeping requirements from section 10 of this notice are associated with the IRA-related changes to Form 3468 and Form 8835 that were approved, and will continue to be approved, under OMB control numbers 1545-0123 and 1545-0047. This notice does not alter any previously approved information collection requirements and does not create new collection requirements not already approved by OMB.

SECTION 13. EFFECT ON OTHER DOCUMENTS

Notice 2023-38 and Notice 2024-41 are both modified as provided in this notice.

SECTION 14. DRAFTING INFORMATION

The principal author of this notice is the Office of Associate Chief Counsel (Energy, Credits, and Excise Tax). However, other personnel from the Treasury Department and the IRS participated in its development. For further information regarding this notice, call the energy security guidance contact number at (202) 317-5254 (not a toll-free call).

Calculating the qualifying payment amount in 2025

Notice 2025–12

SECTION 1. PURPOSE AND SCOPE

Pursuant to Treas. Reg. § 54.9816-6T(c), 29 CFR 2590.716-6(c), and 45 CFR 149.140(c), this notice provides the percentage increase for calculating the qualifying payment amounts (QPAs) for items and services furnished during 2025 for purposes of sections 9816 and 9817 of the Internal Revenue Code (Code), sections 716 and 717 of the Employee Retirement Income Security Act of 1974 (ERISA), and sections 2799A–1 and 2799A–2 of the Public Health Service Act (PHS Act). These provisions, added by the No Surprises Act,[1] provide protections against surprise medical bills in certain circumstances. This notice was drafted in consultation with the Departments of Labor and Health and Human Services. Similar guidance for items and services furnished during 2022, 2023 and 2024 was published in Revenue Procedure 2022–11, Notice 2022–11, Notice 2023–4 and Notice 2024–1.[2]

SECTION 2. BACKGROUND

The QPA serves as the basis for calculating patient cost sharing for items or services subject to the surprise billing provisions of the No Surprises Act in certain circumstances. The QPA is also one of the factors considered by a certified independent dispute resolution (IDR) entity to determine which of two offers submitted by parties to a payment dispute in the Federal IDR process best represents the value of a qualified IDR item or service as the out-of-network rate.

The QPA is generally the median of the contracted rates recognized by the plan or issuer on January 31, 2019, for the same or similar item or service that is provided by a provider in the same or similar specialty or a facility of the same or similar facility type and provided in the geographic region in which the item or service is furnished, increased for inflation. Pursuant to Treas. Reg. § 54.9816-6T(c), 29 CFR 2590.716-6(c), and 45 CFR 149.140(c), plans and issuers were first required to calculate the QPA for items and services furnished during 2022. Thus, 2019 generally is the base year for items and services furnished in 2022, increased for all subsequent years. The median contracted rate is determined with respect to all plans of the plan sponsor or all coverage offered by the issuer that are offered in the same insurance market. In general, for years after 2022, the plan or issuer must calculate the QPA by increasing the QPA determined for an item or service furnished in the immediately preceding year by the percentage increase, as published in annual guidance. QPAs determined based on later years (for example, QPAs for group health plans or health insurance issuers not offering coverage in 2019 or items or services not covered in 2019) are adjusted based on

[1] The No Surprises Act was enacted as Title I of Division BB of the Consolidated Appropriations Act, 2021, Pub. L. 116-260, 134 Stat. 1182 (2020).

[2] Revenue Procedure 2022-11, 2022-3 IRB 449; Notice 2022-11, 2022-14 IRB 939, Notice 2023-4, 2023-2 IRB 321, and Notice 2024-1, 2023-2 IRB 314.

the year for which the QPA is first determined.

In general

Under Treas. Reg. § 54.9816-6T(c)(1)(i), 29 CFR 2590.716-6(c)(1)(i), and 45 CFR 149.140(c)(1)(i), for an item or service furnished during 2022, plans and issuers must calculate the QPA by increasing the median contracted rate (as determined in accordance with Treas. Reg. § 54.9816-6T(b), 29 CFR 2590.716-6(b), and 45 CFR 149.140(b))[3,4] for the same or similar item or service under such plan or coverage on January 31, 2019, by the combined percentage increase as published by the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) to reflect the percentage increase in the Consumer Price Index for All Urban Consumers (U.S. city average) (CPI-U) over 2019, the percentage increase over 2020, and the percentage increase over 2021.[5] Pursuant to Revenue Procedure 2022–11, for items and services provided on or after January 1, 2022, and before January 1, 2023, the combined percentage increase to adjust the median contracted rate for the same or similar item or service under such plan or coverage, on January 31, 2019, is 1.0648523983.

Pursuant to Treas. Reg. § 54.9816-6T(c)(1)(ii), 29 CFR 2590.716-6(c)(1)(ii), and 45 CFR 149.140(c)(1)(ii), for an item or service furnished during 2023 or a subsequent year, the plan or issuer must calculate the QPA by increasing the QPA determined for such an item or service furnished in the immediately preceding year, by the percentage increase as published by the Treasury Department and the IRS.

New plans and coverage

Under Treas. Reg. § 54.9816-6T(c)(2), 29 CFR 2590.716-6(c)(2), and 45 CFR 149.140(c)(2), with respect to a sponsor of a plan or issuer offering group or individual health insurance coverage in a geographic region in which the sponsor or issuer did not offer any group health plan or health insurance coverage in 2019, for the first year in which the group health plan or group or individual health insurance coverage is offered in the region, if the plan or issuer does not have sufficient information to calculate the median of the contracted rates for an item or service provided in the geographic region, the plan or issuer must determine the QPA pursuant to Treas. Reg. § 54.9816-6T(c)(3)(i), 29 CFR 2590.716-6(c)(3)(i), and 45 CFR 149.140(c)(3)(i) for an item or service furnished in 2022 (or the first coverage year for the item or service with respect to the plan or coverage). For each subsequent year the group health plan or group or individual health insurance coverage is offered in the region, the plan or issuer must calculate the QPA by increasing the QPA determined for items or services provided in the immediately preceding year by the percentage increase in the CPI-U over the preceding year.[6]

Insufficient information; newly covered items and services

Pursuant to Treas. Reg. § 54.9816-6T(c)(3)(i), 29 CFR 2590.716-6(c)(3)(i), and 45 CFR 149.140(c)(3)(i), for an item or service furnished during 2022 (or, in the case of a newly covered item or service, during the first coverage year for the item or service with respect to the plan or coverage), a plan or issuer that does not have sufficient information to calculate the median of the contracted rates in 2019 for the same or similar item or service provided in a geographic region must calculate the QPA by first identifying the rate that is equal to the median of the in-network allowed amounts for the same or similar item or service provided in the geographic region in 2021, determined by the plan or issuer through use of any eligible database, and then increasing that rate by the percentage increase in the CPI-U over 2021. Similarly, in the case of a newly covered item or service furnished during the first coverage year, when a plan or issuer does not have sufficient information to calculate the median of the contracted rates in the first coverage year for the item or service, the plan or issuer must calculate the QPA by using an eligible database to determine the rate that is equal to the median of the in-network allowed amounts for the same or similar item or service provided in the geographic region in the year immediately preceding the first coverage year, and then increasing that rate by the percentage increase in the CPI-U over the preceding year.

Under Treas. Reg. § 54.9816-6T(c)(3)(ii), 29 CFR 2590.716-6(c)(3)(ii), and 45 CFR 149.140(c)(3)(ii), for an item or service furnished in a subsequent year (before the first sufficient information year for the item or service with respect to the plan or coverage), the plan or issuer must calculate the QPA by increasing the QPA determined for the item or service for the year immediately preceding the subsequent year, by the percentage increase in the CPI-U over the preceding year.

The percentage increase in the CPI-U for items and services provided in 2022 over the preceding year is the average CPI-U for 2021 over the average CPI-U for 2020. Pursuant to Notice 2022–11, the percentage increase from 2021 to 2022 is 1.0299772040. The percentage increase in the CPI-U for items and services provided in 2023 over the preceding year is the average CPI-U for 2022 over the average CPI-U for 2021. Pursuant to Notice 2023–4, the percentage increase from 2022 to 2023 is 1.0768582128. The percentage increase in the CPI-U for items and ser-

[3] As modified by the August 24, 2023, opinion and order in *Texas Medical Association et al. v. United States Department of Health and Human Services et al.*, Case No. 6:22-cv-450-JDK (E.D. Tex.), and the October 30, 2024, Fifth Circuit opinion and order in *Tex. Medical Ass'n, et al. v. U.S. Dep't of Health & Human Servs et al.*, Case No. 23-40605 (5th Cir.), that partially reversed the district court's order. The Departments of Labor, Health and Human Services, and Treasury, and the Office of Personnel Management are reviewing the Fifth Circuit's decision and intend to issue further enforcement guidance in the near future.

[4] 5 U.S.C. 8902(p) requires that contracts with carriers under the Federal Employees Health Benefits (FEHB) Act comply with the protections against surprise billing. Accordingly, the guidance provided in this notice applies to FEHB carriers to the extent consistent with their contracts. See 5 CFR 890.114.

[5] The calculations of the QPAs for anesthesia services, air ambulance services, and certain other items or services furnished during 2022 for which a plan or issuer has sufficient information to calculate the median of the contracted rates in 2019 differ slightly, but all use the same formula for increasing a base rate by the combined percentage increase as published by the Treasury Department and the IRS to reflect the percentage increase in the CPI-U over 2019 and subsequent years. *See* Treas. Reg. § 54.9816-6T(c)(1)(iii)-(vii), 29 CFR 2590.716-6(c)(1)(iii)-(vii), and 45 CFR 149.140(c)(1)(iii)-(vii).

[6] The calculations of the QPAs for anesthesia services, air ambulance services, and certain other items or services furnished in a subsequent year differ slightly, but all use the same formula for increasing the indexed median contracted rate determined for the item or service in the immediately preceding year by the percentage increase. *See* Treas. Reg. § 54.9816-6T(c)(2)(ii), 29 CFR 2590.716-6(c)(2)(ii), and 45 CFR 149.140(c)(2)(ii).

vices provided in 2024 over the preceding year is the average CPI-U for 2023 over the average CPI-U for 2022. Pursuant to Notice 2024–1, the percentage increase from 2023 to 2024 is 1.0543149339.

New service codes

In the case of a plan or issuer that does not have sufficient information to calculate the median of the contracted rates for the same or similar item or service provided in a geographic region and determine the QPA in accordance with the previously described methodology because the item or service is billed under a new service code, for items or services furnished in 2022 (or for newly covered items and services, during the first coverage year for the item or service), the plan or issuer must identify a reasonably related service code that existed in the immediately preceding year and calculate the QPA pursuant to Treas. Reg. § 54.9816-6T(c)(4)(i), 29 CFR 2590.716-6(c)(4)(i), and 45 CFR 149.140(c)(4)(i).

Under Treas. Reg. § 54.9816-6T(c)(4)(ii), 29 CFR 2590.716-6(c)(4)(ii), and 45 CFR 149.140(c)(4)(ii), for an item or service furnished in a subsequent year (before the first sufficient information year for the item or service with respect to such plan or coverage or before the first year for which an eligible database has sufficient information to calculate a rate under Treas. Reg. § 54.9816-6T(c)(3)(i), 29 CFR 2590.716-6(c)(3)(i), and 45 CFR 149.140(c)(3)(i) in the immediately preceding year), the plan or issuer must calculate the QPA by increasing the QPA determined for the item or service for the year immediately preceding the subsequent year by the percentage increase in the CPI-U over the preceding year.

SECTION 3. GUIDANCE

The percentage increase in the CPI-U over a preceding year is calculated by dividing the average CPI-U for the preceding year by the average CPI-U for the year immediately prior to the preceding year. For this purpose, the average CPI-U for a year is the average of the monthly CPI-Us published by the Bureau of Labor Statistics of the Department of Labor for the 12-month period ending on August 31 of each year, rounded to 10 decimal places. The percentage increase in the CPI-U for items and services provided in 2025 over the preceding year is the average CPI-U for 2024 over the average CPI-U for 2023. Pursuant to this calculation, the percentage increase from 2024 to 2025 is 1.0317904930. Further, pursuant to prior notices, plans and issuers may round any resulting QPAs to the nearest dollar.

To calculate the adjusted QPA, the prior year's adjusted QPA is multiplied by the percentage increase for the most recent year. To simplify this calculation, this notice provides cumulative percentage increases. To calculate the adjusted QPA for items and services furnished in 2025 using the cumulative percentage increase, the "base year" QPA is multiplied by the cumulative percentage increase for the year the base QPA originated. A plan or issuer may choose whether to use the cumulative percentage increase or the percentage increase, but the selected method must be applied consistently for all QPAs calculated for items and services furnished during 2025. A plan or issuer is not permitted to use one method for certain QPAs and a different method for other QPAs.

BASE YEAR OF QPA ORIGINATION	CUMULATIVE PERCENTAGE INCREASE FOR QPA FROM BASE YEAR TO 2024	PERCENTAGE INCREASE FOR QPA FROM 2024 TO 2025	CUMULATIVE PERCENTAGE INCREASE FOR QPA FROM BASE YEAR TO 2025
2019	1.2089777165	1.0317904930	1.2474117141
2021	1.1693822450	1.0317904930	1.2065574831
2022	1.1353476955	1.0317904930	1.1714409585
2023	1.0543149339	1.0317904930	1.0878321254
2024	1.0000000000	1.0317904930	1.0317904930

Consult Notice 2024–1 regarding the application of these percentage increases.

SECTION 4. EFFECTIVE DATE

The effective date of this notice is January 1, 2025.

SECTION 5. DRAFTING INFORMATION

The principal author of this notice is Regan Rusher of the Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes). For further information regarding this notice, contact Regan Rusher at 202–317–5500 (not a toll-free number).

26 CFR 601.201: Rulings and determination letters (Also Part 1, § 831)

Rev. Proc. 2025-13

SECTION 1. PURPOSE

This revenue procedure provides a streamlined procedure for a taxpayer that has elected the application of the alternative tax for certain insurance companies under § 831(b) of the Internal Revenue Code (Code)[1] to obtain the automatic consent of the Secretary of the Treasury or her delegate (Secretary) to revoke such election.

SECTION 2. BACKGROUND

.01 Section 831(a) imposes a tax for each taxable year on the taxable income of every insurance company other than a life insurance company (non-life insurance company). Section 831(b) provides an alternative tax to the tax imposed by § 831(a) for certain non-life insurance companies (alternative tax). The alternative tax for these non-life insurance companies is a tax computed for each taxable year by multiplying the taxable investment income (as defined in § 834(a)) of the company for the taxable year by the rates in § 11(b).

.02 Section 831(b)(2)(A) provides that the alternative tax applies to every non-life insurance company if (1) the company's net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed $2,200,000 (adjusted for inflation[2]), (2) the company meets the diversification requirements in § 831(b)(2)(B), and (3) the company makes an election to apply the alternative tax (§ 831(b) Election) for the taxable year.

.03 Pursuant to § 301.9100-8(a)(2), the non-life insurance company must make a § 831(b) Election by the due date (taking into account any extensions of time to file obtained by the taxpayer) of the tax return for the first taxable year for which the election is effective. In general, under § 301.9100-8(a)(3), a § 831(b) Election is made by attaching a statement to the tax return for the first taxable year for which the election is to be effective.

.04 Section 1010(f)(1) of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342, 3454 (1988), added flush language to § 831(b)(2)(A). The flush language provides that a § 831(b) Election applies to the taxable year for which it is made and for all subsequent taxable years for which the requirements of § 831(b)(2)(A)(i) and (ii) are met and that a § 831(b) Election, once made, may be revoked only with the consent of the Secretary. The legislative history explains that "[t]his clarification reflects Congress's intent that the [§ 831(b)] election not be used as a means of eliminating tax liability (e.g., by making the election only for the years the taxpayer does not have net operating losses)." S. Rep. No. 445, at 127 (1988).

.05 To secure the Secretary's consent, a taxpayer seeking revocation of its § 831(b) Election has been required to submit a request for a letter ruling under the procedures set forth in Rev. Proc. 2025-1, 2025-1 I.R.B. 1 (Dec. 30, 2024) (or successor) and pay a user fee.

.06 The Department of the Treasury and the Internal Revenue Service (IRS) published proposed regulations that would designate certain micro-captive transactions as listed transactions and certain other micro-captive transactions as transactions of interest in a notice of proposed rulemaking published in the ***Federal Register*** (88 FR 21547) on April 11, 2023 (proposed regulations). Comments on the proposed regulations requested a streamlined process by which the IRS will approve requests for revocation of a § 831(b) Election.

.07 In response to the comments received on the proposed regulations, this revenue procedure provides a streamlined procedure for a taxpayer that has made a § 831(b) Election to obtain the automatic consent of the Secretary to revoke such election effective for the taxable year for which consent is sought (revocation year), which may be the taxable year in which consent is sought or the first preceding taxable year provided the taxpayer timely submits the revocation request described in section 4.02 of this revenue procedure.

SECTION 3. SCOPE

This revenue procedure applies to a taxpayer that has made a § 831(b) Election that has not been revoked and has no net operating losses arising in a taxable year to which the § 831(b) Election applied that can be carried over to the revocation year.

SECTION 4. PROCEDURE

.01 A taxpayer within the scope of section 3 of this revenue procedure may obtain the automatic consent of the Secretary to revoke its § 831(b) Election by submitting the revocation request described in section 4.02 of this revenue procedure. A user fee is not required for a revocation request submitted under this revenue procedure. The IRS will not send an acknowledgement of receipt for a revocation request submitted under this revenue procedure.

.02 A revocation request is described in this section 4.02 if the requirements of sections 4.02(1) through (4) are met. See section 5 of this revenue procedure for a model revocation request letter.

(1) The request identifies the taxpayer and contains the taxpayer's taxpayer identification number, address, and telephone number; states that the taxpayer requests automatic consent to revocation of its § 831(b) Election under this revenue procedure; and identifies the revocation year. The revocation year may be the taxable year in which the taxpayer submits the revocation request described in section 4.02 of this revenue procedure, or the first preceding taxable year provided the taxpayer submits the revocation request described in section 4.02 of this revenue procedure no later than the date on which the taxpayer files its timely-filed (including extensions) Federal income tax return for such taxable year. For example, a calendar

[1] Unless otherwise specified, all "Section" or "§" references are to sections of the Code or the Procedure and Administration Regulations (26 CFR part 301).

[2] *See* § 831(b)(2)(E). For taxable years beginning in 2025, the limit on net written premiums or direct written premiums (whichever is greater) is $2,850,000. *See* section 2.36 of Rev. Proc. 2024-40, 2024-45 I.R.B. 1100, 1107 (Nov. 4, 2024).

year taxpayer that submits a revocation request during calendar year 2025 may request that 2025 be the revocation year. Alternatively, the taxpayer may request that calendar year 2024 be the revocation year provided the taxpayer submits the revocation request described in section 4.02 of this revenue procedure no later than the date on which the taxpayer files its timely-filed (including extensions) Federal income tax return for calendar year 2024.

(2) The request includes representations that the taxpayer (a) has made a § 831(b) Election that is in effect as of the date of filing the request; (b) has no net operating losses arising in a taxable year that was prior to the revocation year to which the § 831(b) Election applied that can be carried over to the revocation year; (c) is timely submitting the request (as provided in section 4.02(3) of this revenue procedure) no later than the date on which it files its timely-filed (including extensions) Federal income tax return for the revocation year; and (d) will not make a § 831(b) Election for the five taxable years following the revocation year.

(3) The request is signed in accordance with section 7.01(13) of Rev. Proc. 2025-1 (or successor), dated, and submitted (as described in section 4.02(3)(a) or (b) of this revenue procedure) no later than the date on which the taxpayer files its timely-filed (including extensions) Federal income tax return for the revocation year. Requests submitted by an authorized representative of the taxpayer must adhere to the authorized representative requirements set forth in section 7.01(14) of Rev. Proc. 2025-1 (or successor), and the request must be accompanied by a duly executed Form 2848, *Power of Attorney and Declaration of Representative*, in accordance with section 7.01(15) of Rev. Proc. 2025-1 (or successor).

(a) A request submitted on paper must be sent to the Commissioner of Internal Revenue, Attn: CC:FIP:4, Room 3547, 1111 Constitution Avenue, NW, Washington, DC 20224. The principles of § 7502 apply to determine whether a mailed statement is submitted timely.

(b) A request submitted by facsimile (fax) must be sent to the Commissioner of Internal Revenue, Attn: CC:FIP:4, to (855) 574-9026.

(4) The request must be accompanied by the following declaration, which is signed in accordance with section 7.01(16)(b) of Rev. Proc. 2025-1 (or successor): "**Under penalties of perjury, I declare that I have examined this request, including the representations set forth herein and any accompanying documents, and, to the best of my knowledge and belief, the request contains all the relevant facts relating to the request, and such facts are true, correct, and complete.**"

.03 A taxpayer within the scope of section 3 of this revenue procedure may choose not to seek the automatic consent of the Secretary to revoke its § 831(b) Election under this revenue procedure and instead submit a request for a letter ruling granting consent to revoke its § 831(b) Election under the procedures set forth in Rev. Proc. 2025-1 (or successor) and pay the applicable user fee.

SECTION 5. MODEL REVOCATION REQUEST LETTER

[***Insert date***]

Automatic Revocation Request under Rev. Proc. 2025-13

Commissioner of Internal Revenue
Associate Chief Counsel (Financial Institutions & Products)
Attn: CC:FIP:4
Room 3547
1111 Constitution Ave, N.W.
Washington, D.C. 20224
(F) (855) 574-9026

Dear IRS Representative:

[***Insert Taxpayer name, address, and EIN number***] (Taxpayer) submits to the Internal Revenue Service (IRS) this revocation request in accordance with Rev. Proc. 2025-13, 2025-8 I.R.B. 816. We request the IRS's automatic consent to revocation of the section 831(b) election made by Taxpayer, such revocation to be effective for the taxable year beginning [***Insert date***] (revocation year).

In support of this request, Taxpayer makes the following representations:

(1) Taxpayer elected the alternative tax under section 831(b) of the Internal Revenue Code, and the election is in effect as of the date of this request;
(2) Taxpayer has no net operating losses arising in a taxable year to which the section 831(b) election applied that can be carried over to the revocation year;
(3) Taxpayer is timely submitting this request (as provided in section 4.02(3) of Rev. Proc. 2025-13) no later than the date on which it files its timely-filed (including extensions) Federal income tax return for the revocation year; and
(4) Taxpayer will not make a section 831(b) election for the five taxable years following the revocation year.

[***Insert signature and title of authorized signatory***]

Penalties of Perjury Statement

Under penalties of perjury, I declare that I have examined this request, including the representations set forth herein and any accompanying documents, and, to the best of my knowledge and belief, the request contains all the relevant facts relating to the request, and such facts are true, correct, and complete.

[***Insert Taxpayer Name***]

By: ______________________________
[***Insert Name of Authorized Signatory***]

Title: ______________________________

Date: ______________________________

SECTION 6. AREAS NOT COVERED BY THIS REVENUE PROCEDURE

The Secretary's grant of automatic consent to revoke a taxpayer's § 831(b) Election obtained under this revenue procedure does not constitute an opinion, express or implied, concerning the tax consequences of any aspect of taxpayer's business, including, but not limited to, whether any part of taxpayer's business constitutes insurance for Federal income tax purposes, whether taxpayer qualified as an insurance company for any taxable year, or whether taxpayer was properly taxed under § 831(b) for any taxable year.

SECTION 7. EFFECTIVE DATE

.01 This revenue procedure applies to a request to revoke a § 831(b) Election submitted on or after January 13, 2025.

.02 If, before January 13, 2025, a taxpayer submitted a request for a letter ruling to revoke its § 831(b) Election, and the request is pending with the national office on January 13, 2025, the taxpayer may choose to seek the automatic consent of the Secretary to revoke its § 831(b) Election under this revenue procedure by notifying the national office contact person assigned to the letter ruling request before February 12, 2025, that the taxpayer chooses to convert the request for a letter ruling to a request for automatic consent under this revenue procedure. This notification must make the representations set forth in section 4.02(2) of this revenue procedure; identify the revocation year for which automatic consent is requested, which may be the taxable year for which revocation was requested in the pending letter ruling request or a later taxable year; and be accompanied by the declaration described in section 4.02(4) of this revenue procedure. If the taxpayer timely notifies the national office that it chooses to convert the request for a letter ruling to a request for automatic consent under this revenue procedure, the national office will send a letter to the taxpayer acknowledging its request and will return the user fee submitted with the request for a letter ruling.

SECTION 8. PAPERWORK REDUCTION ACT

The collection(s) of information in this revenue procedure have been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1522.

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.

The collection(s) of information in this revenue procedure are in section 4. This information is required to determine whether a taxpayer qualifies for automatic consent under this revenue procedure. The collection of information is required to obtain a benefit. The likely respondents are non-life insurance companies that have made a § 831(b) Election.

The estimated total annual reporting and/or recordkeeping burden for Rev. Proc. 2025-1 is 316,020 hours.

For Rev. Proc. 2025-1, the estimated annual burden per respondent/recordkeeper varies from 1 to 200 hours, depending on individual circumstances, with an estimated annual average burden of 80 hours. The estimated number of respondents and/or recordkeepers for Rev. Proc. 2025-1 is 3,956.

The estimated total annual reporting and/or recordkeeping burden for this revenue procedure adds 46 hours to the burden imposed by Rev. Proc. 2025-1.

The estimated annual burden per respondent/recordkeeper for this revenue procedure varies from 1 to 3 hours, depending on individual circumstances, with an estimated average burden of 2 hours. The estimated number of additional respondents and/or recordkeepers added to Rev. Proc. 2025-1 by this revenue procedure is 20, increasing the estimated number of respondents and/or recordkeepers to Rev. Proc. 2025-1 to 3,976.

The estimated annual frequency of responses is on occasion.

Books and 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 return information are confidential, as required by § 6103.

SECTION 9. DRAFTING INFORMATION

The principal author of this revenue procedure is Elizabeth M. Hill of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure, contact Elizabeth M. Hill on 202-317-6995 (not a toll-free number).

Part IV

Notice of Proposed Rulemaking

Automatic Enrollment Requirements Under Section 414A

REG-100669-24

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document sets forth proposed regulations that would provide guidance with respect to the automatic enrollment requirements that apply to certain retirement plans. The proposed regulations reflect statutory changes made by the SECURE 2.0 Act of 2022 requiring that certain cash or deferred arrangements and salary reduction agreements be eligible automatic contribution arrangements that satisfy additional specified requirements. The proposed regulations would affect participants in, beneficiaries of, employers maintaining, and administrators of certain retirement plans that include cash or deferred arrangements or annuity contracts purchased under salary reduction agreements and other retirement plans that include eligible automatic contribution arrangements. This document also provides notice of a public hearing.

DATES: Written or electronic comments must be received by March 17, 2025. A public hearing on this proposed regulation has been scheduled for April 8, 2025, at 10 a.m. ET. Requests to speak and outlines of topics to be discussed at the public hearing must be received by March 17, 2025. If no outlines are received by March 17, 2025, the public hearing will be cancelled.

ADDRESSES: Commenters are strongly encouraged to submit public comments electronically. Submit electronic submissions via the Federal eRulemaking Portal at *www.regulations.gov* (indicate IRS and REG-100669-24) by following the online instructions for submitting comments. Requests for a public hearing must be submitted as prescribed in the "Comments and Public Hearing" section. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment submitted electronically or on paper to its public docket on *www.regulations.gov*. Send paper submissions to: CC:PA:01:PR (REG-100669-24), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, call Christina M. Cerasale at (202) 317-4102 or Kara M. Soderstrom at (202) 317-6799; concerning submission of comments, the hearing, and the access code to attend the hearing by telephone, call the Publications and Regulations Section at (202) 317-6901 (not toll-free numbers) or email *publichearings@irs.gov* (preferred).

SUPPLEMENTARY INFORMATION:

Authority

These proposed regulations are promulgated under section 7805(a) of the Internal Revenue Code (Code), which provides that "the Secretary shall prescribe all needful rules and regulations for the enforcement of [the Code], including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue." In addition, section 341 of the SECURE 2.0 Act of 2022 (SECURE 2.0 Act), enacted on December 29, 2022, as Division T of the Consolidated Appropriations Act, 2023, Public Law 117-328, 136 Stat. 4459 (2022), instructs the Secretaries of the Treasury and Labor (or their delegates) to adopt regulations related to the consolidation of notices required for defined contribution plans under the Code and the Employee Retirement Income Security Act of 1974, Public Law 93-406, 88 Stat. 829, as amended (ERISA).

Background

This notice of proposed rulemaking sets forth a proposed regulation under section 414A of the Code that would be added to the Income Tax Regulations (26 CFR part 1). Section 414A, which was added to the Code by section 101 of the SECURE 2.0 Act, provides that certain retirement plans must automatically enroll employees.

In addition to adding a new regulation under section 414A of the Code, this notice of proposed rulemaking sets forth proposed amendments to the regulations under section 414(w). These amendments to §1.414(w)-1 would reflect the application of section 414A and the exception to the notice requirements for unenrolled participants set forth in section 414(bb), as added to the Code by section 320 of the SECURE 2.0 Act. The proposed amendments to §1.414(w)-1 also would address section 402A(e)(5)(C) of the Code, which was added to the Code by section 127 of the SECURE 2.0 Act, as well as section 341 of the SECURE 2.0 Act. Section 402A(e)(5)(C) of the Code and section 341 of the SECURE 2.0 Act permit the consolidation of certain notices required under the Code and ERISA.

I. *In General*

A. *Cash or deferred arrangements and salary reduction agreements*

Section 401(k)(1) provides that a profit-sharing, stock bonus, pre-ERISA money purchase, or rural cooperative plan will not fail to qualify under section 401(a) merely because it includes a cash or deferred arrangement (CODA)[1] that is a

[1] *Under §1.401(k)-1(a)(2)(i), a CODA generally is an arrangement providing for an election by an employee to have the employer provide either contributions to a plan described in section 401(a) or payments directly in cash.*

qualified CODA. Under section 401(k)(2), a CODA is a qualified CODA only if it satisfies certain requirements. These requirements include that elective contributions under the CODA are subject to the section 401(k)(2)(B) restriction on when distributions may be made, and that the arrangement satisfies the actual deferral percentage (ADP) test in section 401(k)(3)(A)(ii).[2]

Section 403(b)(1) of the Code provides for an exclusion from gross income of certain contributions that are used to purchase an annuity contract, including contributions that are made under a salary reduction agreement. Although there is no direct definition of salary reduction agreement in section 403(b), several provisions of the Code set forth rules that apply to the use of a salary reduction agreement to purchase an annuity contract described in section 403(b). For example, section 403(b)(11) provides distribution restrictions that apply to "contributions made pursuant to a salary reduction agreement."

B. *Automatic enrollment*

Section 902 of the Pension Protection Act of 2006, Public Law 109-280, 120 Stat. 780 (PPA '06), added sections 401(k)(13) and 414(w) to the Code to facilitate automatic contribution arrangements (also referred to as automatic enrollment) in qualified CODAs under section 401(k). Section 414(w) also applies to automatic contribution arrangements under section 403(b) plans; section 457(b) plans maintained by governmental employers described in section 457(e)(1)(A); simplified employee pensions, the terms of which provide for a salary reduction arrangement described in section 408(k)(6); and SIMPLE individual retirement accounts described in section 408(p). An automatic contribution arrangement is a CODA or other similar arrangement providing for elections on the part of eligible employees that includes a default election under which an eligible employee is treated as having elected to have a specified contribution made on the employee's behalf under the plan while permitting the employee to make an affirmative election to have contributions made in a different amount on the employee's behalf (including no contributions).[3]

1. Qualified automatic contribution arrangements under section 401(k)(13)

Section 401(k)(13) provides a design-based safe harbor for a CODA that provides for automatic enrollment at a specified level and meets certain employer contribution, notice, and other requirements. A CODA that satisfies these requirements, referred to as a qualified automatic contribution arrangement (QACA), is treated as satisfying the ADP test.

Section 401(k)(13)(C)(ii) provides that the default election in a QACA ceases to apply to any eligible employee if the employee makes an affirmative election to not have any elective contributions made on the employee's behalf or to have elective contributions made in a specified amount or percentage of compensation on the employee's behalf. Reflecting that provision, §1.401(k)-3(j)(1)(ii) provides that the default election ceases to apply with respect to an eligible employee for periods of time with respect to which the employee has an affirmative election that is currently in effect to have elective contributions made in a different amount on the employee's behalf (in a specified amount or percentage of compensation) or not have any elective contributions made on the employee's behalf.

Section 401(k)(13)(C)(iii) sets forth a series of minimum default contribution percentages (based on the plan year that the arrangement first applies to an employee) that an automatic contribution arrangement must satisfy to be a QACA and requires that the default contribution percentages apply uniformly. Under §1.401(k)-3(j)(2)(iii), a plan does not fail to satisfy this uniform percentage requirement merely because: (1) the percentage varies based on the number of years or portions of years an eligible employee has participated in the automatic contribution arrangement intended to be a QACA; (2) the rate of elective contributions under a cash or deferred election that is in effect immediately prior to the effective date of the default percentage under the QACA is not reduced; (3) the rate of elective contributions is limited so as not to exceed the limits of sections 401(a)(17), 402(g) (determined with or without catch-up contributions), and 415; or (4) the default election is not applied during the period an employee is not permitted to make elective contributions pursuant to section 414(u)(12)(B)(ii).

Section 401(k)(13)(C)(iv) provides an exception from the application of the default election under a QACA for eligible employees who were eligible to participate in the CODA (or a predecessor CODA) immediately before the effective date of the QACA and who have an election in effect on that effective date. Reflecting that provision, §1.401(k)-3(j)(1)(iii) provides that an automatic contribution arrangement does not fail to be a QACA merely because the default election is not applied to an employee who was eligible under the CODA (or a predecessor arrangement) immediately prior to the effective date of the QACA and on that effective date had an affirmative election in effect (that remains in effect) to have elective contributions made on the employee's behalf (in a specified amount or percentage of compensation) or not have elective contributions made on the employee's behalf.

Section 1.401(k)-3(j)(2)(iv) provides that minimum percentages in a QACA are determined without regard to whether an employee has continued to be eligible to make contributions under the plan. However, §1.401(k)-3(j)(2)(iv) provides that a plan is permitted to treat an employee who for an entire plan year did not have contributions made pursuant to a default election under a QACA as if the employee also had not had such contributions for any prior plan year.

[2] *The ADP test in section 401(k)(3)(A)(ii) compares the average deferral percentage for highly compensated employees with the average deferral percentage for non-highly compensated employees. As an alternative to satisfying the annual ADP test, a plan may satisfy the provisions of section 401(k)(11), (12), (13), or (16).*

[3] *Section 902 of PPA '06 also added a new section 514(e) to ERISA, which broadly provides that, notwithstanding any other provision of section 514, title I of ERISA supersedes State laws that would directly or indirectly prohibit or restrict the inclusion of an automatic contribution arrangement in a plan.*

2. Eligible automatic contribution arrangements under section 414(w)

Section 414(w) facilitates automatic enrollment by providing relief from the distribution restrictions under section 401(k)(2)(B), 403(b)(7), 403(b)(11), or 457(d)(1)(A) in the case of an eligible automatic contribution arrangement (EACA). Under this relief, a plan may permit an employee who was automatically enrolled under an EACA to take a distribution within a limited period after the initial default elective contribution with respect to the employee was made.

Under section 414(w)(1) and (2), an applicable employer plan[4] that contains an EACA is permitted to allow employees to elect to receive a distribution, called a permissive withdrawal, equal to the amount of default elective contributions (and attributable earnings) made with respect to the employee beginning with the first payroll period to which the EACA applies to the employee and ending with the effective date of the election. The election must be made within 90 days after the date of the first default elective contribution with respect to the employee under the arrangement.[5]

Section 414(w)(3) defines an EACA as an arrangement under which: (1) a participant may elect to have the employer make payments as contributions under the plan on behalf of the participant, or to the participant directly in cash; (2) the participant is treated as having elected to have the employer make such contributions in an amount equal to a uniform percentage of compensation provided under the plan until the participant specifically elects not to have such contributions made (or specifically elects to have such contributions made at a different percentage); and (3) participants are provided a notice that satisfies the requirements of section 414(w)(4).

Section 414(w)(4) provides that the administrator of a plan that includes an EACA must, within a reasonable period before each plan year, provide each employee to whom the arrangement applies for the plan year written notice of the employee's rights and obligations under the arrangement that is sufficiently accurate and comprehensive to apprise the employee of the employee's rights and obligations. Section 414(w)(4)(A)(ii) requires that the notice be written in a manner calculated to be understood by the average employee to whom the arrangement applies. Section 414(w)(4)(B) provides that the notice must explain: (1) the employee's rights under the arrangement to elect not to have elective contributions made on the employee's behalf (or to elect to have contributions made at a different percentage), and (2) how contributions made under the arrangement will be invested in the absence of any investment decision by the employee. In addition, the employee must be given a reasonable period of time after receipt of the notice and before the first elective contribution is made to make an election described in the notice.

The Treasury Department and the IRS issued a regulation under section 414(w) on February 24, 2009 (TD 9447, 74 FR 8200). Section 1.414(w)-1(b)(2) includes rules that address the uniform percentage requirement of section 414(w)(3)(B), including rules that incorporate the exceptions to the uniform percentage requirement for a default elective contribution for a QACA set forth in §1.401(k)-3(j)(2)(iii).

II. *New Automatic Enrollment Requirements and Other Changes Regarding EACAs Under the SECURE 2.0 Act*

A. *Section 101 of the SECURE 2.0 Act*

Section 101 of the SECURE 2.0 Act adds section 414A to the Code. Under section 101(c) of the SECURE 2.0 Act, the amendments made by section 101 apply to plan years beginning after December 31, 2024.

Section 414A(a)(1) of the Code generally provides that a CODA will not be treated as a qualified CODA described in section 401(k) unless the CODA satisfies the automatic enrollment requirements of section 414A(b). Similarly, section 414A(a)(2) generally provides that an annuity contract otherwise described in section 403(b) that is purchased under a salary reduction agreement will not be treated as described in section 403(b) unless the salary reduction agreement satisfies the automatic enrollment requirements of section 414A(b).

Under section 414A(b)(1), a CODA or salary reduction agreement satisfies the automatic enrollment requirements of section 414A(b) if the CODA or salary reduction agreement is an EACA (as defined in section 414(w)(3)) that satisfies the additional requirements of section 414A(b)(2) through (4). Section 414A(b)(2) requires the EACA to allow employees to make permissible withdrawals (as defined in section 414(w)(2)). Under section 414A(b)(3)(A)(i), the minimum initial default contribution percentage under the EACA must be at least 3 percent (but not more than 10 percent), and under section 414A(b)(3)(A)(ii), the default contribution percentage must increase by one percentage point for each plan year beginning after each completed year of participation under the EACA, up to a maximum default contribution percentage of at least 10 percent (but not more than 15 percent).[6] Section 414A(b)(4) provides that amounts contributed pursuant to the EACA for which no investment is elected by a participant must be invested in accordance with the requirements of 29 CFR 2550.404c-5[7] (or any successor regulations).

Section 414A(c) sets forth certain exceptions to the requirements of section 414A(a). In general, section 414A(a) does not apply to any: (1) SIMPLE

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[4] *Section 414(w)(5) defines an applicable employer plan for purposes of section 414(w) as a trust described in section 401(a) that is exempt from tax under section 501(a), a plan described in section 403(b), a section 457(b) plan that is maintained by a governmental employer described in section 457(e)(1)(A), a simplified employee pension the terms of which provide for a salary reduction arrangement described in section 408(k)(6), or a SIMPLE individual retirement account described in section 408(p).*

[5] *Section 414(w)(1)(A) and (B) provides that the amount of the distribution is includible in the gross income of the employee for the taxable year in which the distribution is made but is not subject to the additional income tax on early distributions under section 72(t).*

[6] *Section 414A(b)(3)(B) provides a reduced maximum default contribution percentage of 10 percent for certain plans with respect to certain plan years.*

[7] *The requirements of 29 CFR 2550.404c-5 relate to investments in qualified default investment alternatives.*

401(k) plan described in section 401(k)(11); (2) qualified CODA established before December 29, 2022 (the date of enactment of the SECURE 2.0 Act); (3) section 403(b) plan established before December 29, 2022; (4) governmental plan described in section 414(d); (5) church plan described in section 414(e); (6) plan maintained by a new business as described in section 414A(c)(4)(A); or (7) plan maintained by a small business as described in section 414A(c)(4)(B).

Certain of the exceptions in section 414A(c) include special rules for plans maintained by more than one employer. Section 414A(c)(2)(B) provides rules that apply in the case of an employer that, after December 29, 2022, adopts a plan maintained by more than one employer. Under that provision, the exception to section 414A(a) for a qualified CODA or 403(b) plan established before December 29, 2022, will not apply to that adopting employer, and the rules of section 414A(a) will apply with respect to that employer as if the plan were a single plan. In addition, under section 414A(c)(4)(C), the new business and small business exceptions to section 414A(a) are applied separately to each participating employer in a plan maintained by more than one employer, and all participating employers to which section 414A(a) applies (after the application of the new business exception in section 414A(c)(4)(A) and the small business exception in section 414A(c)(4)(B)) are treated as maintaining a separate plan for purposes of section 414A.

On December 20, 2023, the Treasury Department and the IRS released Notice 2024-2, 2024-2 IRB 316, which provides initial guidance on certain provisions of the SECURE 2.0 Act. Section II.A of Notice 2024-2 provides initial guidance in the form of questions and answers regarding certain issues related to section 414A of the Code that primarily addresses the scope of the exceptions under section 414A(c)(2) to the requirements of section 414A.

Q&A A-1 of Notice 2024-2 provides that, for purposes of section 414A(c)(2)(A)(i) (the exception to section 414A(a) for a qualified CODA established before December 29, 2022), a qualified CODA is established on the date plan terms providing for the CODA are adopted initially, even if the plan terms providing for the CODA are effective after the adoption date.

Q&A A-2 of Notice 2024-2 provides rules that apply in the case of a merger of a plan maintained by a single employer that includes a qualified CODA established before December 29, 2022 (a pre-enactment qualified CODA), with another plan that includes a pre-enactment qualified CODA. Under Q&A A-2, the treatment of the qualified CODA included in the ongoing plan as a pre-enactment qualified CODA is unaffected by the merger (without regard to whether the ongoing plan is maintained by a single employer or more than one employer).

Q&A A-3 of Notice 2024-2 provides that if a plan that includes a qualified CODA that was not established before December 29, 2022, is merged with a plan that includes a pre-enactment qualified CODA, then, after the merger, the qualified CODA included in the ongoing plan generally will not be treated as a pre-enactment qualified CODA. However, if, in connection with a disposition, acquisition, or other transaction described in section 410(b)(6)(C), a plan maintained by a single employer that includes a qualified CODA that was not established before December 29, 2022, is merged with another plan maintained by a single employer that includes a pre-enactment qualified CODA, and the plan that includes the pre-enactment qualified CODA is designated as the ongoing plan, then the qualified CODA included in the ongoing plan continues to be treated as a pre-enactment qualified CODA after the merger, provided that the merger occurs by the end of the section 410(b)(6)(C) transition period.

Q&A A-3 also provides that if a plan maintained by a single employer includes a qualified CODA that was not established before December 29, 2022, and is merged into a plan maintained by more than one employer that includes a pre-enactment qualified CODA, then the qualified CODA included in the ongoing plan would not be treated as a pre-enactment qualified CODA with respect to that employer. However, in that case, the merger would not affect whether the qualified CODA is treated as a pre-enactment qualified CODA with respect to other employers that participate in the ongoing plan.

Q&A A-4 of Notice 2024-2 provides that if a plan that includes a qualified CODA is spun off from a plan that includes a pre-enactment qualified CODA, the qualified CODA included in the new spun-off plan generally is also treated as being a pre-enactment qualified CODA. However, if the plan from which the new plan was spun off was a plan maintained by more than one employer that was established before December 29, 2022, then the qualified CODA included in the spun-off plan is treated as a pre-enactment qualified CODA only if the qualified CODA in the plan maintained by more than one employer was treated as a pre-enactment qualified CODA with respect to the employer sponsoring the spun-off plan.

Q&A A-5 of Notice 2024-2 provides that, in general, the rules of section 414A that apply to qualified CODAs also apply to section 403(b) plans. However, the exception to section 414A(a) for a section 403(b) plan established before December 29, 2022, applies without regard to the date of adoption of plan terms that provide for salary reduction agreements.

Q&A A-6 of Notice 2024-2 explains that, unless an exception set forth in section 414A(c) applies (for example, the exception for a new or small business), section 414A(a) applies to a starter 401(k) deferral-only arrangement described in section 401(k)(16)(B), or to a safe harbor deferral-only plan described in section 403(b)(16)(B), for plan years beginning after December 31, 2024.

The Treasury Department and the IRS received 12 written comments in response to Notice 2024-2 that address the guidance provided in Section II.A of the notice. The Treasury Department and the IRS reviewed all 12 comments, and this preamble addresses those that are relevant and within scope for this notice of proposed rulemaking. All written comments responding to Notice 2024-2 are available for public inspection and copying at *www.regulations.gov*, and certain of those comments that address Section II.A of Notice 2024-2 are discussed in the Explanation of Provisions portion of this preamble.

B. *SECURE 2.0 Act changes regarding EACA notices*

1. Notice requirements for unenrolled participants

Section 320(b) of the SECURE 2.0 Act adds section 414(bb) to the Code, effective for plan years beginning after December 31, 2022. Section 414(bb)(1) provides that, with respect to any defined contribution plan, no disclosure, notice, or other plan document is required to be furnished under the Code to any unenrolled participant if the unenrolled participant is furnished: (1) an annual reminder notice (as defined in section 414(bb)(3)) of the participant's eligibility to participate in the plan and any applicable election deadlines under the plan, and (2) any document requested by the participant that the participant would be entitled to receive notwithstanding section 414(bb).

Section 414(bb)(2) defines an unenrolled participant as an employee who: (1) is eligible to participate in a defined contribution plan, (2) has been furnished the summary plan description pursuant to section 104(b) of ERISA for the plan and any other notices related to eligibility under the plan and required to be furnished under the Code or ERISA in connection with the participant's initial eligibility to participate in the plan, (3) is not participating in the defined contribution plan, and (4) satisfies any other criteria as the Secretary of the Treasury may determine appropriate, as prescribed in guidance issued in consultation with the Secretary of Labor. The last sentence of section 414(bb)(2) of the Code provides that any eligibility to participate in the plan following any period for which the employee was not eligible to participate is to be treated as initial eligibility.

Section 414(bb)(3) provides that the annual reminder notice required under section 414(bb)(1) is the notice described in section 111(c) of ERISA (as added by section 320(a) of the SECURE 2.0 Act).

2. Combining EACA notices with other notices

Section 127 of the SECURE 2.0 Act provides for the creation of pension-linked emergency savings accounts (PLESAs) effective for plan years beginning after December 31, 2023. Among other changes, section 127 of the SECURE 2.0 Act redesignates section 402A(e) of the Code as section 402A(f) and adds a new section 402A(e) regarding PLESAs.[8] Section 402A(e)(5)(A) requires the plan administrator of a plan with a PLESA feature to furnish initial and annual notices to participants describing certain information regarding the PLESA that meet the requirements of section 402A(e)(5)(B). Section 402A(e)(5)(C) permits the initial and annual notices required under section 402A(e)(5)(A) to be included with any other notice under ERISA, including under section 404(c)(5)(B) or 514(e)(3) of ERISA, or under section 401(k)(13)(E) or 414(w)(4) of the Code, if the other notice is provided to the participant at the time required for that notice.

The Department of Labor has provided frequently asked questions regarding PLESAs, including with respect to the permitted consolidation of notices under section 801(d)(3)(C) of ERISA (which is a parallel provision to section 402A(e)(5)(C) of the Code). *See* Q&A-18 of "FAQs: Pension-Linked Emergency Savings Accounts," available at *www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/faqs/pension-linked-emergency-savings-accounts*.

Section 341 of the SECURE 2.0 Act permits a plan (as defined in section 3 of ERISA) to consolidate two or more of the notices required under sections 404(c)(5)(B) and 514(e)(3) of ERISA and sections 401(k)(12)(D), 401(k)(13)(E), and 414(w)(4) of the Code into a single notice, provided that the combined notice satisfies certain requirements. Section 341 of the SECURE 2.0 Act does not prevent the consolidation of any other notices required under ERISA or the Code to the extent otherwise permitted by the Secretary of Labor or the Secretary of the Treasury (or their delegates), as applicable.

On October 24, 2007, the Department of Labor published in the **Federal Register** (72 FR 60452) a final regulation, 29 CFR 2550.404c-5, providing relief from certain fiduciary responsibilities under ERISA for investments made on behalf of participants or beneficiaries who fail to direct the investment of assets in their individual accounts. The preamble to that final regulation indicates that the Department of Labor anticipates that the notice requirements of sections 404(c)(5)(B) and 514(e)(3) of ERISA and sections 401(k)(13)(E) and 414(w)(4) of the Code could be satisfied in a single disclosure document. *See* 72 FR 60455 (regarding the notice requirements under section 404(c)(5)(B) of ERISA and sections 401(k)(13)(E) and 414(w)(4) of the Code) and 72 FR 60466 (regarding the notice requirements under sections 404(c)(5)(B) and 514(e)(3) of ERISA).

To aid plan sponsors for the 2008 plan year (the first plan year that a plan could have included a QACA or EACA), the IRS coordinated with the Department of Labor to post a sample "Automatic Enrollment Notice," available at *www.irs.gov/pub/irs-tege/sample_notice.pdf*. This sample notice is intended to satisfy the notice requirements of sections 404(c)(5)(B) and 514(e)(3) of ERISA and sections 401(k)(13)(E) and 414(w)(4) of the Code.

On April 29, 2008, the Department of Labor issued Field Assistance Bulletin 2008-03. Q&A-10 of Field Assistance Bulletin 2008-03 explains that the notice required under section 401(k)(12)(D) also may be combined with the notice required under section 404(c)(5)(B) of ERISA.

Q&A-18 of "FAQs: Pension-Linked Emergency Savings Accounts" explains that, with respect to section 341 of the SECURE 2.0 Act, the Department of Labor retains its position regarding the consolidation of notices required under sections 404(c)(5)(B) and 514(e)(3) of ERISA and sections 401(k)(12)(D), 401(k)(13)(E), and 414(w)(4) of the Code. Q&A-18 also explains that, under section 801(d)(3)(C) of ERISA, the initial and annual notices that must be furnished to PLESA participants may be included with any other notice under ERISA, including under section 404(c)(5)(B) or 514(e)(3) of ERISA, or under section 401(k)(13)(E) or 414(w)(4) of the Code, if such other notice is provided to the participant at the time required for such notice.

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[8] *On January 12, 2024, the Treasury Department and the IRS released Notice 2024-22, 2024-6 IRB 662, which provides initial guidance regarding anti-abuse rules under section 402A(e)(12) of the Code, as added by section 127 of the SECURE 2.0 Act, and also addresses whether Rev. Rul. 74-55, 1974-1 CB 89, and Rev. Rul. 74-56, 1974-1 CB 90, are applicable to PLESAs.*

Explanation of Provisions

I. *Proposed §1.414A-1*

A. *General rule*

In accordance with section 414A(a)(1), the proposed regulation generally would provide that a CODA will not be treated as a qualified CODA unless the plan that includes the CODA provides that any cash or deferred election under the CODA must satisfy the automatic enrollment requirements of section 414A. The proposed regulation would clarify that the determination of whether a CODA fails to satisfy these automatic enrollment requirements (and, therefore, fails to be a qualified CODA) is made on a plan-year basis.

Similarly, in accordance with section 414A(a)(2), the proposed regulation generally would provide that an annuity contract described in section 403(b) that is purchased pursuant to a salary reduction agreement will not be treated as purchased under a section 403(b) plan for a plan year unless the plan provides that any salary reduction agreement under the plan must satisfy the automatic enrollment requirements of section 414A.

B. *Automatic enrollment requirements*

1. *In general*

As described in section II.A of the Background portion of this preamble, section 414A(a) generally requires a qualified CODA, or an annuity contract described in section 403(b) that is purchased under a salary reduction agreement, to satisfy the automatic enrollment requirements of section 414A(b), which require the CODA or salary reduction agreement to be an EACA, as described in section 414(w)(3), that meets the requirements of section 414A(b)(2) through (4). Section 414A(c) sets forth exceptions to the requirements of section 414A(a) for certain plans.

The Treasury Department and the IRS received comments in response to Notice 2024-2 requesting that the guidance provide that certain categories of employees need not be covered by an EACA for section 414A(b) to be satisfied. However, although section 414A(c) provides several exceptions to the requirements of section 414A(a) for certain types of plans, there is no provision in section 414A (or in section 101(c) of the SECURE 2.0 Act) that excludes any category of employee from the automatic enrollment requirements of section 414A(b) of the Code if the plan is subject to section 414A(a). Accordingly, the proposed regulation would clarify that a CODA or salary reduction agreement under a plan satisfies the automatic enrollment requirements of section 414A only if the plan provides for an EACA that covers all employees in the plan who are eligible to elect to have contributions made on their behalf under the CODA or pursuant to the salary reduction agreement (including long-term, part-time employees described in section 401(k)(15) of the Code or section 202(c) of ERISA).

Commenters also requested guidance on whether an employee must be automatically enrolled if the employee was eligible to participate in a CODA or salary reduction agreement included in a plan before the CODA or salary reduction agreement became subject to the automatic enrollment requirements of section 414A(b). In response to these comments, the proposed regulation would provide an exception to automatic enrollment for certain employees who are eligible to make a cash or deferred election under a CODA or to enter into a salary reduction agreement that is comparable to the exception for certain current employees under a QACA, as set forth in §1.401(k)-3(j)(1)(iii). Specifically, the proposed regulation would clarify that an EACA will not fail to satisfy section 414A merely because the default election under the EACA does not apply to an employee who, on the date the plan is first required to satisfy the automatic enrollment requirements of the proposed regulation, had an affirmative election in effect (that remains in effect) to have contributions made on the employee's behalf under a cash or deferred election or a salary reduction agreement (in a specified amount or percentage of compensation) or not have contributions made on the employee's behalf under a cash or deferred election or a salary reduction agreement.

2. *Permissive withdrawals*

In accordance with section 414A(b)(2), the proposed regulation would provide that an EACA satisfies the automatic enrollment requirements of section 414A only if the plan that includes the EACA provides that any employee who has default elective contributions made under the EACA may elect to make a permissible withdrawal, as defined in section 414(w)(2) and described in §1.414(w)-1(c) (that is, a withdrawal of default elective contributions and earnings that satisfies certain timing and amount requirements).

3. *Contribution requirements*

To reflect the minimum contribution percentage requirements of section 414A(b)(3), the proposed regulation would provide that an EACA satisfies the automatic enrollment requirements of section 414A only if the default election made on behalf of an employee under the EACA is equal to a uniform percentage of the employee's compensation that is subject to a cash or deferred election or salary reduction arrangement under the plan. The default election would not apply if the employee affirmatively elects to have contributions made in a different amount on the employee's behalf (in a specified amount or percentage of compensation) or not have any contributions made on the employee's behalf, under a cash or deferred election or a salary reduction agreement.

In accordance with section 414A(b)(3)(A)(i), the proposed regulation would provide that the contribution percentage under the default election for each employee's initial period must be a uniform percentage that is not less than 3 percent and not more than 10 percent. The proposed regulation would clarify that an employee's initial period (that is, the employee's "first year of participation" under section 414A(b)(3)(A)(i)) would begin when the employee is first eligible to elect to have contributions made on the employee's behalf under the plan (or if later, when the plan is first required to satisfy the automatic enrollment requirements of section 414A), and the employee's initial period would end on the last day of the following plan year.

As described in section II.A of the Background portion of this preamble, section 414A(b)(3)(A)(ii) generally requires automatic increases of one percentage

point to an employee's minimum default contribution percentage for each plan year beginning after each completed year of participation under the EACA, up to a maximum default contribution percentage of at least 10 percent (but not more than 15 percent). The proposed regulation would provide that, for each plan year beginning after an employee's initial period, the percentage contribution under the default election must be increased by one percentage point until the percentage is at least 10 percent. The proposed regulation also would provide that the percentage may not exceed 15 percent (or the lower percentage specified in section 414A(b)(3)(B), if applicable).

For purposes of satisfying the uniform percentage requirement of section 414A(b)(3)(A), the proposed regulation would adopt the exceptions from the uniform percentage requirement of section 414(w)(3)(B), which are based on the similar exceptions from the uniform percentage requirement for a QACA under §1.401(k)-3(j)(2)(iii). Specifically, the proposed regulation would clarify that an EACA does not fail to satisfy the uniform percentage requirement merely because: (1) the percentage used for the default election varies based on the number of years (or portions of years) since the beginning of the initial period for an employee, (2) the rate of contributions under a cash or deferred election or salary reduction agreement that is in effect for an employee immediately prior to the date that the default election under the proposed regulation first applies to the employee is not reduced, (3) the rate of contributions under a cash or deferred election or salary reduction agreement is limited so as not to exceed certain applicable limits under the Code, or (4) the default election is not applied during the period an employee is not permitted to have contributions made on the employee's behalf under a cash or deferred election or salary reduction agreement under section 414(u)(12)(B)(ii), which provides for a six-month suspension of elective deferrals (and employee contributions) if an individual elects to receive a distribution by reason of the individual being treated as having been severed from employment while performing military service.

The proposed regulation would provide rules, based on the rules for a QACA under §1.401(k)-3(j)(2)(iv), that would address the default percentage that would apply for an employee who did not have default elective contributions made for an entire plan year. The proposed regulation would provide different rules that could be used depending on whether the employee was not eligible to have contributions made on the employee's behalf under a CODA or salary reduction agreement or had made an affirmative election to have contributions made in a different amount (including an election not to have contributions made).

Specifically, the proposed regulation would permit a plan to provide that if, after an employee's initial period began, the employee did not have default elective contributions made for an entire plan year, then the employee's initial period is redetermined. If no default elective contributions were made solely because the employee was not eligible to elect to have contributions made on the employee's behalf under a cash or deferred election or salary reduction agreement for that entire plan year, then a plan would be permitted to provide that the employee's initial period would be redetermined so that it begins on the date the employee is again eligible to elect to have contributions made on the employee's behalf under the plan. An employer would likely adopt this provision to determine the default contribution rate that applies to an employee who was rehired more than one plan year after the employee terminated employment.

However, if no default elective contributions were made solely because the employee made an affirmative election to have contributions made on the employee's behalf under a cash or deferred election or salary reduction agreement in a different amount (including an election not to have contributions made), then a plan would be permitted to provide that the employee's initial period would be redetermined so that it begins on any date specified under the plan that is later than the date the employee's original initial period ended. For example, a plan is permitted to be amended to provide that, as of a specific date, the default election will apply to all employees who previously made an affirmative election that has been in effect for a period of at least one plan year to have contributions made on behalf of the employees under the plan at a rate that is below the uniform percentage that applies during an initial period (so that the uniform percentage that applies during the initial period will apply unless the employee makes a new affirmative election). An employer might adopt such an amendment to facilitate an increase in the rate of contributions made on behalf of its employees.

4. *Investment requirements*

In accordance with the investment requirements of section 414A(b)(4), the proposed regulation would provide that an EACA satisfies the automatic enrollment requirements of section 414A only if amounts contributed pursuant to the EACA, and for which no investment is elected by the employee, are invested in accordance with the requirements of 29 CFR 2550.404c-5 (or any successor regulations).

C. *Exceptions for certain types of plans and businesses*

1. SIMPLE 401(k) plans

In accordance with section 414A(c)(1), the proposed regulation would provide that the automatic enrollment requirements of section 414A do not apply to any SIMPLE 401(k) plan (as described in section 401(k)(11) and §1.401(k)-4).

2. Governmental and church plans

In accordance with section 414A(c)(3), the proposed regulation would provide that the automatic enrollment requirements of section 414A do not apply to any governmental plan (within the meaning of section 414(d)) or any church plan (within the meaning of section 414(e)).

3. New and small businesses

Section 414A(c)(4)(A) provides that the automatic enrollment requirements of section 414A(a) do not apply to any qualified CODA, or any annuity contract purchased under a plan, while the employer

maintaining the plan (and any predecessor employer) has been in existence for less than 3 years. However, section 414A does not specify the date as of which a plan must satisfy the automatic enrollment requirements of section 414A(b) if the exception for new businesses under section 414A(c)(4)(A) ceases to apply to the plan.

In response to Notice 2024-2, the Treasury Department and the IRS received a comment requesting clarification that a plan will not fail to satisfy the automatic enrollment requirements of section 414A(b) if the plan includes an EACA no later than the first plan year that begins on or after the third anniversary of the employer's existence. The Treasury Department and the IRS agree that a plan should not be required to implement an EACA in the middle of a plan year. Therefore, the proposed regulation would clarify that the automatic enrollment requirements of section 414A do not apply to a plan for a plan year if, as of the beginning of the plan year, the employer maintaining the plan (aggregated with any predecessor employer) has been in existence for less than 3 years.

Section 414A(c)(4)(B) provides that the automatic enrollment requirements of section 414A(a) do not apply to any qualified CODA, or any annuity contract purchased under a plan, earlier than the date that is 1 year after the close of the first taxable year of the employer maintaining the plan with respect to which that employer normally employed more than 10 employees. However, section 414A(c)(4)(B) does not specify any method for counting the number of employees for this purpose.

In response to Notice 2024-2, the Treasury Department and the IRS received comments requesting clarification regarding the method for counting employees for purposes of the small business exception under section 414A(c)(4)(B). One commenter raised the issue of how to count employees for this purpose but did not suggest a specific method. Another commenter recommended that the Treasury Department and the IRS adopt a monthly averaging approach, which the commenter explained would be similar to the approach used for purposes of section 4980H. However, section 4980H does not use the phrase "normally employed"; instead, that phrase is used in section 4980B(d)(1). Therefore, the proposed regulation would clarify that the number of employees that the employer normally employs for a taxable year is determined using the rules of Q&A-5 of §54.4980B-2.

Similar to the clarification provided in the proposed regulation for new businesses, the proposed regulation would clarify that the automatic enrollment requirements of section 414A do not apply to any qualified CODA, or any annuity contract purchased under a section 403(b) plan, before the first plan year that begins at least 12 months after the close of the first taxable year of the employer maintaining the plan with respect to which that employer normally employed more than 10 employees.

As described in section II.A of the Background portion of this preamble, section 414A(c)(4)(C) provides special rules for the new and small business exceptions in the case of "a plan maintained by more than 1 employer." The proposed regulation would clarify that the phrase "a plan maintained by more than 1 employer" means a multiple employer plan.[9] Accordingly, the proposed regulation would reflect the provisions of section 414A(c)(4)(C) by providing that, in the case of a multiple employer plan, the exceptions for new and small businesses apply on an employer-by-employer basis. Thus, if an employer participating in a multiple employer plan is a new or small business, it would be exempt from the automatic enrollment requirements of section 414A, but that exemption would have no impact on whether section 414A applies to the employees of the other participating employers.

D. *Exceptions for plans established before the enactment of section 414A*

1. *In general*

As described in section II.A of the Background portion of this preamble, section 414A(c)(2)(A) provides an exception from the requirements of section 414A(a) in the case of a qualified CODA, or section 403(b) plan, that is established before December 29, 2022, and Q&A A-1 and Q&A A-5 of Notice 2024-2 provide guidance with respect to the date that a qualified CODA or section 403(b) plan is established for purposes of section 414A(c)(2)(A). Notice 2024-2 refers to a qualified CODA or section 403(b) plan that is eligible for the exception under section 414A(c)(2)(A) as a pre-enactment qualified CODA or pre-enactment section 403(b) plan, and this Explanation of Provisions uses the term pre-enactment plan to encompass both pre-enactment qualified CODAs and pre-enactment section 403(b) plans.

The proposed regulation would reflect the provisions of section 414A(c)(2)(A)(i) and incorporate the guidance provided in Q&A A-1 of Notice 2024-2 by generally providing that the automatic enrollment requirements of section 414A do not apply to any plan that includes a qualified CODA if the plan terms providing for the qualified CODA were adopted initially before December 29, 2022, even if the plan terms providing for the CODA are effective after that date. The proposed regulation also would reflect the provisions of section 414A(c)(2)(A)(ii) and incorporate the guidance provided in Q&A A-5 of Notice 2024-2 by providing that the automatic enrollment requirements of section 414A do not apply to any section 403(b) plan adopted initially before December 29, 2022, without regard to the date of adoption of plan terms providing for salary reduction agreements.

2. *Merger of plans established before the enactment of section 414A*

With respect to the merger of two pre-enactment plans (neither of which is a multiple employer plan) or the merger of a pre-enactment plan that is not a multiple employer plan with a pre-enactment multiple employer plan, the proposed regulation would incorporate the guidance provided in Q&A A-2 of Notice 2024-2 (which, under Q&A A-5 of Notice 2024-2, also applies to section 403(b) plans). Thus,

[9] *This interpretation is consistent with the heading of section 414A(c)(4)(C) ("Treatment of multiple employer plans") and the interpretation in §1.413-2(a)(2) and (3) of the substantially identical language in section 413(c) ("a plan maintained by more than one employer").*

the plan after the merger will be treated as a pre-enactment plan.

The proposed regulation generally would extend the guidance provided in Q&A A-2 of Notice 2024-2 to the merger of two pre-enactment multiple employer plans. However, the proposed regulation would clarify that a merger involving a multiple employer plan will not affect whether the merged plan is treated as a pre-enactment plan with respect to any employer that maintained the multiple employer plan prior to the merger.

3. *Merger of plan established on or after the enactment of section 414A with a plan established before the enactment of section 414A*

With respect to the merger of a plan that is not a pre-enactment plan and a pre-enactment plan (neither of which is a multiple employer plan), the proposed regulation generally would incorporate the guidance provided in Q&A A-3 of Notice 2024-2 (which, under Q&A A-5 of Notice 2024-2, also applies to section 403(b) plans). With respect to the guidance provided in Q&A A-3 of Notice 2024-2 regarding a plan merger in connection with a transaction described in section 410(b)(6)(C), the proposed regulation generally would incorporate that guidance by providing that a pre-enactment plan will continue to be treated as a pre-enactment plan after a merger with a plan that is not a pre-enactment plan if there is a transaction described in §1.410(b)-2(f), the pre-merger pre-enactment plan is designated as the ongoing plan, and the plan merger occurs within the transition period described in section 410(b)(6)(C)(ii). In addition, the proposed regulation would expand the rule in Q&A A-3 of Notice 2024-2 to address certain situations in which a plan maintained by a single employer that is not a pre-enactment plan is merged into a multiple employer plan. Under this expansion, the multiple employer plan would be treated as a pre-enactment plan with respect to the employer that sponsored the merged-in plan if, with respect to the participating employer that engaged in the transaction, the multiple employer plan was treated as a pre-enactment plan before the transaction. As is the case of any merger involving a multiple employer plan, the merger would not affect whether the multiple employer plan is treated as a pre-enactment plan with respect to any other employer.

Under section 410(b)(6)(C)(ii), the transition period begins on the date of the change in members of a controlled group (as described in section 414(b), (c), (m), or (o)) and ends on the last day of the first plan year beginning after the date of that change. In response to Notice 2024-2, one commenter requested that the guidance provided in Q&A A-3 be modified to extend the time period for a plan merger until the end of the first plan year that begins after the end of the section 410(b)(6)(C) transition period. The proposed regulation would not extend the time period set forth in Q&A A-3 of Notice 2024-2 because that is the time period specified in the Code for an employer to implement changes to its plans that may be needed following a transaction described in section 410(b)(6)(C).

With respect to a merger of a multiple employer plan that is a pre-enactment plan with a multiple employer plan that is not a pre-enactment plan, the proposed regulation would clarify the guidance provided in Q&A A-3 of Notice 2024-2 by providing that the merger will not affect whether the merged plan is treated as a pre-enactment plan with respect to any employer that maintained either multiple employer plan prior to the merger.

4. *Treatment of adoption of, or merger with, a multiple employer plan*

As described in section II.A of the Background portion of this preamble, section 414A(c)(2)(B) provides special rules that apply in the case of an employer that adopts, after December 29, 2022, a plan maintained by more than one employer. Consistent with the interpretation of the statutory phrase “a plan maintained by more than 1 employer” in section 414A(c)(4)(C), as described in section I.C.3 of this Explanation of Provisions, the proposed regulation would clarify that the phrase “a plan maintained by more than one employer” in section 414A(c)(2)(B) means a multiple employer plan. Thus, the proposed regulation would provide that if an employer adopts a multiple employer plan after December 29, 2022, then, with respect to that employer, the multiple employer plan will not be treated as a pre-enactment plan. However, this treatment would not affect employers who adopted the multiple employer plan on or before December 29, 2022.

With respect to the merger of a plan (other than a multiple employer plan) with a multiple employer plan after December 29, 2022, the proposed regulation generally would incorporate the guidance provided in Q&A A-2 and Q&A A-3 of Notice 2024-2 (which, under Q&A A-5 of Notice 2024-2, also applies to section 403(b) plans). Thus, for example, if an employer merged a plan that was not a pre-enactment plan into a pre-enactment multiple employer plan after December 29, 2022, the multiple employer plan generally would not be treated as a pre-enactment plan with respect to that employer after the merger.

In response to Notice 2024-2, the Treasury Department and the IRS received a number of comments expressing concern that, in the case of an employer maintaining a pre-enactment plan that is merged into a multiple employer plan that was established after December 29, 2022, the multiple employer plan would not be treated as a pre-enactment plan with respect to that employer after the merger. The comments requested guidance providing that if a pre-enactment plan is merged into a multiple employer plan, then the merged-in plan does not lose its pre-enactment status with respect to the employer that maintained the merged-in plan regardless of whether the multiple employer plan was established before or after December 29, 2022. In response to these comments, the proposed regulation would provide that, if an employer maintains a pre-enactment plan that is merged into a multiple employer plan after December 29, 2022, then the post-merger multiple employer plan will be treated as a pre-enactment plan with respect to that employer. This rule would apply regardless of the date of establishment of the multiple employer plan.

The proposed regulation also would clarify that the special rule set forth in section 414A(c)(2)(B) regarding the adoption of a multiple employer plan after December 29, 2022, applies on an employer-by-employer basis. Thus, under the

proposed regulation, neither an employer's adoption of a multiple employer plan nor a merger of an employer's plan into a multiple employer plan after December 29, 2022, would affect whether the multiple employer plan is treated as a pre-enactment plan with respect to any other employer maintaining the plan.

5. *Plan spin-off*

The proposed regulation would incorporate the guidance provided in Q&A A-4 of Notice 2024-2 by providing that if a portion of a pre-enactment plan is spun off from that plan, the resulting spun-off plan will be treated as a pre-enactment plan if either the plan from which the spin-off occurred was not a multiple employer plan, or the plan from which the spin-off occurred was a multiple employer plan that was treated as a pre-enactment plan with respect to the employer maintaining the spun-off plan.

6. *Other plan amendments*

In response to Notice 2024-2, the Treasury Department and the IRS received comments requesting guidance on whether changes to a plan's design or other plan amendments would affect the date the plan was established for purposes of section 414A(c)(2)(A). In response to these comments, the proposed regulation would clarify that a plan will not fail to be a pre-enactment plan merely because the plan is amended, provided that the amendment is not an amendment relating to an adoption of a multiple employer plan or a plan merger. This rule would apply even if the plan amendment expands eligibility to participate in the CODA (or to enter into a salary reduction agreement) to other employees of the employer that maintains the plan or to employees of another employer in the employer's controlled group. The proposed regulation also would clarify that if a pre-enactment plan is merged with a plan that does not include a CODA or permit any salary reduction agreements, then the merged plan will continue to be a pre-enactment plan after the merger.

In response to Notice 2024-2, the Treasury Department and the IRS also received comments requesting guidance on whether a change in a plan's service provider would affect the date the plan was established for purposes of section 414A(c)(2)(A). Generally, a mere change in a plan's recordkeeper would not necessitate an amendment to the plan. However, if a plan's change of recordkeeper or any similar change required a plan amendment that does not relate to the adoption of a multiple employer plan or a plan merger, then, under the proposed regulation, the amendment would not cause the plan to fail to be a pre-enactment plan.

E. *Applicability date*

1. Statutory applicability date

In accordance with section 101(c) of the SECURE 2.0 Act, the proposed regulation would provide that section 414A applies to plan years beginning after December 31, 2024.

2. Regulatory applicability date

The proposed regulation would apply to plan years that begin more than 6 months after the date that final regulations under section 414A are issued. For earlier plan years, a plan would be treated as having complied with section 414A if the plan complies with a reasonable, good faith interpretation of section 414A.

As explained in section I.B.1 of this Explanation of Provisions, the proposed regulation would require an EACA to cover all employees in the plan who are eligible to elect to have contributions made on their behalf for the automatic enrollment requirements of the proposed regulation to be satisfied. If a CODA or section 403(b) plan that provides for salary reduction agreements becomes subject to the requirements of section 414A(a) as of the first day of the plan year beginning after December 31, 2024 (2025 plan year), but employees who became eligible to participate in the CODA or to enter into a salary reduction agreement before the first day of the 2025 plan year (and who do not have affirmative elections in effect on that date) are not covered under the EACA, then those employees would have to be covered under the EACA on the first day of the first plan year that the final regulations apply to the CODA or to the section 403(b) plan that provides for salary reduction agreements (first applicable plan year).

As a result, under the proposed regulation, unless employees who became eligible to participate in the CODA or to enter into a salary reduction agreement before the first day of the 2025 plan year have affirmative elections in effect on the first day of the first applicable plan year, those employees would need to be automatically enrolled as of that date in order for the requirements of the regulation to be satisfied. In that case, the default contribution percentage would be the percentage that would apply under the EACA for the first applicable plan year had those employees been automatically enrolled starting on the first day of the 2025 plan year. As an alternative, the plan terms could reflect the provision in the proposed regulation permitting the redetermination of the initial period in the case of an employee who did not have default elective contributions made for an entire plan year (so that the plan would be permitted to provide that the initial contribution percentage that applies to those employees is the percentage that would apply under the EACA had the initial period for those employees started on the first day of the first applicable plan year).

F. *Other matters*

1. *Multiemployer plans*

As described in section I.D.4 of this Explanation of provisions, the proposed regulation would clarify that, for purposes of section 414A(c)(2)(B), the phrase "a plan maintained by more than one employer" means "a multiple employer plan." Thus, the phrase "a plan maintained by more than one employer" would not be interpreted to include a multiemployer plan or a plan maintained by members of a controlled group. As a result, under the proposed regulation, a pre-enactment multiemployer plan would continue to be treated as a pre-enactment plan with respect to an employer that adopts the plan after December 29, 2022, or with respect to an employer that maintains a plan that is merged into the multiemployer plan after December 29, 2022 (regardless of the date the merged-in plan was established). Similarly, a pre-enactment plan would continue to be treated as a pre-enactment plan

with respect to additional members of an employer's controlled group if eligibility to participate in the plan is expanded to include employees of those employers after December 29, 2022.

2. *PLESAs*

The Department of Labor published a request for information soliciting public feedback on several sections of the SECURE 2.0 Act in the **Federal Register** (88 FR 54511). In response to comments received, this preamble addresses the interaction of the rules for a PLESA and the automatic enrollment requirements of section 414A.

If a plan with a qualified CODA includes a PLESA, then the PLESA is part of the CODA. Thus, an affirmative election to contribute to a PLESA is an affirmative election to contribute to the CODA. If the plan is subject to the automatic enrollment requirements of section 414A, then an affirmative election to contribute to a PLESA would be an affirmative election under the CODA for purposes of the proposed regulation.

If an employee is automatically enrolled to contribute to a PLESA, the investment requirements of section 414A(b)(4) and proposed §1.414A-1(c)(4) (which reference the Department of Labor's rules for qualified default investment alternatives under 29 CFR 2550.404c-5) generally would not be satisfied with respect to the automatic contributions to the PLESA.[10] Thus, automatic contributions to the PLESA would not be able to be used to satisfy the automatic enrollment requirements under section 414A.

II. *Section 1.414(w)-1*

A. *Employees covered by the EACA*

As explained in section I.B.1 of this Explanation of Provisions, proposed §1.414A-1 would clarify that, in order for a CODA or salary reduction agreement under section 403(b) to satisfy the automatic enrollment requirements of section 414A, all employees in the plan who are eligible to elect to have contributions made on their behalf under the CODA or pursuant to a salary reduction agreement must be covered by the EACA. Section 1.414(w)-1(b)(1) currently provides that an EACA need not cover all employees who are eligible to elect to have contributions made on their behalf under the applicable employer plan. For consistency with proposed §1.414A-1, this notice of proposed rulemaking would amend §1.414(w)-1(b)(1) to clarify that the section 414A requirement to be covered by an EACA overrides the existing rule in the EACA regulations.

B. *Special rules relating to notices*

1. *Unenrolled participants*

As described in section II.B of the Background portion of this preamble, section 320 of the SECURE 2.0 Act adds new section 414(bb) to the Code. This notice of proposed rulemaking would reflect section 414(bb) by amending §1.414(w)-1 to add a new paragraph under which, if the requirements of section 414(bb)(1) are satisfied with respect to an unenrolled participant (as defined in section 414(bb)(2)),[11] then the requirement to give the section 414(w)(4) notice of an employee's rights and obligations does not apply to the participant. Thus, an unenrolled participant does not need to be given the annual EACA notice, provided that the participant is furnished (1) annual reminder notices under section 414(bb)(1)(A), and (2) any document requested by the participant (if the participant would be entitled to receive the document in the absence of section 414(bb) and section 111 of ERISA).

2. *Consolidation of notices*

As described in section II.B of the Background portion of this preamble, section 402A(e)(5)(C) of the Code (as added by section 127 of the SECURE 2.0 Act) permits the initial and annual notices required under section 402A(e)(5)(A) of the Code to be included with any other notice under ERISA, including under section 404(c)(5)(B) or 514(e)(3) of ERISA, or under section 401(k)(13)(E) or 414(w)(4) of the Code, if the other notice is provided to the participant at the time required for that notice. In addition, section 341 of the SECURE 2.0 Act permits a plan to consolidate two or more of the notices required under sections 404(c)(5)(B) and 514(e)(3) of ERISA and sections 401(k)(12)(D), 401(k)(13)(E), and 414(w)(4) of the Code into a single notice, provided that the combined notice satisfies certain requirements.

The proposed amendment to §1.414(w)-1 would address section 402A(e)(5)(C) of the Code and section 341 of the SECURE 2.0 Act by adding a new paragraph that provides that the EACA notice required under §1.414(w)-1(b)(3) generally may be combined with one or more of the notices required under section 404(c)(5)(B), 514(e)(3), or 801(d)(3)(A) of ERISA and section 401(k)(12)(D) or 401(k)(13)(E) of the Code. Consistent with section 341 of the SECURE 2.0 Act, the proposed regulation would require that the combined notice include the required content, clearly identify the issues addressed therein, be furnished at the time and with the frequency required for each notice, be presented in a manner that is reasonably calculated to be understood by the average plan participant, and not obscure or fail to highlight the primary information required for each notice.

Proposed Applicability Date

Section 1.414A-1 and the amendments to §1.414(w)-1 are proposed to apply to plan years that begin more than 6 months after the date that final regulations under section 414A are issued. For a plan year

[10] *The Department of Labor published frequently asked questions online providing general compliance information under ERISA regarding PLESAs providing that, generally, the investment option designated for PLESAs cannot be the same as a plan's qualified default investment alternative under 29 CFR 2550.404c-5(e)(4)(i). However, Q&A-15 does indicate that a PLESA's investment option could meet the requirements for a qualified default investment alternative for a short period of time.*

[11] *Section 414(bb)(2) defines an unenrolled participant as an employee who: (1) is eligible to participate in a defined contribution plan, (2) has been furnished the summary plan description pursuant to section 104(b) of ERISA for the plan and any other notices related to eligibility under the plan and required to be furnished under the Code or ERISA in connection with the participant's initial eligibility to participate in the plan, (3) is not participating in the defined contribution plan, and (4) satisfies any other criteria as the Secretary of the Treasury may determine appropriate, as prescribed in guidance issued in consultation with the Secretary of Labor.*

beginning after December 31, 2024, but before the applicability date of those final regulations, a plan is treated as having complied with section 414A if the plan complies with a reasonable, good faith interpretation of section 414A.

Special Analyses

I. *Regulatory Planning and Review*

Pursuant to the Memorandum of Agreement, Review of Treasury Regulations under Executive Order 12866 (June 9, 2023), tax regulatory actions issued by the IRS are not subject to the requirements of section 6 of Executive Order 12866, as amended. Therefore, a regulatory impact assessment is not required.

II. *Paperwork Reduction Act*

The Paperwork Reduction Act of 1995 (44 U.S.C. 3501 - 3520) (PRA) requires that a Federal agency obtain the approval of the Office of Management and Budget (OMB) before collecting information from the public, whether such collection of information is mandatory, voluntary, or required to obtain or retain a benefit. A Federal agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collections of information in these proposed regulations contain third-party disclosure requirements that are necessary to comply with the statutory requirement under section 414A of the Code (which requires certain CODAs or salary reduction agreements to be EACAs) and that are necessary if a plan applies section 414(bb) (which eliminates certain disclosure and notice requirements for unenrolled participants if an annual notice is provided to the unenrolled participants). These collections of information generally would be provided by businesses or other for-profit institutions, nonprofit institutions, organizations, and state or local governments that sponsor retirement plans that include EACAs to individuals in order to meet the statutory notice requirements for EACAs under section 414(w)(4).

The collection of information under proposed §1.414(w)-1(b)(4) related to unenrolled participants is required in order for a plan to apply section 414(bb). Section 414(bb) provides that no disclosure, notice, or other plan document is required to be furnished under the Code to an unenrolled participant if the unenrolled participant is furnished an annual reminder notice of the unenrolled participant's eligibility to participate in the plan and any applicable election deadlines under the plan. In accordance with section 414(bb), the proposed regulation would allow unenrolled participants to be furnished an annual reminder notice instead of the annual notice required for EACAs under section 414(w)(4) and §1.414(w)-1(b)(3). The burden is as follows:

Estimated number of respondents: 90,000 – 140,000 plans.

Estimated frequency of responses: Varies*.

**The notice would only need to be furnished to unenrolled participants once per year, however, plans have multiple unenrolled participants within a given year. For calculation purposes, IRS is estimating that each employer plan has 35 unenrolled participants that could receive the annual notice.*

Estimated average annual burden per respondent: 1 hour*, to draft the notice and provide it to unenrolled participants.

**The IRS estimates that the reporting burden per response would not be burdensome because the notice does not need to be customized per participant.*

Estimated total annual reporting burden: 90,000 – 140,000 hours.

The collections of information in these proposed regulations also contain third-party disclosure requirements that are necessary to comply with the statutory rule under section 414A, which requires certain CODAs and salary reduction agreements to be EACAs (as defined in section 414(w)(3)). Under §1.414(w)-1(b)(3), initial and annual written notices must be given to each employee to whom the EACA applies of the employee's rights and obligations under the EACA. Proposed §1.414A-1 would not change the notice requirements for an EACA under §1.414(w)-1 but would subject certain CODAs and salary reduction agreements to the notice requirements for an EACA by requiring those CODAs and salary reduction agreements to be EACAs (as required by section 414A). This requirement to be an EACA would not affect pre-enactment plans. IRS anticipates about 16,000 new plans could be established within a given year that would not otherwise be EACAs except for the requirements of section 414A.

Estimated number of respondents: 16,000.

Estimated frequency of responses: Varies*.

**Notice would need to be given to eligible employees once per year. For calculation purposes, IRS is estimating that each employer plan has 60 eligible employees that would receive the annual notice.*

Estimated average annual burden per respondent: 1 hour*, to draft the notice and provide it to eligible employees.

**The IRS estimates that the reporting burden per response would not be burdensome because the notice does not need to be customized per participant.*

Estimated total annual reporting burden: 16,000 hours.

IRS is soliciting feedback on these third-party disclosure requirements and their associated burden. The third-party disclosure requirements contained in this notice of proposed rulemaking have been submitted to OMB for review in accordance with the Paperwork Reduction Act under OMB Control Number 1545-2135. Commenters are strongly encouraged to submit public comments electronically. Written comments and recommendations for the proposed information collection should be sent to *www.reginfo.gov/public/do/PRAMain*, with copies to the Internal Revenue Service. Find this particular information collection by using the search function at *www.reginfo.gov/public/do/PRAMain*. Submit electronic submissions for the proposed information collection to the IRS via email at *pra.comments@irs.gov* (indicate REG-100669-24 on the Subject line). Comments on the collection of information should be received by March

17, 2025. Comments are specifically requested concerning:

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

The accuracy of the estimated burden associated with the proposed collection of information;

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

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

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

III. *Regulatory Flexibility Act*

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these proposed regulations will not have a significant economic impact on a substantial number of small entities. Although section 414A provides an exception from the automatic enrollment requirements for some small entities, other small entities that sponsor section 401(k) or 403(b) plans that are established on or after December 29, 2022, may need to provide for automatic enrollment in the plans and default cash or deferred or salary reduction elections for employees who are otherwise eligible to participate in the plans. Automatic enrollment and default elections, and the resulting additional contributions to a plan, apply to compensation that employees would have otherwise received and do not require additional amounts to be paid. Section 414A does not require plans to provide for nonelective contributions or matching contributions. Before the enactment of section 101 of the SECURE 2.0 Act, plans were permitted, but not required, to provide for automatic enrollment. Accordingly, any additional recordkeeping or administrative costs resulting from the automatic enrollment requirements that apply to certain section 401(k) and 403(b) plans sponsored by small entities are not expected to be significant. Therefore, a regulatory flexibility analysis under the Regulatory Flexibility Act is not required.

The Treasury Department and the IRS invite comments on the impacts these proposed regulations may have on small entities. 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 their impact on small businesses.

IV. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or Tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. The proposed regulations do not propose any rule that would include any Federal mandate that may result in expenditures by State, local, or Tribal governments, or by the private sector, in excess of that threshold.

V. *Executive Order 13132: Federalism*

Executive Order 13132 (Federalism) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or preempts State law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. The proposed regulations do not propose rules that would have federalism implications, impose substantial direct compliance costs on State and local governments that are not required by statute, or preempt State law within the meaning of the Executive order. This is because section 414A, by its terms, does not apply to governmental plans.

Comments and Public Hearing

Before final regulations are adopted to implement section 414A of the Code, or to revise the regulations under section 414(w) to reflect changes made by sections 101, 320, and 341 of the SECURE 2.0 Act, consideration will be given to comments regarding the notice of proposed rulemaking that are submitted timely to the IRS as prescribed in this preamble under the **ADDRESSES** section. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. Comments specifically are requested on whether guidance is needed to define the term "predecessor employer" as used in section 414A(c)(4)(A) of the Code and on the criteria that should apply for an individual to be an unenrolled participant under section 414(bb)(2). All comments will be made available at *www.regulations.gov*. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn.

A public hearing has been scheduled for April 8, 2025, beginning at 10 a.m. ET in the Auditorium of the Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. Participants may alternatively attend the public hearing by telephone.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit an outline of the topics to be addressed and the time to be devoted to each topic by March 17, 2025, as prescribed in the preamble under the **DATES** section. A period of 10 minutes will be allocated to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing. If no outline of the topics to be discussed at the hearing is received by March 17, 2025, the public hearing will be cancelled. If the public hearing is cancelled, a notice of cancellation of the public hearing will be published in the **Federal Register**.

Individuals who want to testify in person at the public hearing must send an email to *publichearings@irs.gov* to

have their names added to the building access list. The subject line of the email must contain the regulation number REG-100669-24 and the language TESTIFY In Person. For example, the subject line may say: Request to TESTIFY In Person at Hearing for REG-100669-24.

Individuals who want to testify by telephone at the public hearing must send an email to *publichearings@irs.gov* to receive the telephone number and access code for the hearing. The subject line of the email must contain the regulation number REG-100669-24 and the language TESTIFY Telephonically. For example, the subject line may say: Request to TESTIFY Telephonically at Hearing for REG-100669-24.

Individuals who want to attend the public hearing in person without testifying must also send an email to *publichearings@irs.gov* to have their names added to the building access list. The subject line of the email must contain the regulation number REG-100669-24 and the language ATTEND In Person. For example, the subject line may say: Request to ATTEND Hearing In Person for REG-100669-24. Requests to attend the public hearing must be received by 5 p.m. ET on April 4, 2025.

Individuals who want to attend the public hearing by telephone without testifying must also send an email to *publichearings@irs.gov* to receive the telephone number and access code for the hearing. The subject line of the email must contain the regulation number REG-100669-24 and the language ATTEND Hearing Telephonically. For example, the subject line may say: Request to ATTEND Hearing Telephonically for REG-100669-24. Requests to attend the public hearing must be received by 5 p.m. ET on April 4, 2025.

Hearings will be made accessible to people with disabilities. To request special assistance during the hearing, please contact the Publications and Regulations Branch of the Office of Associate Chief Counsel (Procedure and Administration) by sending an email to *publichearings@irs.gov* (preferred) or by telephone at (202) 317-6901 (not a toll-free number) by April 3, 2025.

Statement of Availability of IRS Documents

IRS Revenue Procedures, Revenue Rulings notices, and other guidance cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at *www.irs.gov*.

Drafting Information

The principal authors of these proposed regulations are Christina M. Cerasale and Kara M. Soderstrom, of the Office of the Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes (EEE)). However, other personnel from the Treasury Department and the IRS participated in the development of the proposed regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, the Treasury Department and the IRS propose to amend 26 CFR part 1 as follows:

PART 1—INCOME TAXES

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

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

* * * * *

Par. 2. Section 1.414(w)-1 is amended by:

a. Revising the second sentence of paragraph (b)(1); and

b. Adding paragraph (b)(4).

The revision and addition read as follows:

§1.414(w)-1 Permissible withdrawals from eligible automatic contribution arrangements.

* * * * *

(b) *Eligible automatic contribution arrangement*—(1) *In general*. * * * Except to the extent required under section 414A (which applies to plan years beginning after December 31, 2024), an eligible automatic contribution arrangement need not cover all employees who are eligible to elect to have contributions made on their behalf under the applicable employer plan.

* * * * *

(4) *Special rules*—(i) *No requirement to provide notice to unenrolled participant.* If the requirements of section 414(bb)(1) are satisfied with respect to an unenrolled participant described in section 414(bb)(2), then the requirement to give the notice of an employee's rights and obligations set forth in paragraph (b)(3) of this section does not apply to the participant.

(ii) *Consolidation of notices*. The notice described in paragraph (b)(3) of this section may be combined with one or more of the notices required under section 404(c)(5)(B), 514(e)(3), or 801(d)(3)(A) of the Employee Retirement Income Security Act of 1974 (Public Law 93-406, 88 Stat. 829), as amended, and any notice required under section 401(k)(12)(D) or (13)(E), provided that the combined notice—

(A) Includes the required content,

(B) Clearly identifies the issues addressed therein,

(C) Is furnished at the time and with the frequency required for each notice,

(D) Is presented in a manner that is reasonably calculated to be understood by the average plan participant, and

(E) Does not obscure or fail to highlight the primary information required for each notice.

* * * * *

Par. 3. Section 1.414A-1 is added to read as follows:

§1.414A-1 Automatic enrollment requirements under section 414A.

(a) *Overview*. This section provides rules regarding the automatic enrollment requirements under section 414A. Paragraph (b) of this section provides that a plan that includes a qualified cash or deferred arrangement under section 401(k) or a salary reduction agreement under section 403(b) is required to satisfy the automatic enrollment requirements of paragraph (c) of this section unless an exception described in paragraph (d) of this section (for certain types

of plans and businesses) or paragraph (e) of this section (for a cash or deferred arrangement or section 403(b) plan established before December 29, 2022) applies to the plan. The applicability date of section 414A and the applicability date of this section are set forth in paragraph (f) of this section.

(b) *General rule*—(1) *Qualified cash or deferred arrangements*. Except as provided in paragraph (d) or (e) of this section, a cash or deferred arrangement will not be treated as a qualified cash or deferred arrangement described in §1.401(k)-1(a)(4)(i) for a plan year unless the plan that includes the arrangement provides that any cash or deferred election under the arrangement must satisfy the automatic enrollment requirements of paragraph (c) of this section.

(2) *Section 403(b) plans with salary reduction agreements*. Except as provided in paragraph (d) or (e) of this section, an annuity contract described in section 403(b) that is purchased pursuant to a salary reduction agreement described in §31.3121(a)(5)-2(a)(1) (that is, an election to reduce compensation pursuant to a cash or deferred election as defined in §1.401(k)-1(a)(3)) will not be treated as purchased under a section 403(b) plan for a plan year unless the plan provides that any salary reduction agreement under the plan must satisfy the automatic enrollment requirements of paragraph (c) of this section.

(c) *Automatic enrollment requirements*—(1) *In general*—(i) *Arrangement must be an eligible automatic contribution arrangement*. A cash or deferred arrangement or salary reduction agreement under a plan satisfies the automatic enrollment requirements of this paragraph (c) only if the plan provides for an eligible automatic contribution arrangement (as defined in section 414(w)(3)) that—

(A) Covers the employees described in paragraph (c)(1)(ii) of this section, and

(B) Satisfies the additional requirements of paragraphs (c)(2) through (4) of this section.

(ii) *Employees covered under the eligible automatic contribution arrangement*. The employees who must be covered by the eligible automatic contribution arrangement are all employees in the plan who are eligible to elect to have contributions made on their behalf under a cash or deferred arrangement or pursuant to a salary reduction agreement.

(iii) *Exception to default election for employees with an affirmative election.* An eligible automatic contribution arrangement will not fail to satisfy the requirements of this paragraph (c) merely because the default election under the arrangement does not apply to an employee who, on the date paragraph (b) of this section first applies to the plan that includes the cash or deferred arrangement or salary reduction agreement, had an affirmative election in effect (that remains in effect) to—

(A) Have contributions made on the employee's behalf under a cash or deferred election or a salary reduction agreement (in a specified amount or percentage of compensation); or

(B) Not have contributions made on the employee's behalf under a cash or deferred election or a salary reduction agreement.

(2) *Arrangement must permit permissive withdrawals*. An eligible automatic contribution arrangement satisfies the requirements of this paragraph (c)(2) only if the plan that includes the arrangement provides that any employee who has default elective contributions made under the arrangement may elect to make a permissible withdrawal (as defined in section 414(w)(2) and described in §1.414(w)-1(c)).

(3) *Contribution requirements*—(i) *Default election*. An eligible automatic contribution arrangement under a plan satisfies the requirements of this paragraph (c)(3) only if, under the arrangement, the default election made on behalf of an employee is equal to a uniform percentage, as described in paragraph (c)(3)(ii) of this section, of the employee's compensation that is subject to a cash or deferred election or salary reduction arrangement under the plan, unless the employee affirmatively elects to—

(A) Have contributions made in a different amount on the employee's behalf under a cash or deferred election or a salary reduction agreement (in a specified amount or percentage of compensation); or

(B) Not have contributions made on the employee's behalf under a cash or deferred election or a salary reduction agreement.

(ii) *Uniform percentage*—(A) *Initial period*—(*1*) *Initial percentage*. The contribution percentage under the default election for each employee's initial period must be a uniform percentage that is not less than 3 percent and not more than 10 percent.

(*2*) *Beginning of initial period*. An employee's initial period begins when the employee is first eligible to elect to have contributions made on the employee's behalf under the plan (or if later, when section 414A first applies to the plan).

(*3*) *End of initial period*. The employee's initial period ends on the last day of the plan year that follows the plan year that includes the date the initial period begins.

(B) *Subsequent plan years*. For each plan year beginning after an employee's initial period under the arrangement, the percentage contribution under the default election must be increased by 1 percentage point until the percentage is at least 10 percent. However, the percentage may not exceed 15 percent (or the lower percentage specified in section 414A(b)(3)(B), if applicable).

(iii) *Exception to uniform percentage requirement*. An eligible automatic contribution arrangement does not fail to satisfy the uniform percentage requirement of paragraph (c)(3)(ii) of this section merely because—

(A) The percentage used for the default election varies based on the number of years (or portions of years) since the beginning of the initial period for an employee;

(B) The rate of contributions under a cash or deferred election or salary reduction agreement that is in effect for an employee immediately prior to the date that the default election under paragraph (c) of this section first applies to the employee is not reduced;

(C) The rate of contributions under a cash or deferred election or salary reduction agreement is limited so as not to exceed the applicable limits of sections 401(a)(17), 401(k)(16), 402(g) (determined with or without catch-up contributions), 403(b)(16), and 415; or

(D) The default election provided under paragraph (c)(3)(i) of this section is not applied during the period an employee is not permitted to have contributions

made on the employee's behalf under a cash or deferred election or salary reduction agreement in order for the plan to satisfy the requirements of section 414(u)(12)(B)(ii).

(iv) *Treatment of periods without default contributions*—(A) *Permissive redetermination of initial period in certain situations*. The uniform percentages described in paragraph (c)(3)(ii) of this section are based on the date an employee's initial period begins. However, if, after the employee's initial period began, the employee did not have default elective contributions made for an entire plan year, then the plan is permitted to provide that the employee's initial period is redetermined as described in paragraph (c)(3)(iv)(B) or (C) of this section.

(B) *Redetermination for employee who became ineligible*. If, for an entire plan year, no default elective contributions were made solely because the employee was not eligible to elect to have contributions made on the employee's behalf under a cash or deferred election or salary reduction agreement for that plan year, then the plan is permitted to provide that the employee's initial period is redetermined so that it begins on the date the employee is again eligible to elect to have contributions made on the employee's behalf under the plan.

(C) *Redetermination for employee who remained eligible and made an affirmative election.* If, for an entire plan year, no default elective contributions were made solely because the employee made an affirmative election to have contributions made on the employee's behalf under a cash or deferred election or salary reduction agreement in a different amount (including an election not to have contributions made), then the plan is permitted to provide that the initial period is redetermined so that it begins on any date specified under the plan that is later than the date specified in paragraph (c)(3)(ii)(A)(*3*) of this section.

(4) *Investment requirements*. An eligible automatic contribution arrangement satisfies the requirements of this paragraph (c)(4) only if amounts contributed pursuant to the arrangement, and for which no investment is elected by the employee, are invested in accordance with the requirements of 29 CFR 2550.404c-5 (or any successor regulations).

(d) *Exceptions for certain types of plans and businesses*—(1) *SIMPLE 401(k) plans*. Paragraph (b) of this section does not apply to any SIMPLE 401(k) plan (as described in section 401(k)(11) and §1.401(k)-4).

(2) *Governmental plans*. Paragraph (b) of this section does not apply to any governmental plan (within the meaning of section 414(d)).

(3) *Church plans*. Paragraph (b) of this section does not apply to any church plan (within the meaning of section 414(e)).

(4) *New and small businesses*—(i) *New businesses*. Paragraph (b) of this section does not apply to any qualified cash or deferred arrangement, or any annuity contract purchased under a section 403(b) plan, for a plan year if, as of the beginning of the plan year, the employer maintaining the plan (aggregated with any predecessor employer) has been in existence for less than 3 years.

(ii) *Small businesses.* Paragraph (b) of this section does not apply to any qualified cash or deferred arrangement, or any annuity contract purchased under a section 403(b) plan, before the first plan year that begins at least 12 months after the close of the first taxable year of the employer maintaining the plan with respect to which that employer normally employed more than 10 employees. For this purpose, the number of employees that the employer normally employs for a taxable year is determined using the rules of Q&A-5 of §54.4980B-2 of this chapter.

(iii) *Applicability to multiple employer plans*. In the case of a multiple employer plan, the exceptions provided in paragraphs (d)(4)(i) and (ii) of this section apply on an employer-by-employer basis.

(iv) *Example*—(A) *Facts*. Employer Q has been in existence since July 1, 2026, and does not have a predecessor employer. Employer Q maintains Plan X, which has a plan year that is the calendar year and includes a cash or deferred arrangement. Plan X was effective on January 1, 2027, and provides that a cash or deferred election must be an affirmative election. Employee M, who became eligible to elect to have contributions made on Employee M's behalf under Plan X on January 1, 2027, made an affirmative election not to have elective contributions made on Employee M's behalf and that affirmative election is in effect on January 1, 2030. Employee N, who also became eligible to elect to have contributions made on Employee N's behalf under Plan X on January 1, 2027, has not made any election to have (or not have) contributions made on Employee N's behalf under Plan X. Effective January 1, 2030, Plan X is amended to include an eligible automatic contribution arrangement that satisfies the requirements of paragraphs (c)(2) through (4) of this section. The amendment provides that an employee who has a cash or deferred election that is an affirmative election and is in effect on January 1, 2030, is not subject to the default election under the eligible automatic contribution arrangement that is included in Plan X.

(B) *Analysis and Conclusion*. Because the exception for new businesses set forth in paragraph (d)(4)(i) of this section ceases to apply to Plan X for plan years beginning on or after January 1, 2030, paragraph (b) of this section first applies to Plan X as of that date. Pursuant to paragraph (c)(1)(iii) of this section, the eligible automatic contribution arrangement required to be included in Plan X for plan years beginning on January 1, 2030, does not fail to satisfy the requirements of paragraph (c) of this section merely because the default election under the arrangement does not apply to Employee M as a result of Employee M's affirmative election. However, Plan X does not satisfy the requirements of section 414A unless the default election in paragraph (c)(3) of this section applies to Employee N because of the absence of an affirmative election made by Employee N to have elective contributions made on Employee N's behalf in a different amount (or to not have elective contributions made on Employee N's behalf).

(e) *Exception for plans established before the enactment of section 414A*—(1) *In general*. Subject to the rules of application in paragraphs (e)(2) through (6) of this section, paragraph (b) of this section does not apply to—

(i) Any plan that includes a qualified cash or deferred arrangement if the plan terms providing for the qualified cash or deferred arrangement were adopted initially before December 29, 2022 (the date of the enactment of section 414A), even if the plan terms providing for the cash or deferred arrangement are effective after that date, or

(ii) Any section 403(b) plan adopted initially before December 29, 2022, without regard to the date of adoption of plan terms providing for salary reduction agreements.

(2) *Merger of plans established before the enactment of section 414A*—(i) *General rule*. If two plans described in paragraph (e)(1)(i) of this section are merged, then the merged plan will be treated as a plan described in paragraph (e)(1)(i) of this section. Similarly, if two section 403(b) plans described in paragraph (e)(1)(ii) of this section are merged, then the merged plan will be treated as a section 403(b) plan described in paragraph (e)(1)(ii) of this section.

(ii) *Effect of merger of multiple employer plans on participating employers*. If either of the plans described in paragraph (e)(2)(i) of this section are multiple employer plans, then the merger will not affect whether the merged plan is treated as a plan described in paragraph (e)(1) of this section with respect to any employer that maintained the multiple employer plan prior to the merger.

(3) *Merger of a plan established on or after the enactment of section 414A with a plan established before the enactment of section 414A*—(i) *General rule*—(A) *Section 401(k) plans*. Except as provided in paragraphs (e)(3)(ii), (iii), and (4)(ii) of this section, if a plan that includes a cash or deferred arrangement and that is not described in paragraph (e)(1)(i) of this section is merged with a plan described in paragraph (e)(1)(i) of this section, then the merged plan will not be treated as a plan described in paragraph (e)(1)(i) of this section.

(B) *Section 403(b) plans*. Except as provided in paragraphs (e)(3)(ii), (iii), and (4)(ii) of this section, if a section 403(b) plan that is not described in paragraph (e)(1)(ii) of this section is merged with a plan described in paragraph (e)(1)(ii) of this section, then the merged plan will not be treated as a plan described in paragraph (e)(1)(ii) of this section.

(ii) *Exception for certain transactions*. A plan that is maintained by a single employer and described in paragraph (e)(1) of this section will continue to be treated as described in paragraph (e)(1) of this section after a merger described in paragraph (e)(3)(i) of this section, if—

(A) There is a transaction described in §1.410(b)-2(f),

(B) The plan described in paragraph (e)(1) of this section is designated as the ongoing plan, and

(C) The plan merger occurs within the transition period described in section 410(b)(6)(C)(ii).

(iii) *Applicability to multiple employer plans*—(A) *Applicability of exception for certain transactions involving a merger into a multiple employer plan*. In the case of a merger of a plan that is not a multiple employer plan and not described in paragraph (e)(1) of this section into a multiple employer plan that is designated as the ongoing plan, paragraph (e)(3)(ii) of this section applies even though the ongoing plan is a multiple employer plan and without regard to whether that plan is a plan described in paragraph (e)(1) of this section, provided that prior to the transaction described in paragraph (e)(3)(ii)(A) of this section, the multiple employer plan was treated as a plan described in paragraph (e)(1) of this section with respect to the employer that maintained the multiple employer plan and engaged in the transaction.

(B) *Merger of multiple employer plans*. If both of the plans described in paragraph (e)(3)(i) of this section are multiple employer plans, then the exception in paragraph (e)(3)(ii) of this section does not apply. In such a case, the merger will not affect whether the merged plan is treated as a plan described in paragraph (e)(1) of this section with respect to any employer that maintained either multiple employer plan prior to the merger.

(4) *Treatment of adoption of, or merger with, a multiple employer plan*—(i) *In general*. If, after December 29, 2022, an employer adopts a multiple employer plan, then, with respect to that employer, the multiple employer plan will not be treated as a plan described in paragraph (e)(1) of this section. The same treatment will apply if the employer maintains a plan other than a multiple employer plan that is merged with a multiple employer plan after December 29, 2022, unless the merger is described in paragraph (e)(3)(iii) of this section.

(ii) *Exception for mergers involving plans established before the enactment of section 414A*. Paragraph (e)(4)(i) of this section does not apply if the plan that is merged into the multiple employer plan is a plan described in paragraph (e)(1) of this section. Thus, if the employer maintains a plan described in paragraph (e)(1) of this section that is merged into the multiple employer plan after December 29, 2022, then the multiple employer plan will be treated as a plan described in paragraph (e)(1) of this section with respect to that employer.

(iii) *Effect on other participating employers*. Neither an adoption nor a merger described in paragraph (e)(4)(i) or (ii) of this section affects whether the multiple employer plan is treated as a plan described in paragraph (e)(1) of this section with respect to any other employer maintaining the plan.

(5) *Plan spin-off*. If a portion of a plan described in paragraph (e)(1) of this section is spun off from that plan, the resulting spun-off plan will be treated as a plan described in paragraph (e)(1) of this section if either—

(i) The plan from which the spin-off occurred was not a multiple employer plan, or

(ii) The plan from which the spin-off occurred was a multiple employer plan that was treated as described in paragraph (e)(1) of this section with respect to the employer maintaining the spun-off plan.

(6) *Other plan amendments*—(i) *Treatment of amendments to a plan established before the enactment of section 414A*. A plan described in paragraph (e)(1) of this section will not fail to be described in paragraph (e)(1) of this section merely because the plan is amended, provided that the amendment is not an amendment relating to an action described in paragraph (e)(2), (3), or (4) of this section. The preceding sentence applies even if the amendment expands eligibility to participate in the cash or deferred arrangement, or to enter into a salary reduction agreement, to other employees of the employer that maintains the plan or to employees of another employer that is aggregated with the employer that maintains the plan under section 414(b), (c), or (m).

(ii) *Mergers with plans that do not include cash or deferred arrangements or salary reduction agreements.* If an employer maintains a plan that is described in paragraph (e)(1) of this section and that plan is merged with a plan that does not include a cash or deferred arrangement or permit a salary reduction agreement, then the merged plan will continue to be a plan described in paragraph (e)(1) of this section after the merger.

(7) *Examples*. The following examples illustrate the application of this paragraph (e). For purposes of the examples, each plan is maintained on a calendar-year basis, includes a cash or deferred arrangement that was adopted on the same date that the plan was adopted, and is not a SIMPLE 401(k) plan, governmental plan, or church plan. These examples assume that this section applies for plan years beginning on or after January 1, 2026, and, unless otherwise specifically provided, any plan merger does not occur in connection with a transaction described in §1.410(b)-2(f).

(i) *Example 1*—(A) *Facts*. Plan A, which is maintained by a single employer, Employer R, was adopted on January 1, 2021. Plan B, which is maintained by a single employer, Employer S, was adopted on January 1, 2025. On July 1, 2026, Plan A is merged with Plan B, and Plan A is the surviving plan in the merger.

(B) *Analysis and Conclusion*. The merger is a merger of a plan described in paragraph (e)(1)(i) of this section with a plan that is not described in paragraph (e)(1)(i) of this section and is not a merger described in paragraph (e)(3)(ii) or (4) of this section. Under paragraph (e)(3)(i)(A) of this section, Plan A will no longer be a plan described in paragraph (e)(1)(i) of this section and will be subject to paragraph (b) of this section after the merger (unless an exception described in paragraph (d)(4) of this section, relating to new or small businesses, applies to Employer R).

(ii) *Example 2*—(A) *Facts*. The facts are the same as in paragraph (e)(7)(i) of this section (*Example 1*), except that there is an acquisition described in §1.410(b)-2(f), and the plan merger occurs within the transition period described in section 410(b)(6)(C)(ii).

(B) *Analysis and Conclusion*. The merger satisfies the requirements of paragraph (e)(3)(ii) of this section. Accordingly, Plan A will continue to be excepted from paragraph (b) of this section as a plan described in paragraph (e)(1)(i) of this section after the merger.

(iii) *Example 3*—(A) *Facts*. Plan C, a multiple employer plan, was established on January 1, 2021. Plan D, a plan maintained by Employer T that is not a multiple employer plan, was adopted on January 1, 2024. Plan D merges with Plan C on December 31, 2024.

(B) *Analysis and Conclusion*. The merger is described in paragraph (e)(4)(i) of this section and because Plan D is not a plan described in paragraph (e)(1)(i) of this section, the merger is not excepted under paragraph (e)(4)(ii) of this section. Similarly, because there was no transaction described in §1.410(b)-2(f), the merger is not described in paragraph (e)(3)(iii) of this section. Accordingly, with respect to Employer T, Plan C will not be a plan described in paragraph (e)(1)(i) of this section and will be subject to paragraph (b) of this section after the merger (unless an exception described in paragraph (d)(4) of this section, relating to new or small businesses, continues to apply to Employer T). However, under paragraph (e)(4)(iii) of this section, the merger does not affect whether Plan C is treated as a plan described in paragraph (e)(1)(i) of this section with respect to any other employers.

(iv) *Example 4*—(A) *Facts*. Plan E, a plan maintained by Employer U that is not a multiple employer plan, was adopted on January 1, 2021. Plan F, a multiple employer plan, was established on January 1, 2024. Plan E merges with Plan F on December 31, 2024.

(B) *Analysis and Conclusion*. Under paragraph (e)(4)(ii) of this section, the portion of Plan F that applies with respect to Employer U will continue to be excepted from paragraph (b) of this section as a plan described in paragraph (e)(1)(i) of this section after the merger. However, under paragraph (e)(4)(iii) of this section, the merger does not affect whether Plan F is treated as a plan described in paragraph (e)(1)(i) of this section with respect to any other employers.

(v) *Example 5*—(A) *Facts*. Plan G, a plan maintained by Employer V that is not a multiple employer plan, was adopted on January 1, 2021. Plan G is amended, effective January 1, 2026, to add an additional participating employer, a subsidiary that is 100 percent owned by Employer V.

(B) *Analysis and Conclusion*. Because the expansion of eligibility is not an amendment relating to an action described in paragraph (e)(2), (3), or (4) of this section, Plan G will continue to be excepted from paragraph (b) of this section as a plan described in paragraph (e)(1)(i) of this section after the amendment pursuant to paragraph (e)(6)(i) of this section.

(vi) *Example 6*—(A) *Facts*. Plan J, a multiple employer plan, was established on January 1, 2021. Employer W adopts Plan J on January 1, 2022. Effective January 1, 2026, the assets and account balances attributable to the employees of Employer W are spun off to form a new plan, Plan K, maintained solely by Employer W.

(B) *Analysis and Conclusion*. Under paragraph (e)(5)(ii) of this section, Plan K will be excepted from paragraph (b) of this section as a plan described in paragraph (e)(1)(i) of this section.

(f) *Applicability dates*—(1) *Statutory applicability date*. Section 414A applies to plan years beginning after December 31, 2024.

(2) *Regulatory applicability date*. This section applies to plan years beginning after [**DATE SIX MONTHS AFTER DATE OF PUBLICATION OF FINAL RULE**]. For earlier plan years, a plan is treated as having complied with section 414A if the plan complies with a reasonable, good faith interpretation of section 414A.

Douglas W. O'Donnell,
Deputy Commissioner.

(Filed by the Office of the Federal Register January 10, 2025, 8:45 a.m., and published in the issue of the Federal Register for January 14, 2025, 90 FR 3092)

Notice of Proposed Rulemaking

Catch-Up Contributions

REG-101268-24

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document sets forth proposed regulations that would provide guidance for retirement plans that permit participants who have attained age 50 to make additional elective deferrals that are catch-up contributions. The proposed regulations reflect statutory changes made by the SECURE 2.0 Act of 2022, including the requirement that catch-up contributions made by certain catch-up eligible participants must be designated Roth contributions. The proposed regulations would affect participants in, beneficiaries of, employers maintaining, and administrators of certain retirement plans. This document also provides notice of a public hearing.

DATES: Written or electronic comments must be received by March 14, 2025. A public hearing on this proposed regulation has been scheduled for April 7, 2025, at 10 a.m. ET. Requests to speak and outlines of topics to be discussed at the public hearing must be received by March 14, 2025. If no outlines are received by March 14, 2025, the public hearing will be cancelled. Requests to attend the public hearing must be received by 5 p.m. on April 3, 2025.

ADDRESSES: Commenters are strongly encouraged to submit public comments electronically via the Federal eRulemaking Portal at *www.regulations.gov* (indicate IRS and REG-101268-24) by following the online instructions for submitting comments. Requests for a public hearing must be submitted as prescribed in the "Comments and Public Hearing" section. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment submitted electronically or on paper to its public docket on *www.regulations.gov*. Send paper submissions to: CC:PA:01:PR (REG-101268-24), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed

regulations, call Jessica S. Weinberger at (202) 317-6349 or Jason E. Levine at (202) 317-4117; concerning submission of comments, the hearing, and the access code to attend the hearing by telephone, call the Publications and Regulations Section at (202) 317-6901 (not toll-free numbers) or email *publichearings@irs.gov* (preferred).

SUPPLEMENTARY INFORMATION:

Authority

This notice of proposed rulemaking sets forth proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 401(k), 403(b), and 414(v) of the Internal Revenue Code (Code) relating to catch-up contributions. These proposed regulations are issued by the Secretary of the Treasury or the Secretary's delegate (Secretary) under the express delegations of authority in sections 401(m)(9), 414(v)(7)(D), and 7805(a) of the Code.

Section 401(m)(9) provides, in part, that "[t]he Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection and subsection (k)." Section 414(v)(7)(D) provides a specific delegation of authority with respect to the requirements of section 414(v)(7)(A), stating, "[t]he Secretary may provide by regulations that an eligible participant may elect to change the participant's election to make additional elective deferrals if the participant's compensation is determined to exceed the limitation under subparagraph (A) after the election is made." Section 7805(a) provides that "the Secretary shall prescribe all needful rules and regulations for the enforcement of [the Code], including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue."

Background

This notice of proposed rulemaking sets forth proposed amendments to the Income Tax Regulations under section 414(v) of the Code. Section 414(v) permits a plan to allow catch-up eligible participants to make additional elective deferrals that are catch-up contributions and sets forth requirements relating to those contributions. These proposed regulations would amend the regulations under section 414(v) to reflect changes to the catch-up contribution requirements for certain catch-up eligible participants pursuant to sections 109, 117, and 603 of Division T of the Consolidated Appropriations Act, 2023, Public Law 117-328, 136 Stat. 4459 (2022), known as the SECURE 2.0 Act of 2022 (SECURE 2.0 Act).

This document also proposes conforming amendments to the regulations under sections 401(k) and 403(b) of the Code that reflect section 603 of the SECURE 2.0 Act.

I. *Statutory and Regulatory Framework*

Section 414(v)(1) of the Code provides that an applicable employer plan will not be treated as failing to meet any requirement of the Code solely because it permits an eligible participant to make additional elective deferrals (as defined in section 414(v)(6)(B)) in any plan year. "Applicable employer plan" is defined in section 414(v)(6)(A) to mean a qualified plan under section 401(a) (qualified plan), a plan under which amounts are contributed by an individual's employer for an annuity contract described in section 403(b) (section 403(b) plan), an eligible deferred compensation plan under section 457 of an eligible employer described in section 457(e)(1)(A) (eligible governmental 457(b) plan),[1] an arrangement meeting the requirements of section 408(k) (SEP arrangement), or an arrangement meeting the requirements of section 408(p) (SIMPLE IRA plan). Under section 414(v)(5), an eligible participant is a participant who is generally eligible to make elective deferrals under an applicable employer plan and who would attain age 50 by the end of the taxable year, with respect to whom no further elective deferrals may (without regard to section 414(v)) be made to the plan for the plan year (or other applicable year) by reason of a limitation or restriction listed in section 414(v)(3) or a comparable limitation or restriction included in the terms of the plan.

Under section 414(v)(2)(A), the amount of additional elective deferrals that a plan may permit a participant to make pursuant to section 414(v)(1) for a taxable year is limited to the lesser of: (1) the applicable dollar amount under section 414(v)(2)(B) (referred to as the applicable dollar catch-up limit), and (2) the excess (if any) of the participant's compensation (as defined in section 415(c)(3)) for the year over any other elective deferrals of the participant for such year that are made without regard to section 414(v). Section 414(v)(2)(B)(i) provides the applicable dollar catch-up limit for an applicable employer plan other than a plan described in section 401(k)(11) (SIMPLE 401(k) plan) or a SIMPLE IRA plan. Section 414(v)(2)(B)(ii) provides the applicable dollar catch-up limit for a SIMPLE 401(k) plan or a SIMPLE IRA plan (collectively referred to as SIMPLE plans). Section 414(v)(2)(C) provides that the applicable dollar catch-up limits under section 414(v)(2)(B)(i) and (ii) are subject to annual adjustment based on changes in the cost of living. Section 414(v)(2)(D) provides that, for purposes of section 414(v)(2), all applicable employer plans, other than eligible governmental 457(b) plans, that are maintained by the same employer (as determined under section 414(b), (c), (m), or (o)) are treated as a single plan, and all eligible governmental 457(b) plans that are maintained by the same employer are treated as a single plan.

Under section 414(v)(3)(A)(i), a catch-up contribution is not, with respect to the year in which the contribution is made, subject to certain otherwise applicable limitations, including those contained in section 401(a)(30) (limiting a participant's elective deferrals during a calendar year to the amount permitted under section 402(g)), section 403(b) (including the requirement under section 403(b)(1)(E) that a contract purchased under a salary reduction agreement must meet the requirements of section 401(a)(30)), and section 457(b)(2) (limiting a participant's

[1] Section 414(v)(6)(C) provides that section 414(v) does not apply to a participant in an eligible governmental 457(b) plan for any year for which a higher limitation applies to the participant under section 457(b)(3).

elective deferrals for a taxable year, determined without regard to any increase to the limitation under section 457(b)(3), to the applicable dollar amount in section 457(e)(15)). Under section 414(v)(3)(B), catch-up contributions are excluded from consideration for purposes of certain nondiscrimination tests.

Section 414(v)(4) provides that an applicable employer plan is treated as failing to meet the nondiscrimination requirements under section 401(a)(4) with respect to benefits, rights, and features unless the plan allows all catch-up eligible participants to make the same election with respect to catch-up contributions. For purposes of section 414(v)(4), all plans maintained by employers who are treated as a single employer under section 414(b), (c), (m), or (o) are treated as one plan (with the exception of a plan described in section 410(b)(6)(C)(i) for the duration of the transition period described in section 410(b)(6)(C)(ii) with respect to that plan).

Section 414(v) was added to the Code by section 631 of the Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107-16, 115 Stat. 38, and the Treasury Department and the IRS issued comprehensive regulations under section 414(v) in 2003 (TD 9072, 68 FR 40510). Subsequently, provisions relating to catch-up contributions under section 414(v) were incorporated into regulations under sections 401(k), 403(b), and 457(b).

II. *SECURE 2.0 Act Changes to Section 414(v)*

A. *Section 109 of the SECURE 2.0 Act*

For a taxable year beginning after December 31, 2024, section 109 of the SECURE 2.0 Act amends section 414(v)(2) of the Code to increase the applicable dollar catch-up limit under section 414(v)(2)(B)(i) and (ii) in the case of a catch-up eligible participant who attains age 60, 61, 62, or 63 during the taxable year. For such a participant in an applicable employer plan other than a SIMPLE plan, the increased applicable dollar catch-up limit is 150 percent of the otherwise applicable dollar catch-up limit under section 414(v)(2)(B)(i) in effect for 2024. For such a participant in a SIMPLE plan, the increased applicable dollar catch-up limit is 150 percent of the otherwise applicable dollar catch-up limit under section 414(v)(2)(B)(ii) in effect for 2025. In either case, for a year beginning after December 31, 2025, the increased applicable dollar catch-up limit is subject to adjustment to reflect changes in the cost of living, in accordance with the last sentence of section 414(v)(2)(C).

B. *Section 117 of the SECURE 2.0 Act*

A SIMPLE plan is an alternative plan design under which employees of an eligible employer as defined in section 408(p)(2)(C)(i) (that is, generally, an employer that had no more than 100 employees who received at least $5,000 of compensation from the employer for the preceding calendar year) are permitted to elect to have salary reduction contributions (or elective contributions, in the case of a SIMPLE 401(k) plan) made on their behalf.[2] Among other things, section 117 of the SECURE 2.0 Act amends section 414(v)(2) of the Code to increase the applicable dollar catch-up limit under section 414(v)(2)(B)(ii) for SIMPLE plans sponsored by certain eligible employers who are described in section 408(p)(2)(E)(iv).[3] The increased applicable dollar catch-up limit is available automatically to a SIMPLE plan sponsored by an eligible employer described in section 408(p)(2)(E)(iv) that had no more than 25 employees who received at least $5,000 of compensation from the employer for the preceding calendar year. Other eligible employers described in section 408(p)(2)(E)(iv) may make an election for the increased applicable dollar catch-up limit to apply and, if the election is made, the employer must make additional matching or nonelective contributions.

The increased applicable dollar catch-up limit, which applies to taxable years beginning after December 31, 2023, is 110 percent of the otherwise applicable dollar catch-up limit under section 414(v)(2)(B)(ii) for calendar year 2024. For a year beginning after December 31, 2024, the increased applicable dollar catch-up limit is subject to adjustment to reflect changes in the cost of living, in accordance with section 414(v)(2)(C)(ii).

C. *Section 603 of the SECURE 2.0 Act*

Section 603(a) of the SECURE 2.0 Act amends section 414(v) of the Code to add section 414(v)(7). Section 414(v)(7)(A) sets forth the requirement that catch-up contributions made by certain catch-up eligible participants must be designated Roth contributions (the Roth catch-up requirement). Specifically, under section 414(v)(7)(A), in the case of a catch-up eligible participant whose wages as defined in section 3121(a) (that is, wages for purposes of the Federal Insurance Contributions Act (FICA), codified at subtitle C, chapter 21 of the Code, or FICA wages) for the preceding calendar year from the employer sponsoring the plan exceeded $145,000, section 414(v)(1) applies only if any catch-up contributions made by the participant are designated Roth contributions (as defined in section 402A(c)(1)).

Section 414(v)(7)(B) provides that, in the case of an applicable employer plan with respect to which section 414(v)(7)(A) applies to any participant for a plan year, section 414(v)(1) does not apply to the plan unless the plan provides that any catch-up eligible participant may make catch-up contributions as designated Roth contributions.

Section 414(v)(7)(C) provides that section 414(v)(7)(A) does not apply to SEP arrangements or SIMPLE IRA plans. Under section 414(v)(7)(D), regulations may provide that a catch-up eligible participant may elect to change the participant's election to make catch-up contributions if the participant's compensation is determined to exceed the wage limitation under section 414(v)(7)(A) (Roth catch-up

[2] The annual limit on salary reduction contributions or elective contributions is lower for SIMPLE plans than for other types of plans. However, SIMPLE plans are not subject to nondiscrimination testing, and the employer must make certain contributions.

[3] An eligible employer is described in section 408(p)(2)(E)(iv) if, during the three-taxable-year period preceding the first year that the employer maintained the SIMPLE plan, the employer (including any member of the employer's controlled group or any predecessor of the employer or member of its controlled group) has not established or maintained a qualified plan, a section 403(a) annuity plan, or a section 403(b) plan under which contributions were made or benefits were accrued for substantially the same employees as are eligible to participate in the SIMPLE plan. *See* Q&A E-1 in Notice 2024-2, 2024-2 IRB 316.

wage threshold) after the election is made. Under section 414(v)(7)(E), for taxable years beginning after December 31, 2024, the Roth catch-up wage threshold is adjusted for changes in the cost of living.

Section 603(b) of the SECURE 2.0 Act includes conforming amendments with respect to section 603(a). Section 603(b)(1) of the SECURE 2.0 Act strikes section 402(g)(1)(C) of the Code. Prior to its elimination, section 402(g)(1)(C) provided that a catch-up eligible participant's gross income did not include elective deferrals in excess of the applicable dollar amount under section 402(g)(1)(B) to the extent that the amount of those elective deferrals did not exceed the applicable dollar catch-up limit under section 414(v)(2)(B)(i) for the taxable year (without regard to the treatment of the elective deferrals by an applicable employer plan under section 414(v)).

Section 603(b)(2) of the SECURE 2.0 Act amends section 457(e)(18)(A)(ii) of the Code and, pursuant to this amendment, a portion of the catch-up contributions made to an eligible governmental 457(b) plan in accordance with section 457(b)(3) and (e)(18) by a catch-up eligible individual for the last three taxable years ending before the individual attains normal retirement age must be designated Roth contributions. The portion that is subject to this Roth requirement is the amount by which the applicable dollar catch-up limit under section 414(v)(2)(B)(i) exceeds the maximum permitted contribution set forth in section 457(b)(3) (determined without regard to section 457(e)(18)).

Under section 603(c) of the SECURE 2.0 Act, the amendments made by section 603 of the SECURE 2.0 Act apply to taxable years beginning after December 31, 2023.

III. *Notice 2023-62*

In August 2023, the Treasury Department and the IRS issued Notice 2023-62, 2023-37 IRB 817. Notice 2023-62 clarifies that, despite the elimination of section 402(g)(1)(C) of the Code under section 603(b)(1) of the SECURE 2.0 Act, applicable employer plans may, for taxable years beginning after December 31, 2023, continue to permit catch-up eligible participants to make elective deferrals that exceed the applicable dollar amount under section 402(g)(1)(B) of the Code (or deferrals that exceed the applicable dollar amount under section 457(e)(15)) if those contributions in excess of the applicable dollar amount satisfy the requirements for catch-up contributions under section 414(v). In addition, pursuant to Notice 2023-62, the first two taxable years beginning after December 31, 2023, are regarded as an administrative transition period with respect to the Roth catch-up requirement. During the administrative transition period, catch-up contributions made by a participant who is subject to the Roth catch-up requirement will be treated as satisfying the requirements of section 414(v)(7)(A), even if the contributions are not designated Roth contributions.

Notice 2023-62 also summarizes anticipated guidance from the Treasury Department and the IRS with respect to the implementation of section 603 of the SECURE 2.0 Act as follows: (1) the Roth catch-up requirement would not apply in the case of a catch-up eligible participant who did not have FICA wages for the preceding calendar year from the employer sponsoring the plan; (2) in the case of a catch-up eligible participant who is subject to the Roth catch-up requirement, a plan administrator and an employer would be permitted to treat an election by the participant to make catch-up contributions on a pre-tax basis as an election by the participant to make catch-up contributions that are designated Roth contributions; and (3) a catch-up eligible participant's FICA wages for the preceding calendar year from one participating employer in an applicable employer plan that is maintained by more than one employer (including a multiemployer plan) would not be aggregated with the participant's FICA wages for the preceding calendar year from another participating employer in the plan for purposes of determining whether the participant's FICA wages for that year exceeded the Roth catch-up wage threshold. The notice requested comments with respect to the anticipated guidance summarized in the notice, additional matters under consideration relating to a plan without a qualified Roth contribution program, and, more generally, the provisions of section 603 of the SECURE 2.0 Act.

Explanation of Provisions

I. *Amendments to Regulations Under Sections 401(k) and 403(b) – Deemed Roth Catch-up Election*

Section 414(v)(7)(A) of the Code provides that in the case of a participant who is subject to the Roth catch-up requirement, section 414(v)(1) applies only if any catch-up contributions made by the participant are designated Roth contributions made pursuant to the participant's election. Notice 2023-62 requested comments on anticipated future guidance expected to permit plan administrators and employers to treat an election by a participant to make catch-up contributions on a pretax basis as an election to make catch-up contributions as designated Roth contributions if the participant is subject to the Roth catch-up requirement. All comments received were in favor of this approach.

Accordingly, proposed §1.401(k)-1(f)(5)(iii) would permit a plan to provide, for taxable years beginning after December 31, 2023, that a participant who is subject to the Roth catch-up requirement is deemed to have irrevocably designated any catch-up contributions as designated Roth contributions in accordance with the requirements of §1.401(k)-1(f)(1)(i). Under the proposed regulation, a plan that provides for such a deemed Roth catch-up election would be required, as is the case for any other designated Roth contribution, to: (1) treat catch-up contributions subject to the deemed Roth catch-up election as not excludible from the participant's gross income, and (2) maintain the catch-up contributions in a designated Roth account. A plan would be permitted to provide for a deemed Roth catch-up election without regard to whether it requires separate elections for elective deferrals that are not catch-up contributions and for additional elective deferrals that are catch-up contributions or uses a spillover design.[4] However, in accordance

[4] Under a spillover design, a participant who would attain age 50 by the end of the taxable year makes one election with respect to elective deferrals for a plan year and, after the participant's elective deferrals reach a Code or plan limitation on elective deferrals that are not catch-up contributions, additional elective deferrals automatically begin counting toward the applicable dollar catch-up limit under section 414(v)(2).

with section 414(v)(7)(D), the application of a deemed Roth catch-up election to a participant would be conditioned, under proposed §1.401(k)-1(f)(5)(iv), on the participant having an effective opportunity (determined based on all of the relevant facts and circumstances, in accordance with §1.401(k)-1(e)(2)(ii)) to make a new election that is different than the deemed election. For example, under the proposed regulation, a plan would need to permit a participant subject to a deemed Roth catch-up election to elect to cease making additional elective deferrals.

The proposed amendments to §1.403(b)-3(c)(1) would incorporate proposed §1.401(k)-1(f)(5)(iii) and (iv), so that a section 403(b) plan would be permitted to include a deemed Roth catch-up election, subject to the requirement to provide a participant subject to a deemed catch-up election with the effective opportunity to make a different election. This amendment would be part of a broader incorporation of all of §1.401(k)-1(f)(3) and (5) into the rules relating to designated Roth contributions under section 403(b) plans; the incorporation of §1.401(k)-1(f)(3), (f)(5)(i), and (f)(5)(ii) is not a substantive legal change, as these provisions were previously applicable with respect to section 403(b) plans.[5]

II. *Proposed Revisions to §1.414(v)-1*

A. *Overview*

The proposed revisions and additions to §1.414(v)-1 would mainly reflect changes made by sections 109 and 117 of the SECURE 2.0 Act. In particular, the revisions to §1.414(v)-1 would: (1) reflect the increased applicable dollar catch-up limits permitted under sections 109 and 117 of the SECURE 2.0 Act (along with updated cost-of-living adjustments), and (2) clarify the application of the universal availability requirement under Code section 414(v)(4) to an applicable employer plan that permits certain catch-up eligible participants to make catch-up contributions in an amount equal to the increased applicable dollar catch-up limit for participants attaining age 60 through 63. In addition, a provision would be added to the general rules under §1.414(v)-1(a) indicating that the rules relating to the Roth catch-up requirement under section 414(v)(7) can be found in proposed §1.414(v)-2.

B. *Increased applicable dollar catch-up limit during the year of attainment of age 60 through 63 under section 109 of the SECURE 2.0 Act*

Current §1.414(v)-1(c)(2)(i) sets forth the applicable dollar catch-up limit that applies to all catch-up eligible participants in an applicable employer plan that is not a SIMPLE plan. The proposed regulations would retain that rule (other than the provisions applicable to taxable years beginning in calendar years before 2006) and would note the existence of a higher limit for individuals attaining age 60 through 63 set forth in proposed §1.414(v)-1(c)(2)(i)(B). Specifically, proposed §1.414(v)-1(c)(2)(i)(B) sets forth the increased applicable dollar catch-up limit that would apply for a taxable year beginning after 2024 with respect to a catch-up eligible participant in an applicable employer plan other than a SIMPLE plan who would attain age 60, 61, 62, or 63 on the participant's birthday occurring during the taxable year. The increased applicable dollar catch-up limit under proposed §1.414(v)-1(c)(2)(i)(B) is 150 percent of the applicable dollar catch-up limit that applies during a taxable year beginning in 2024 (that is, $11,250, which is 150 percent of $7,500), adjusted for changes in the cost of living.

Similarly, current §1.414(v)-1(c)(2)(ii) sets forth the applicable dollar catch-up limit that applies to all catch-up eligible participants in a SIMPLE plan. The proposed regulations would retain those provisions (other than the provisions applicable to taxable years beginning in calendar years before 2006) and would note the existence of a higher limit for individuals attaining age 60 through 63 set forth in proposed §1.414(v)-1(c)(2)(ii)(B) (and a higher limit for participants in certain SIMPLE plans set forth in proposed §1.414(v)-1(c)(2)(ii)(C)). Specifically, proposed §1.414(v)-1(c)(2)(ii)(B) sets forth the increased applicable dollar catch-up limit that would apply for a taxable year beginning after 2024, with respect to a catch-up eligible participant in a SIMPLE plan who would attain age 60, 61, 62, or 63 on the participant's birthday occurring during the taxable year. The increased applicable dollar catch-up limit under proposed §1.414(v)-1(c)(2)(ii)(B) is 150 percent of the applicable dollar catch-up limit that applies during a taxable year beginning in 2025 (that is, $5,250, which is 150 percent of $3,500), adjusted for changes in the cost of living.

Current §1.414(v)-1(c)(2)(iii) provides for cost-of-living adjustments to the applicable dollar catch-up limits that apply under current §1.414(v)-1(c)(2)(i) and (ii). The proposed regulations would retain that provision and would also set forth the cost-of-living adjustments to the increased applicable dollar catch-up limits for individuals attaining age 60 through 63.

C. *Increased applicable dollar catch-up limit for certain SIMPLE plans under section 117 of the SECURE 2.0 Act*

In accordance with section 117 of the SECURE 2.0 Act, proposed §1.414(v)-1(c)(2)(ii)(C) would set forth an increased applicable dollar catch-up limit that would apply for a taxable year beginning in 2024 under a SIMPLE plan that is sponsored by an eligible employer described in Code section 408(p)(2)(E)(iv) and for which the increased applicable dollar catch-up limit under section 414(v)(2)(B)(iii) applies automatically or by election. The increased applicable dollar catch-up limit is 110 percent of the applicable dollar catch-up limit that applies during a taxable year beginning in 2024 (that is, $3,850, which is 110 percent of $3,500), adjusted for changes in the cost of living. For taxable years beginning

[5] This Notice of Proposed Rulemaking (NPRM) does not propose to incorporate proposed §1.401(k)-1(f)(5)(iii) and (iv) into the regulations relating to eligible governmental 457(b) plans because those regulations do not currently provide for the inclusion of a qualified Roth contribution program in an eligible governmental 457(b) plan. On June 22, 2016, proposed regulations relating to the inclusion of a qualified Roth contribution program in an eligible governmental 457(b) plan were published in the Federal Register (81 FR 40548) and those proposed regulations have not been finalized.

after 2024, proposed §1.414(v)-1(c)(2)(iii)(C) would set forth the cost-of-living adjustments to this increased applicable dollar catch-up limit.

D. *Different applicable dollar catch-up limits and universal availability*

In accordance with the universal availability requirement in section 414(v)(4), existing §1.414(v)-1(e)(1)(i) sets forth a general rule that an applicable employer plan that offers catch-up contributions and that is otherwise subject to section 401(a)(4) (including a plan that is subject to section 401(a)(4) pursuant to section 403(b)(12)) will not satisfy the requirements of section 401(a)(4) unless all catch-up eligible participants who participate under any applicable employer plan maintained by the employer are provided with an effective opportunity to make the same dollar amount of catch-up contributions.

The Treasury Department and the IRS do not believe that a plan should fail to satisfy the universal availability requirement merely because the plan utilizes the increased limit for catch-up eligible participants attaining age 60 through 63 that is permitted under the Code pursuant to section 414(v)(2)(E). Thus, a new provision would be added to §1.414(v)-1(e)(1) setting forth an exception to the general rule in §1.414(v)-1(e)(1)(i) for a plan that permits each catch-up eligible participant to make elective deferrals up to the statutory maximum dollar amount of catch-up contributions permitted with respect to the participant. Under this new exception, an applicable employer plan would not fail to satisfy the requirements of section 401(a)(4) merely because the plan allows catch-up eligible participants who are subject to the increased applicable dollar catch-up limit for participants attaining age 60 through 63 under section 414(v)(2)(E) to make catch-up contributions up to that increased limit, while permitting other catch-up eligible participants to make catch-up contributions only up to the applicable dollar catch-up limit that applies generally under section 414(v)(2)(B)(i) or (ii), as applicable.[6]

Similarly, an applicable employer plan that covers employees in both the United States and Puerto Rico would not fail to satisfy the requirements of section 401(a)(4) merely because the plan allows catch-up eligible participants whose catch-up contributions are subject to the limit set forth in section 1081.01(d)(7) of the Puerto Rico Internal Revenue Code of 2011 (13 L.P.R.A. section 30391(d)(7)), as amended (Puerto Rico Code), to make catch-up contributions only up to the amount of that limit.[7] The Treasury Department and the IRS request comments on the application of the limits in the case of an employee who performs service for an employer both in Puerto Rico and the United States in the same year.

III. *Proposed §1.414(v)-2*

A. *General rules relating to the requirements of section 414(v)(7)*

1. Roth catch-up requirement under section 414(v)(7)(A)

Proposed §1.414(v)-2(a) would set forth general rules relating to the Roth catch-up requirement under section 414(v)(7)(A). Under proposed §1.414(v)-2(a)(2), if a catch-up eligible participant in an applicable employer plan had FICA wages for the preceding calendar year from the employer sponsoring the plan (as defined in proposed §1.414(v)-2(b)(3)) that exceeded $145,000, then section 414(v)(1) would apply with respect to the participant's elective deferrals that are catch-up contributions only if they are designated Roth contributions (as defined in section 402A(c)(1)). Under proposed §1.414(v)-2(a)(3), the $145,000 Roth catch-up wage threshold would be subject to cost-of-living adjustments, in accordance with section 414(v)(7)(E).[8] Under proposed §1.414(v)-2(a)(4), the Roth catch-up requirement would not apply to a participant in a SEP arrangement or a SIMPLE IRA plan, in accordance with section 414(v)(7)(C).

Consistent with section 414(v)(7)(A) and the description of anticipated guidance in Notice 2023-62, proposed §1.414(v)-2(a)(2) would provide that a participant who did not have FICA wages exceeding $145,000 (as adjusted) from the employer sponsoring the plan for the preceding calendar year would not be subject to the Roth catch-up requirement under the plan for the current year. Proposed §1.414(v)-2(a)(2) would define FICA wages by reference to the FICA taxes imposed by sections 3101(a) and 3111(a), not sections 3101(b) and 3111(b), and notes that the wages are taken into account for this purpose in the same year that they are taken into account for FICA tax purposes. Accordingly, an individual who did not have any FICA wages from the employer sponsoring the plan for the preceding calendar year (for example, a partner who had only self-employment income; an individual who had wages under section 3231(e) that are subject to taxation under the Railroad Retirement Tax Act, codified at title 45, chapter 9 of the United States Code, rather than FICA; or a State or local government employee whose services were excluded from the definition of employment under section 3121(b)(7) without regard to section 3121(u)) would not be subject to the Roth catch-up requirement under the plan in the current year. Similarly, an individual who received cash compensation from the employer sponsoring the plan in the preceding calendar year but nevertheless did not have any FICA wages from the employer for that year (for example, because the compensation was taxed in an earlier year pursuant to section 3121(v)(2)) would not be subject to the Roth catch-up requirement under the plan in the current year.

Further, proposed §1.414(v)-2 would not require that the Roth catch-up wage threshold be prorated for the first year of hire. Thus, a participant who worked for the employer sponsoring the plan for

[6] The higher applicable dollar catch-up limit for participants attaining age 60 through 63 may, but is not required to be, included in an applicable employer plan. Thus, an applicable employer plan may also be designed to limit the catch-up contributions for those participants to the same applicable dollar catch-up limit that applies for all other catch-up eligible participants.

[7] For taxable years beginning in 2024, the limit on catch-up contributions that can be made by a participant who is eligible to make catch-up contributions under the Puerto Rico Code is $1,500.

[8] The Roth catch-up wage threshold of $145,000 would be applied to a catch-up eligible participant's 2023 FICA wages to determine whether the Roth catch-up requirement applies to the participant's catch-up contributions made for 2024. In accordance with Notice 2024-80, 2024-47 IRB 1120, the Roth catch-up wage threshold that would be applied to a catch-up eligible participant's 2024 FICA wages to determine whether the Roth catch-up requirement applies to the participant's catch-up contributions made for 2025 remains $145,000.

only part of the preceding calendar year would be subject to the Roth catch-up requirement in the current year only if the participant had wages exceeding the full Roth catch-up wage threshold from the employer for the preceding calendar year.

2. Availability of Roth catch-up contributions under section 414(v)(7)(B)

Section 414(v)(7)(B) provides that, in the case of an applicable employer plan with respect to which section 414(v)(7)(A) applies to any participant for a plan year, section 414(v)(1) shall not apply to the plan unless the plan provides that any catch-up eligible participant may make catch-up contributions as designated Roth contributions. In accordance with section 414(v)(7)(B), proposed §1.414(v)-2(a)(5)(i) would provide that if any catch-up eligible participant who is subject to the Roth catch-up requirement is permitted to make catch-up contributions as designated Roth contributions under an applicable employer plan for a plan year, then the plan would be required to allow all other catch-up eligible participants to also make catch-up contributions as designated Roth contributions for the plan year.[9]

Proposed §1.414(v)-2(a)(5)(ii) sets forth a rule that would address the application of section 414(v)(7)(B) to a plan that is subject to the qualification requirements of both section 401(a) and section 1081.01 of the Puerto Rico Code (dual-qualified plan).[10] If a dual-qualified plan that covers both employees in the United States and employees in Puerto Rico permits any catch-up eligible participant who is subject to the Roth catch-up requirement to make catch-up contributions as designated Roth contributions for a plan year, then, in accordance with section 414(v)(7)(B), the plan is generally required to permit all catch-up eligible participants to make catch-up contributions as designated Roth contributions for the plan year. The Puerto Rico Code does not provide for designated Roth contributions, but it does allow plans to offer the opportunity to make after-tax contributions. Accordingly, in the case of a dual-qualified plan that permits Roth catch-up contributions for participants in the United States, proposed §1.414(v)-2(a)(5)(ii) would treat the requirements of section 414(v)(7)(B) as satisfied with respect to a catch-up eligible participant who is subject to section 1081.01 of the Puerto Rico Code if the plan permits the participant to make catch-up contributions as after-tax contributions within the meaning of section 1081.01(a)(15) of the Puerto Rico Code.

B. *Rules of operation for implementing the Roth catch-up requirement*

1. Designated Roth contributions that are treated as catch-up contributions for purposes of the Roth catch-up requirement

The Treasury Department and the IRS received comments in response to Notice 2023-62 requesting clarification that designated Roth contributions made at any point within a year may be counted towards satisfaction of the Roth catch-up requirement, even if the designated Roth contributions are made earlier than the contributions that are determined to be catch-up contributions (that is, before the participant is considered to have reached an applicable limit on elective deferrals for the year).

In general, under existing §1.414(v)-1(b)(2)(i)(A) and (c)(3), the amount of a participant's elective deferrals in excess of an applicable limit is determined as of the end of a plan year (or limitation year, in the case of the section 415(c) limit) by comparing the participant's total elective deferrals for the plan year (or total annual additions for the limitation year) with the applicable limit for the plan year (or limitation year). However, under §1.414(v)-1(c)(3), in the case of an applicable limit that is applied on the basis of a year other than the plan year or limitation year (for example, the calendar-year limit on elective deferrals under section 401(a)(30)), the determination of whether elective deferrals are treated as catch-up contributions is made at the time they are deferred. Thus, if the timing rule in §1.414(v)-1(c)(3) that applies for purposes of determining whether an elective deferral is a catch-up contribution also applies for purposes of determining whether a designated Roth contribution is a catch-up contribution that satisfies the Roth catch-up requirement, then, in the case of elective deferrals that are catch-up contributions because they exceed a calendar-year limit (such as the section 401(a)(30) limit), only elective deferrals that are made after reaching that limit would be taken into account in satisfying the Roth catch-up requirement.

Commenters suggested that limiting the designated Roth contributions that may be taken into account in satisfying the Roth catch-up requirement in this manner is not an appropriate approach. For example, a commenter noted that if this approach is used, then a catch-up eligible participant who would like to make elective deferrals for a calendar year in an amount equal to the sum of the section 401(a)(30) limit on elective deferrals and the applicable dollar catch-up limit would be required to make the elective deferrals as designated Roth contributions during the latter part of the year (or after the section 401(a)(30) limit is reached). This would be required even if the participant would prefer to have designated Roth contributions made throughout the year or even if the participant had already frontloaded the designated Roth contributions by making elective deferrals in an amount equal to the applicable dollar catch-up limit as designated Roth contributions during the earlier part of the year.

To address commenters' concerns, provide maximum flexibility for participants, and alleviate administrative burdens, proposed §1.414(v)-2(b)(1) would take into account designated Roth contributions that are made prior to an applicable limit being reached for purposes of determining whether the Roth catch-up requirement is satisfied. Under proposed §1.414(v)-2(b)

[9] By contrast, if none of the participants who are subject to the Roth catch-up requirement are permitted to make catch-up contributions under a plan for a plan year (for example, if a plan does not include a qualified Roth contribution program), then section 414(v)(7)(A) would not be considered to apply to any catch-up eligible participant in the plan for the plan year (and the requirement of section 414(v)(7)(B) would not apply to the plan). This interpretation of section 414(v)(7)(B) is consistent with the Joint Committee on Taxation general explanation of the provision. *See* JCS-1-23 (December 2023).

[10] For purposes of this NPRM, a dual-qualified plan includes a plan for which an election under section 1022(i)(2) of the Employee Retirement Income Security Act of 1974 (Public Law 93-406, 88 Stat. 829), as amended (ERISA), has been made.

(1), an elective deferral that is determined to be a catch-up contribution at the time of contribution under the timing rules in §1.414(v)-1(c)(3) (for example, on account of exceeding the section 401(a)(30) limit) would be required to be made as a designated Roth contribution by a participant who is subject to the Roth catch-up requirement only to the extent the participant has not previously made elective deferrals as designated Roth contributions during the calendar year or taxable year equal to the applicable dollar catch-up limit. Thus, if a catch-up eligible participant's total elective deferrals that are designated Roth contributions over the course of a calendar year or taxable year equal or exceed the total elective deferrals that are determined to be catch-up contributions, then the participant would satisfy the Roth catch-up requirement.[11]

2. Plans that do not include a qualified Roth contribution program

In accordance with section 402A(a), an applicable employer plan may, but is not required to, include a qualified Roth contribution program within the meaning of section 402A(b). However, in the case of a catch-up eligible participant who is subject to the Roth catch-up requirement, section 414(v)(1) applies only if any catch-up contributions made by the participant are designated Roth contributions. Therefore, if an applicable employer plan does not include a qualified Roth contribution program, then a participant who is subject to the Roth catch-up requirement would be prohibited from making catch-up contributions under the plan.

The proposed regulations would not require an applicable employer plan to include a qualified Roth contribution program. Thus, under the proposed regulations, an applicable employer plan that does not have a qualified Roth contribution program would be allowed to permit catch-up eligible participants who are not subject to the Roth catch-up requirement to make catch-up contributions even though catch-up eligible participants who are subject to the Roth catch-up requirement would not be permitted to make catch-up contributions.

However, the universal availability requirement under existing §1.414(v)-1(e) provides that an applicable employer plan will be treated as failing to meet the nondiscrimination requirements under section 401(a)(4) with respect to benefits, rights, and features unless all catch-up eligible participants under the plan are provided with an effective opportunity to make the same dollar amount of catch-up contributions. Proposed §1.414(v)-1(e)(1)(iii) would add a rule providing that an applicable employer plan would not violate the universal availability requirement merely because the plan permits each catch-up eligible participant to make elective deferrals up to the maximum dollar amount of catch-up contributions permitted under applicable law with respect to that participant. If a plan does not include a qualified Roth contribution program, then the maximum dollar amount of catch-up contributions permitted based on applicable law with respect to a catch-up eligible participant in the plan who is subject to the Roth catch-up requirement is $0. Proposed §1.414(v)-2(b)(2) would address this situation by providing that an applicable employer plan that does not include a qualified Roth contribution program does not fail to satisfy the universal availability requirement merely because the plan (or another applicable employer plan maintained by the employer that does not include a qualified Roth contribution program) does not permit catch-up eligible participants who are subject to the Roth catch-up requirement to make catch-up contributions.

Generally, under §1.414(v)-1(d)(4), an applicable employer plan does not violate §1.401(a)(4)-4 merely because the group of employees for whom catch-up contributions are currently available is not a group of employees that would satisfy the minimum coverage requirements of section 410(b). Under the proposed regulations, §1.414(v)-1(d)(4) would not apply to an applicable employer plan that does not include a qualified Roth contribution program and permits only catch-up eligible participants who are not subject to the Roth catch-up requirement to make catch-up contributions. The reason the proposed regulations would provide that §1.414(v)-1(d)(4) does not apply to such a plan is that not all catch-up eligible employees under the plan will be able to make catch-up contributions.

Because the Roth catch-up wage threshold is slightly lower than the wage threshold used in the definition of highly compensated employee (HCE) under section 414(q)(1)(B), some non-HCEs may be subject to the Roth catch-up requirement.[12] Thus, if a plan that does not include a qualified Roth contribution program prohibits catch-up eligible participants who are subject to the Roth catch-up requirement from making catch-up contributions, while permitting other catch-up eligible participants to make catch-up contributions, then the outcome of the nondiscrimination test with respect to the availability of catch-up contributions performed under §1.401(a)(4)-4 may be affected. Accordingly, proposed §1.414(v)-2(b)(2) would permit such a plan to also preclude one or more catch-up eligible participants who are HCEs and who are not subject to the Roth catch-up requirement (for example, because they did not receive FICA wages for the preceding year) from making catch-up contributions if doing so facilitates satisfaction of §1.401(a)(4)-4 with respect to the availability of catch-up contributions.

3. Determination of employer sponsoring the plan

The determination as to whether the Roth catch-up requirement applies to a catch-up eligible participant is based on the amount of the participant's FICA wages for the preceding year "from the employer sponsoring the plan," but that phrase is not defined in section 414(v)(7). For purposes of determining an individual's FICA wages, the term "employer" generally means the person for whom the indi-

[11] This is also the case with respect to elective deferrals that are determined to be catch-up contributions because the plan would fail the actual deferral percentage (ADP) test under section 401(k)(3) if it did not correct under section 401(k)(8). The determination of elective deferrals that are catch-up contributions because they are in excess of this ADP limit in §1.414(v)-1(b)(1)(iii) occurs in the plan year following the plan year for which the elective deferrals are made.

[12] This is particularly true if an employer makes the top-paid group election under section 414(q)(1)(B)(ii).

vidual performs service as an employee under the common law standards that apply under §31.3121(d)-1(c). Thus, for purposes of determining the individual's FICA wages, the term "employer" generally refers solely to an individual's common law employer.[13] Because the phrase "from the employer sponsoring the plan" modifies the reference to FICA wages in section 414(v)(7)(A), the determination of whether the Roth catch-up requirement applies to a participant would generally follow the FICA rules and be based on the FICA wages from the participant's common law employer.

Thus, proposed §1.414(v)-2(b)(3) would provide that, with respect to each catch-up eligible participant who is subject to the Roth catch-up requirement, the term "employer sponsoring the plan" only refers to the participant's common law employer contributing to the plan.[14] Under the proposed regulation, the "employer sponsoring the plan" would not include other entities that are treated as a single employer with a catch-up eligible participant's common law employer under section 414(b), (c), (m), or (o). For example, if there are multiple employers participating in a plan that are treated as a single employer under the controlled group rules, each of the participating employers that is a common law employer would be a separate employer sponsoring the plan.

Similarly, in the context of catch-up contributions made to a multiple employer plan or multiemployer plan by a catch-up eligible participant subject to the Roth catch-up requirement, the "employer sponsoring the plan" means the participant's common law employer that is the source of the participant's FICA wages and contributions to the plan. Some commenters have suggested that the Roth catch-up requirement does not apply to a multiemployer plan because section 3(16)(B) of ERISA defines the "plan sponsor" of a multiemployer plan as the joint board of trustees rather than the contributing employers. Under the interpretation of section 414(v)(7)(A) suggested by the commenters, the employer that is the source of the employee's FICA wages would be a signatory of the collective bargaining agreement pursuant to which the employer's employees participate in the multiemployer plan and a contributor to that plan, but would not be the "employer sponsoring the plan" for purposes of section 414(v)(7)(A).[15] The Treasury Department and the IRS do not agree that this is a reasonable interpretation of section 414(v)(7)(A) because ERISA is a separate statute from the Code and does not include any provisions that directly apply, or are even parallel, to the Code's catch-up contribution rules. Rather, in the context of the Roth catch-up requirement, the "employer sponsoring the plan" is the common law employer that is the source of the participant's FICA wages and contributions to the multiemployer plan.

The Treasury Department and the IRS understand from comments received that multiemployer plans and other plans maintained pursuant to a collective bargaining agreement would benefit from an extended applicability date for the Roth catch-up requirement so that the terms of any applicable collective bargaining agreement can be conformed to that requirement. In response to these comments, proposed §1.414(v)-2(e)(2)(ii) would provide that proposed §1.414(v)-2 does not apply to a plan maintained pursuant to one or more collective bargaining agreements until the first taxable year beginning more than 6 months after the date that final regulations adding §1.414(v)-2 to the Code of Federal Regulations are issued, or, if later, the first taxable year beginning after the date on which the last collective bargaining agreement related to the plan that is in effect on December 31, 2025, terminates (determined without regard to any extension of those collective bargaining agreements).

4. Plans with more than one employer sponsoring the plan

Consistent with the treatment of the term "employer sponsoring the plan" as referring to a catch-up eligible participant's common law employer without aggregation with other employers under section 414(b), (c), (m), or (o), proposed §1.414(v)-2(b)(4) would apply the Roth catch-up requirement on the basis of FICA wages (if any) for the preceding calendar year solely from a participant's common law employer without aggregating those wages with the FICA wages from other employers, including employers that participate in the same plan or employers that are treated as a single employer together with the common law employer under section 414(b), (c), (m), or (o). Thus, a catch-up eligible participant who had FICA wages exceeding $145,000 (as adjusted) in the preceding calendar year from any employer other than the employer sponsoring the plan (as defined with respect to the participant in accordance with proposed §1.414(v)-2(b)(3)) would not be subject to the Roth catch-up requirement under the plan in the current year if the participant did not also have more than $145,000 (as adjusted) of FICA wages for the preceding year from the employer sponsoring the plan. This is consistent with the description of anticipated guidance that was included in Notice 2023-62.

C. *Treatment of pre-tax catch-up contributions that are required to be designated Roth contributions under section 414(v)(7)*

1. Correcting a violation of the section 414(v)(7) Roth catch-up requirement

Section 414(v)(7)(A) provides that section 414(v)(1) applies to catch-up contributions made by a participant who is subject to the Roth catch-up require-

[13] In general, FICA wages are determined separately by related employers. *See* §31.3121(a)(1)-1(a)(3) ("If during a calendar year the employee receives remuneration from more than one employer, the annual wage limitation does not apply to the aggregate remuneration received from all of such employers, but instead applies to the remuneration received during such calendar year from each employer."). *See also* §31.3121(s)-1(a) ("For purposes of section…3121(a)(1), except as otherwise provided…, when two or more related corporations concurrently employ the same individual and compensate that individual…, each of the corporations is considered to have paid only the remuneration it actually disburses to that individual.").

[14] This rule applies even if responsibilities under chapter 21 of the Code are imposed on a third party, such as a section 3401(d) statutory employer, a section 3504 agent, a section 3121(s) common paymaster, a section 3511 certified PEO, or a section 3512 motion picture project employer.

[15] This would not be the case with respect to an employee of the joint board of trustees who participates in the plan. In that case, the joint board of trustees would be both the "sponsor" within the meaning of section 3(16)(B) of ERISA and the common law employer.

ment only if the catch-up contributions are designated Roth contributions. If a participant who is subject to the Roth catch-up requirement makes a pre-tax elective deferral in excess of an applicable limit, then section 414(v)(1) will not apply to that elective deferral and the plan will fail to be qualified unless the plan corrects the failure. A plan is permitted to correct this type of error by distributing the additional elective deferrals that are not catch-up contributions under section 414(v)(1) from the plan in accordance with a permitted correction method specific to the limit on elective deferrals that the additional elective deferrals exceeded (for example, the correction method in §1.402(g)-1(e) for elective deferrals that exceeded the section 401(a)(30) limit, the correction method in section 6.06(1) and (2) of Revenue Procedure 2021-30, 2021-31 IRB 172, for elective deferrals that resulted in the participant's annual additions exceeding the section 415(c) limit, or the correction method in §1.401(k)-2(b)(2) or Appendix B, section 2.01, of Revenue Procedure 2021-30 for elective deferrals that exceeded the ADP limit).

In response to Notice 2023-62, the Treasury Department and the IRS received several comments requesting guidance that would permit a pre-tax elective deferral that exceeds an applicable limit to be treated as a designated Roth contribution in order to satisfy the Roth catch-up requirement (as an alternative to distribution of these elective deferrals from the plan). Commenters requested this guidance with respect to elective deferrals that were intended to be catch-up contributions at the time amounts were contributed (because the contributions exceeded plan or statutory limits) but which were not made as Roth contributions because of an error. Commenters also raised specific concerns relating to elective deferrals that are catch-up contributions because they exceed the ADP limit. This concern arises because the determination of whether an elective deferral exceeds the ADP limit (and, therefore, could be a catch-up contribution) cannot be made until after the close of the plan year (that is, after the elective deferral is made).

The Treasury Department and the IRS agree that a correction procedure by which a plan can correct a section 414(v)(7) failure (that is, a failure to satisfy the Roth catch-up requirement), other than through distribution from the plan of elective deferrals in excess of an applicable limit which fail to comply with section 414(v)(7)(A), is warranted. Thus, proposed §1.414(v)-2(c) would set forth additional permissible methods and related rules for correcting a pre-tax elective deferral that exceeds an applicable limit in order to comply with the Roth catch-up requirement, which are discussed in the next section of this Explanation of Provisions.[16]

2. Additional permissible correction methods for elective deferrals that exceed an applicable limit

Proposed §1.414(v)-2(c)(2) sets forth two new methods that a plan would be permitted to use to correct a failure of the Roth catch-up requirement as it applies to elective deferrals that exceed an applicable limit. Under proposed §1.414(v)-2(c)(2)(i), a plan would be permitted to provide for either correction method but, with respect to a plan year, the plan would be required to apply the same correction method for all participants with elective deferrals in excess of the same applicable limit.

a. Form W-2 correction method

Under the correction method set forth in proposed §1.414(v)-2(c)(2)(ii), a plan would be permitted to correct a participant's pre-tax catch-up contribution that was required to be a designated Roth contribution by transferring the elective deferral (adjusted for allocable gain or loss) from the participant's pre-tax account to the participant's designated Roth account and reporting the contribution (not adjusted for allocable gain or loss) as a designated Roth contribution on the participant's Form W-2 (Wage and Tax Statement) for the year of the deferral (that is, reporting the contribution as if it had been correctly made as a designated Roth contribution). Under this correction method, the contribution (not adjusted for allocable gain or loss) would be includible in the participant's gross income for the year of the deferral as if the contribution had been correctly made as a designated Roth contribution. However, this method would not be permitted to be used if the participant's Form W-2 for that year has already been filed or furnished to the participant.[17]

b. In-plan Roth rollover correction method

Under proposed §1.414(v)-2(c)(2)(iii), a plan would be permitted to correct a participant's pre-tax catch-up contribution that was required to be a designated Roth contribution through an in-plan Roth rollover in accordance with section 402A(c)(4)(E). Under this method, a plan would directly roll over the elective deferral (adjusted for allocable gain or loss) from the participant's pre-tax account to the participant's designated Roth account and report the amount of the in-plan Roth rollover on Form 1099-R (Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.) for the year of rollover. The provisions of Notice 2010-84, 2010-51 IRB 872, and Notice 2013-74, 2013-52 IRB 819, would generally apply to an in-plan Roth rollover used to correct a section 414(v)(7) failure. Thus, the amount directly

[16] Commenters also suggested that a plan be permitted to avoid having to correct section 414(v)(7) failures by requiring that all catch-up contributions be made as designated Roth contributions. The Treasury Department and the IRS have considered that suggestion and concluded that, for a participant who is not subject to the Roth catch-up requirement, allowing a plan design that requires all participants' catch-up contributions to be designated Roth contributions would be inconsistent with the language of section 402A(b)(1), which provides that a designated Roth contribution must be elected by an employee "in lieu of all or a portion of elective deferrals the employee is otherwise eligible to make."

[17] This method would generally not be available with respect to an elective deferral that is a catch-up contribution because it exceeds the ADP limit under a plan with a calendar year plan year. This is because a participant's Form W-2 for a year is generally filed and furnished to the participant prior to determination of any catch-up contributions made by the participant because the elective deferrals exceed the ADP limit for such a plan year.

rolled over to the participant's designated Roth account would be the same as the amount reported on Form 1099-R, and the contribution (adjusted for allocable gain or loss) would be includible in the participant's gross income for the year of the rollover.

3. General correction requirements and deadlines to correct

a. Prerequisite to correct certain section 414(v)(7) failures under the new correction methods

Under proposed §1.414(v)-2(c)(3)(i), a plan would be eligible to use a new correction method with respect to pre-tax elective deferrals that exceed a statutory limit described in §1.414(v)-1(b)(1)(i) (such as contributions that exceed the section 401(a)(30) limit or that result in the participant's annual additions exceeding the section 415(c) limit) only if the plan sponsor or plan administrator has in place practices and procedures designed to result in compliance with section 414(v)(7) at the time an elective deferral is made.[18] A plan would not meet this requirement unless the plan provides for a deemed Roth catch-up election in accordance with proposed §1.401(k)-1(f)(5)(iii) and (iv). Under the deemed Roth catch-up election approach, if a participant who is subject to the Roth catch-up requirement has made pre-tax elective deferrals for a calendar year that equal the section 401(a)(30) limit for the taxable year that begins in the calendar year, then subsequent elective deferrals made by the participant in the calendar year would automatically be made as designated Roth contributions, even if the participant has not made an affirmative election to make catch-up contributions as designated Roth contributions. Similarly, if such a participant has made pre-tax elective deferrals for a limitation year that result in the participant's annual additions for the limitation year exceeding the section 415(c) limit, then subsequent elective deferrals made by the participant in the limitation year would automatically be made as designated Roth contributions.

If a plan does not provide for a deemed Roth catch-up election and the plan accepts a pre-tax elective deferral that would be a catch-up contribution on account of exceeding a statutory limit described in §1.414(v)-1(b)(1)(i) and the elective deferral is required to be a designated Roth contribution in accordance with the Roth catch-up requirement, then the plan would not be eligible to use a correction method described in §1.414(v)-2(c)(2) and, therefore, would have to use an otherwise-applicable correction method to distribute the elective deferral (for example, the correction method in §1.402(g)-1(e) relating to an elective deferral that exceeds the section 401(a)(30) limit).[19]

A plan would not fail to meet the requirement to have in place practices and procedures that are designed to result in compliance with the Roth catch-up requirement at the time an elective deferral is made merely because the plan determines the applicability of the Roth catch-up requirement to a participant solely on the basis of the participant's FICA wages from the employer sponsoring the plan for the preceding calendar year as reported on a timely-filed Form W-2 with respect to the participant. However, if the amount of a participant's FICA wages for the preceding calendar year that is timely reported on a Form W-2 is later determined to be incorrect, a plan would have to correct any pre-tax catch-up contributions that should have been designated Roth contributions on the basis of the adjusted FICA wages for the preceding calendar year.[20]

b. Deadline to correct section 414(v)(7) failures

Proposed §1.414(v)-2(c)(3)(iii) provides the deadlines that would apply for correction of a pre-tax catch-up contribution under the new correction methods for a section 414(v)(7) failure. Under the proposed regulation, the deadline to correct a section 414(v)(7) failure would depend on which limit is the basis for the pre-tax elective deferral being designated a catch-up contribution.[21]

If the elective deferral is a catch-up contribution because it exceeds the section 401(a)(30) limit on elective deferrals, then §1.414(v)-2(c)(3)(iii)(A) would provide that the deadline to complete the corrective steps under proposed §1.414(v)-2(c)(2) is April 15 of the calendar year following the calendar year for which the elective deferral was made. This is consistent with the deadline that applies for correcting excess deferrals above the section 401(a)(30) limit by distribution under §1.402(g)-1(e).

If the elective deferral is a catch-up contribution because it results in the participant's annual additions for a limitation year exceeding the section 415(c) limit, then §1.414(v)-2(c)(3)(iii)(B) would provide that the deadline to complete the corrective steps under proposed §1.414(v)-2(c)(2) is the deadline that applies under §1.415(c)-1(b)(6) for allocating amounts to the limitation year for which the elective deferral was made.

Under proposed §1.414(v)-2(c)(3)(iii)(C), the deadline to correct a pre-tax catch-up contribution that exceeds the ADP limit under the new correction methods would be the date that is 2½

[18] A plan would not be required under proposed §1.414(v)-2(c)(3)(i) to have such practices and procedures in place in order to correct a pre-tax catch-up contribution that is a catch-up contribution because it exceeds an employer-provided limit as described in §1.414(v)-1(b)(1)(ii). A plan would also not be required to have such practices and procedures in place in order to correct a pre-tax elective deferral that is a catch-up contribution because it exceeds the ADP limit as described in §1.414(v)-1(b)(1)(iii). This is because these elective deferrals are not determined to be catch-up contributions under §1.414(v)-1(c)(3) until the last day of the plan year of deferral or in the following plan year.

[19] In the case of a plan that does not provide for a deemed Roth catch-up election, if the plan provides that it will not accept an elective deferral that exceeds an applicable limit on elective deferrals unless the elective deferral is a catch-up contribution, then the plan may be designed to automatically stop elective deferrals for a catch-up eligible participant who is subject to the Roth catch-up requirement after the participant's elective deferrals reach an applicable limit (unless the participant has designated the additional elective deferrals as Roth contributions).

[20] The Treasury Department and the IRS invite comments on whether there are scenarios in which it would not be appropriate to require correction of pre-tax catch-up contributions that are required to be designated Roth contributions on the basis of a subsequent determination that the amount of FICA wages reported on the Form W-2 was incorrect.

[21] If the applicable deadline for a new correction method under the proposed regulations is not satisfied, then a section 414(v)(7) failure would need to be corrected by a distribution from the plan in accordance with the correction principles set forth in section 6 of Revenue Procedure 2021-30.

months (6 months, in the case of plans that include an eligible automatic contribution arrangement within the meaning of section 414(w)) after the close of the plan year for which the excess contribution was made. This is consistent with the deadline under §1.401(k)-2(b)(5) for distributing excess contributions above the ADP limit in order to avoid a 10 percent excise tax on the excess contributions. Under the proposed regulations, this would also be the deadline to correct a pre-tax catch-up contribution that is a catch-up contribution because it exceeds an employer-provided limit (because the determination of catch-up contributions, which are disregarded for purposes of the ADP test, needs to be made before the performance of the ADP test).

Proposed Applicability Date

The amendments to §1.414(v)-1 are proposed to apply with respect to contributions in taxable years that begin more than 6 months after the date that final regulations amending §1.414(v)-1 are issued. However, the proposed regulations would permit a taxpayer to elect to apply: (1) proposed §1.414(v)-1(c)(2)(ii)(C) and (c)(2)(iii)(C) (relating to the higher catch-up limit for certain newly-established SIMPLE plans) with respect to taxable years beginning after December 31, 2023, and (2) proposed §1.414(v)-1(c)(2)(i)(B), (c)(2)(ii)(B), and (c)(2)(iii)(B) (relating to the higher catch-up limit applicable during the taxable year of attainment of age 60 through 63) with respect to taxable years beginning after December 31, 2024.

For a plan that is not maintained pursuant to a collective bargaining agreement, proposed §1.414(v)-2 and the proposed amendments to §§1.401(k)-1 and 1.403(b)-3 are proposed to apply with respect to contributions in taxable years beginning more than 6 months after the date that final regulations adding §1.414(v)-2 to the Code of Federal Regulations are issued. For a plan that is maintained pursuant to one or more collective bargaining agreements, proposed §1.414(v)-2 and the proposed amendments to §§1.401(k)-1 and 1.403(b)-3 are proposed to apply with respect to contributions in taxable years beginning after the later of the first taxable year described in the preceding sentence, or the first taxable year that begins after the date on which the last collective bargaining agreement related to the plan that is in effect on December 31, 2025, terminates (determined without regard to any extension of those agreements). However, under the proposed regulations, a plan would be permitted to apply §1.414(v)-2 and the amendments to §§1.401(k)-1 and 1.403(b)-3 with respect to contributions in taxable years beginning after December 31, 2023.

Special Analyses

I. *Regulatory Planning and Review*

Pursuant to the Memorandum of Agreement, Review of Treasury Regulations under Executive Order 12866 (June 9, 2023), tax regulatory actions issued by the IRS are not subject to the requirements of section 6 of Executive Order 12866, as amended. Therefore, a regulatory impact assessment is not required.

II. *Paperwork Reduction Act*

The Paperwork Reduction Act of 1995 (44 U.S.C. 3501 - 3520) requires that a Federal agency obtain the approval of the Office of Management and Budget (OMB) before collecting information from the public, whether such collection of information is mandatory, voluntary, or required to obtain or retain a benefit. A Federal agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

These proposed regulations contain reporting requirements, contained in §1.414(v)-2(c), that relate to corrections of pre-tax elective deferrals that are catch-up contributions subject to the requirement under section 414(v)(7)(A) of the Code to be designated Roth contributions. These collections of information generally would be used by the IRS for tax compliance purposes and may involve submission of a Form 1099-R to the IRS. This form and its associated burden are approved by the OMB under 1545-0119. The proposed regulation is not changing the reporting procedures already established for this form.

The proposed regulations also contain a recordkeeping requirement that plan administrators maintain written practices and procedures designed to result in real-time compliance with certain requirements of section 414(v)(7)(A). These recordkeeping requirements are expected to be usual and customary business practices that would impose no additional burden on respondents. Therefore, the recordkeeping requirement would not require OMB approval under 5 CFR 1320.3(b)(2).

III. *Regulatory Flexibility Act*

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these proposed regulations will not have a significant economic impact on a substantial number of small entities. These proposed regulations would affect individuals and businesses, some of which may be small entities.

Even if a substantial number of small entities would be affected, the economic impact of these proposed regulations is not expected to be significant. As discussed in the Paperwork Reduction Act section of this preamble, these proposed regulations may involve reporting and ordinary recordkeeping but are not expected to result in an increase in estimated burden. Any additional recordkeeping or administrative costs resulting from the changes relating to catch-up contributions that apply to certain section 401(k) plans, 403(b) plans, and eligible governmental 457(b) plans sponsored by small entities are consistent with existing procedures and are not expected to be significant. Therefore, a regulatory flexibility analysis under the Regulatory Flexibility Act is not required.

The Treasury Department and the IRS invite comments on the impacts these proposed regulations may have on small entities. 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 their impact on small businesses.

IV. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or Tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. The proposed regulations do not propose any rule that would include any Federal mandate that may result in expenditures by State, local, or Tribal governments, or by the private sector, in excess of that threshold.

V. *Executive Order 13132: Federalism*

Executive Order 13132 (Federalism) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or preempts State law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. The proposed regulations do not propose rules that would have federalism implications, impose substantial direct compliance costs on State and local governments, or preempt State law within the meaning of the Executive order.

Comments and Public Hearing

Before these proposed regulations and proposed amendments to the regulations are adopted as final regulations, consideration will be given to comments regarding the notice of proposed rulemaking that are submitted timely to the IRS as prescribed in the preamble under the **ADDRESSES** section. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. All comments will be made available at www.regulations.gov. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn.

A public hearing has been scheduled for April 7, 2025, beginning at 10 a.m. EST in the Auditorium of the Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. Participants may alternatively attend the public hearing by telephone.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit an outline of the topics to be addressed and the time to be devoted to each topic by March 14, 2025, as prescribed in the preamble under the **DATES** section. A period of 10 minutes will be allocated to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing. If no outline of the topics to be discussed at the hearing is received by March 14, 2025, the public hearing will be cancelled. If the public hearing is cancelled, a notice of cancellation of the public hearing will be published in the **Federal Register**.

Individuals who want to testify in person at the public hearing must send an email to *publichearings@irs.gov* to have your name added to the building access list. The subject line of the email must contain the regulation number REG-101268-24 and the language TESTIFY In Person. For example, the subject line may say: Request to TESTIFY In Person at Hearing for REG-101268-24.

Individuals who want to testify by telephone at the public hearing must send an email to *publichearings@irs.gov* to receive the telephone number and access code for the hearing. The subject line of the email must contain the regulation number REG-101268-24 and the language TESTIFY Telephonically. For example, the subject line may say: Request to TESTIFY Telephonically at Hearing for REG-101268-24.

Individuals who want to attend the public hearing in person without testifying must also send an email to *publichearings@irs.gov* to have your name added to the building access list. The subject line of the email must contain the regulation number REG-101268-24 and the language ATTEND In Person. For example, the subject line may say: Request to ATTEND Hearing In Person for REG-101268-24. Requests to attend the public hearing must be received by 5 p.m. EST on April 3, 2025.

Individuals who want to attend the public hearing by telephone without testifying must also send an email to *publichearings@irs.gov* to receive the telephone number and access code for the hearing. The subject line of the email must contain the regulation number REG-101268-24 and the language ATTEND Hearing Telephonically. For example, the subject line may say: Request to ATTEND Hearing Telephonically for REG-101268-24. Requests to attend the public hearing must be received by 5 p.m. EST on April 3, 2025.

Hearings will be made accessible to people with disabilities. To request special assistance during the hearing, please contact the Publications and Regulations Branch of the Office of Associate Chief Counsel (Procedure and Administration) by sending an email to *publichearings@irs.gov* (preferred) or by telephone at (202) 317-6901 (not a toll-free number) by April 2, 2025.

Statement of Availability of IRS Documents

IRS Revenue Procedures, Revenue Rulings notices, and other guidance cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at http://www.irs.gov.

Drafting Information

The principal authors of these proposed regulations are Jessica S. Weinberger and Jason E. Levine, of the Office of the Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes (EEE)). However, other personnel

from the Treasury Department and the IRS participated in the development of the proposed regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, the Treasury Department and the IRS propose to amend 26 CFR part 1 as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries, in numerical order, for §§1.401(k)-1 and 1.414(v)-2 to read in part, as follows:

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

* * * * *

Section 1.401(k)-1 also issued under 26 U.S.C. 401(m)(9).

* * * * *

Section 1.414(v)-2 also issued under 26 U.S.C. 414(v)(7)(D).

* * * * *

Par. 2. Section 1.401(k)-1 is amended by adding paragraphs (f)(5)(iii) and (iv) to read as follows:

§1.401(k)-1 Certain cash or deferred arrangements.

* * * * *

(f) * * *

(5) * * *

(iii) *Deemed Roth catch-up contribution elections*. For taxable years beginning after December 31, 2023, a plan that satisfies the requirements of paragraph (f)(5)(iv) of this section may provide that an employee who is subject to the requirement under section 414(v)(7) to make any catch-up contributions as designated Roth contributions is deemed to have irrevocably designated any elective deferrals that are catch-up contributions as designated Roth contributions in accordance with paragraph (f)(1)(i) of this section. In such a case, the elective deferrals must be--

(A) Treated by the employer as not excludible from the employee's gross income, in accordance with paragraph (f)(2) of this section; and

(B) Maintained by the plan in a separate account, in accordance with paragraph (f)(3) of this section.

(iv) *Election for employees subject to section 414(v)(7)(A).* A plan satisfies the requirements of this paragraph (f)(5)(iv) only if it provides to an employee who is described in paragraph (f)(5)(iii) of this section an effective opportunity (as determined under paragraph (e)(2)(ii) of this section) to make a new election that is different than the deemed election described in paragraph (f)(5)(iii) of this section.

* * * * *

§1.403(b)-3 [Amended]

Par. 3. Section 1.403(b)-3 is amended in paragraph (c)(1) by:

a. Removing the reference "§1.401(k)-1(f)(1) and (2)" and adding, in its place, the reference "§1.401(k)-1(f)(1), (2), (3), and (5)";

b. Adding the language "(or is deemed to be so irrevocably designated in accordance with §1.401(k)-1(f)(5)(iii))" immediately following the language "otherwise eligible to make under the plan"; and

c. Removing the language "(within the meaning of §1.401(k)-1(f)(2))" and adding, in its place, the language "(within the meaning of §1.401(k)-1(f)(3))".

Par. 4. Section 1.414(v)-1 is amended by:

a. In the last sentence of paragraph (a)(1), removing the language "this section and §1.402(g)-2" and adding, in its place, the language "this section, and §§1.414(v)-2 and 1.402(g)-2";

b. Adding paragraph (a)(4);

c. Revising and republishing paragraph (c)(2);

d. Adding paragraph (e)(1)(iii); and

e. Revising and republishing paragraph (i).

The additions and revisions read as follows:

§1.414(v)-1 Catch-up contributions.

(a) * * *

(4) *Catch-up contributions must be designated Roth contributions for certain participants*. For provisions relating to the requirement under section 414(v)(7) that catch-up contributions made by certain catch-up eligible participants must be designated Roth contributions, *see* §1.414(v)-2.

* * * * *

(c) * * *

(2) *Applicable dollar catch-up limit*—(i) *Plans other than SIMPLE Plans*—(A) *In general*. Except as provided in paragraph (c)(2)(i)(B) of this section, the applicable dollar catch-up limit that applies under an applicable employer plan, other than a SIMPLE 401(k) plan described in section 401(k)(11) or a SIMPLE IRA plan described in section 408(p), for a taxable year is $5,000, as adjusted for changes in the cost of living under paragraph (c)(2)(iii)(A) of this section.

(B) *Higher limit applicable during the taxable year of attainment of age 60 through 63*. For a taxable year beginning after 2024, with respect to a catch-up eligible participant who would attain age 60, 61, 62, or 63 during the taxable year, the applicable dollar catch-up limit for the taxable year under an applicable employer plan described in paragraph (c)(2)(i)(A) of this section is $11,250 (which is 150 percent of the applicable dollar catch-up limit described in paragraph (c)(2)(i)(A) of this section for a taxable year beginning in 2024), as adjusted for changes in the cost of living under paragraph (c)(2)(iii)(B) of this section.

(ii) *SIMPLE plans*—(A) *In general*. Except as provided in paragraph (c)(2)(ii)(B) or (C) of this section, the applicable dollar catch-up limit that applies under a SIMPLE 401(k) plan described in section 401(k)(11) or a SIMPLE IRA plan described in section 408(p) for a taxable year is $2,500, as adjusted for changes in the cost of living under paragraph (c)(2)(iii)(A) of this section.

(B) *Higher limit applicable during the taxable year of attainment of age 60 through 63*. For a taxable year beginning after 2024, with respect to a catch-up eligible participant who would attain age 60, 61, 62, or 63 during the taxable year, the applicable dollar catch-up limit for the taxable year under an applicable employer plan described in paragraph (c)(2)(ii)(A) of this section is $5,250 (which is 150 percent of the applicable dollar catch-up limit under paragraph (c)(2)(ii)(A) of this

section for a taxable year beginning in 2025), as adjusted for changes in the cost of living under paragraph (c)(2)(iii)(B) of this section.

(C) *Higher limit for certain SIMPLE plans*. For a taxable year beginning after 2023, the applicable dollar catch-up limit under an applicable employer plan described in paragraph (c)(2)(ii)(A) of this section that is maintained by an eligible employer meeting the requirements in section 408(p)(2)(E)(iv) is $3,850 (which is 110 percent of the applicable dollar catch-up limit in effect under paragraph (c)(2)(ii)(A) of this section for a taxable year beginning in 2024), as adjusted for changes in the cost of living under paragraph (c)(2)(iii)(C) of this section. The preceding sentence applies with respect to a taxable year only if the taxable year begins in a calendar year for which the eligible employer is described in section 408(p)(2)(E)(i)(I) or makes the election described in section 408(p)(2)(E)(i)(II).

(iii) *Cost-of-living adjustments*—(A) *In general*. For a taxable year beginning after 2006, the applicable dollar catch-up limit under paragraph (c)(2)(i)(A) or (c)(2)(ii)(A) of this section (whichever applies to the plan) is the initial amount ($5,000 or $2,500, respectively), increased for changes in the cost of living. The increase is made at the same time and in the same manner as adjustments under section 415(d), except that the base period is the calendar quarter beginning July 1, 2005, and any increase that is not a multiple of $500 is rounded to the next lower multiple of $500.

(B) *Adjustments to higher limit applicable during the taxable year of attainment of age 60 through 63*. For a taxable year beginning after 2025, the applicable dollar catch-up limit under paragraph (c)(2)(i)(B) or (c)(2)(ii)(B) of this section (whichever applies to the plan) is the initial amount ($11,250 in the case of paragraph (c)(2)(i)(B) of this section and $5,250 in the case of paragraph (c)(2)(ii)(B) of this section), increased for changes in the cost of living. The increase is made at the same time and in the same manner as adjustments under section 415(d), except that the base period is the calendar quarter beginning July 1, 2024, and any increase that is not a multiple of $500 is rounded to the next lower multiple of $500.

(C) *Adjustments to higher limit for certain SIMPLE plans*. For a taxable year beginning after 2024, the applicable dollar catch-up limit under paragraph (c)(2)(ii)(C) of this section is the initial amount ($3,850), increased for changes in the cost of living. The increase is made at the same time and in the same manner as adjustments under section 415(d), except that the base period is the calendar quarter beginning July 1, 2023, and any increase that is not a multiple of $500 is rounded to the next lower multiple of $500.

* * * * *

(e) * * *

(1) * * *

(iii) *Plans providing the statutory maximum catch-up contributions*. An applicable employer plan does not fail to satisfy the universal availability requirement of this paragraph (e) merely because of differences among catch-up eligible participants as to the dollar amount of catch-up contributions they are permitted to make, provided that each catch-up eligible participant who participates under any applicable employer plan maintained by the employer is provided with an effective opportunity to make the maximum amount of catch-up contributions permitted for that participant under section 414(v) or, if applicable, section 1081.01(d)(7) of the Puerto Rico Internal Revenue Code of 2011 (13 L.P.R.A. section 30391(d)(7)), as amended. For example, an applicable employer plan does not fail to satisfy the universal availability requirement of this paragraph (e) merely because the plan permits catch-up eligible participants who would attain age 60, 61, 62, or 63 during a taxable year to make catch-up contributions up to the increased applicable dollar catch-up limit in section 414(v)(2)(E) while only permitting other catch-up eligible participants to make catch-up contributions up to the applicable dollar catch-up limit in section 414(v)(2)(B) without regard to section 414(v)(2)(E).

* * * * *

(i) *Applicability dates*—(1) *In general*. Except as described in paragraph (i)(2) of this section or §1.414(v)-2(e), section 414(v) applies to contributions in taxable years beginning on or after January 1, 2002. Except as provided in paragraph (i)(2) of this section, paragraphs (a) through (h) of this section apply to contributions in taxable years beginning on or after January 1, 2004.

(2) *Increases in applicable dollar catch-up limit under section 414(v)(2)*—(i) *Higher limit during the taxable year of attainment of age 60 through 63*. The amendments to section 414(v)(2) made by section 109 of Division T of the Consolidated Appropriations Act, 2023, Public Law 117-328, 136 Stat. 4459 (2022), known as the SECURE 2.0 Act of 2022 (SECURE 2.0 Act) to provide for a higher applicable dollar catch-up limit for individuals who attain age 60, 61, 62, or 63 during the taxable year apply to contributions in taxable years beginning after December 31, 2024. Paragraphs (c)(2)(i)(B), (c)(2)(ii)(B), and (c)(2)(iii)(B) of this section apply to contributions in taxable years beginning after [DATE SIX MONTHS AFTER DATE OF PUBLICATION OF FINAL RULE] (or, at the election of the taxpayer, taxable years beginning after December 31, 2024). Except as provided in paragraph (i)(2)(ii) of this section, for taxable years beginning on or before December 31, 2024, the applicable dollar catch-up limit is determined under §1.414(v)-1(c)(2) as it appeared in the April 1, 2024, edition of 26 CFR part 1.

(ii) *Higher limit for certain SIMPLE plans*. The amendments to section 414(v)(2) made by section 117 of the SECURE 2.0 Act to provide for a higher applicable dollar catch-up limit for certain SIMPLE plans apply to contributions in taxable years beginning after December 31, 2023. Paragraphs (c)(2)(ii)(C) and (c)(2)(iii)(C) of this section apply to contributions in taxable years beginning after [DATE SIX MONTHS AFTER DATE OF PUBLICATION OF FINAL RULE] (or, at the election of the taxpayer, taxable years beginning after December 31, 2023). For taxable years beginning on or before December 31, 2023, the applicable dollar catch-up limit for a SIMPLE 401(k) plan described in section 401(k)(11) or a SIMPLE IRA plan described in section 408(p) is determined under §1.414(v)-1(c)(2)(ii) as it appeared in the April 1, 2024, edition of 26 CFR part 1.

Par. 5. Section 1.414(v)-2 is added to read as follows:

§1.414(v)-2 Catch-up contributions required to be designated Roth contributions under section 414(v)(7).

(a) *Section 414(v)(7) Roth catch-up contribution requirement*—(1) *Organization of this section*. Paragraphs (a)(2) through (5) of this section provide general rules relating to the requirements of section 414(v)(7). Paragraph (b) of this section provides certain rules of operation for implementing the requirements of section 414(v)(7) addressed in this paragraph (a). Paragraph (c) of this section provides rules relating to the treatment of pre-tax catch-up contributions that were required to be designated Roth contributions under section 414(v)(7). Paragraph (d) of this section provides examples illustrating the application of the rules of this section. Paragraph (e) of this section sets forth the statutory and regulatory effective dates relating to the section 414(v)(7) Roth catch-up requirement.

(2) *Roth catch-up contribution requirement in general*. For a taxable year beginning on or after January 1, 2024, if, for the calendar year preceding the calendar year in which the taxable year begins, a catch-up eligible participant in an applicable employer plan had wages (as defined in section 3121(a) for purposes of the taxes imposed by sections 3101(a) and 3111(a), for the year the wages are required to be taken into account for purposes of chapter 21 of the Code) from the employer sponsoring the plan (as determined under paragraph (b)(3) of this section) that exceeded the applicable Roth catch-up wage threshold, then §1.414(v)-1(a)(1) applies only if that participant's catch-up contributions (as described in §1.414(v)-1(a)(1)) under the plan are designated Roth contributions (as defined in section 402A(c)(1)). The Roth catch-up wage threshold that applies for a calendar year is $145,000, as adjusted for changes in the cost of living under paragraph (a)(3) of this section.

(3) *Cost-of-living adjustment*. For a calendar year beginning after December 31, 2024, the applicable Roth catch-up wage threshold in paragraph (a)(2) of this section is the initial amount ($145,000), increased for changes in the cost of living. The increase is made at the same time and in the same manner as adjustments under section 415(d), except that the base period is the calendar quarter beginning July 1, 2023, and any increase that is not a multiple of $5,000 is rounded to the next lower multiple of $5,000.

(4) *Certain plans not subject to section 414(v)(7).* Paragraph (a)(2) of this section does not apply to a plan described in section 408(k) or (p).

(5) *Availability of designated Roth catch-up contributions*—(i) *In general*. Except as provided in paragraph (a)(5)(ii) of this section, if, under an applicable employer plan, any catch-up eligible participant who is subject to the Roth catch-up requirement under paragraph (a)(2) of this section is permitted to make catch-up contributions as designated Roth contributions for a plan year, then all catch-up eligible participants in the plan must be permitted to make catch-up contributions as designated Roth contributions for the plan year.

(ii) *Special rule for participants subject to the Puerto Rico Code*. In the case of a catch-up eligible participant who is subject to the Roth catch-up requirement under paragraph (a)(2) of this section and is subject to section 1081.01 of the Puerto Rico Internal Revenue Code of 2011 (13 L.P.R.A. section 30391), as amended (Puerto Rico Code), paragraph (a)(5)(i) of this section is treated as satisfied if, under the applicable employer plan, that participant is permitted to make catch-up contributions as after-tax contributions within the meaning of section 1081.01(a)(15) of the Puerto Rico Code.

(b) *Rules of operation*—(1) *Determination of catch-up contributions subject to section 414(v)(7) Roth requirement*. For a participant who is subject to the Roth catch-up requirement under paragraph (a)(2) of this section for a plan year, an elective deferral that, in accordance with §1.414(v)-1(c)(3), is treated as a catch-up contribution at the time of deferral (for example, an elective deferral that is a catch-up contribution because it exceeds the section 401(a)(30) limit on elective deferrals) is required to be a designated Roth contribution only to the extent the participant has not previously made elective deferrals that are designated Roth contributions during the calendar year or taxable year equal to the applicable dollar catch-up limit under §1.414(v)-1(c)(2). Thus, for example, if a participant who is subject to the Roth catch-up requirement under paragraph (a)(2) of this section has already made elective deferrals that are designated Roth contributions during the calendar year that equal or exceed the applicable dollar catch-up limit at the time the participant's elective deferrals reach the section 401(a)(30) limit on elective deferrals, section 414(v)(7) would not require the participant's subsequent elective deferrals for the calendar year to be designated Roth contributions even though they are treated as catch-up contributions under §1.414(v)-1(c)(3).

(2) *Treatment of plans without qualified Roth contribution programs*—(i) *In general*. For purposes of §1.414(v)-1(e)(1)(iii), if an applicable employer plan does not include a qualified Roth contribution program (within the meaning of section 402A(b)), then, for a catch-up eligible participant who is subject to the Roth catch-up requirement under paragraph (a)(2) of this section, the maximum amount of catch-up contributions permitted under section 414(v) is $0. Such a plan does not fail to satisfy the universal availability requirement of §1.414(v)-1(e) merely because the plan (or another applicable employer plan maintained by the employer that does not include a qualified Roth contribution program) does not permit catch-up contributions for participants who are subject to the Roth catch-up requirement under paragraph (a)(2) of this section.

(ii) *Application of nondiscrimination requirements*. If an applicable employer plan is described in paragraph (b)(2)(i) of this section, then §1.414(v)-1(d)(4) does not apply to the plan. As a result, a plan that has one or more highly compensated employees (as defined in section 414(q)) who are not subject to the Roth catch-up requirement under paragraph (a)(2) may need to preclude one or more of those highly compensated employees from making catch-up contributions to facilitate satisfaction of §1.401(a)(4)-4 with respect to the availability of catch-up contributions. In such a case, the plan is not treated as failing to satisfy the universal availability requirement of §1.414(v)-1(e) merely because of that preclusion.

(3) *Determination of employer sponsoring the plan*. For purposes of determining the employer sponsoring the plan with respect to a catch-up eligible participant, the employer is the participant's common law employer. Thus, for purposes of this section, the employer sponsoring the plan does not include other entities that are treated as a single employer with a catch-up eligible participant's common law employer under section 414(b), (c), (m), or (o).

(4) *Plans with more than one employer sponsoring the plan.* If an applicable employer plan has more than one employer sponsoring the plan (that is, the plan is sponsored by multiple employers that are aggregated under section 414(b), (c), (m), or (o), or is a multiple employer plan or a multiemployer plan), a catch-up eligible participant's wages for the preceding calendar year from one employer sponsoring the plan are not aggregated with the wages from another employer sponsoring the plan for purposes of determining whether the participant's wages for the preceding calendar year exceeded the applicable Roth catch-up wage threshold in paragraph (a)(2) of this section. Furthermore, even if a catch-up eligible participant's wages for the preceding calendar year from one employer sponsoring the plan exceeded the applicable Roth catch-up wage threshold in paragraph (a)(2) of this section, elective deferrals made from the participant's compensation from another employer sponsoring the plan that are catch-up contributions would not be required to be designated Roth contributions unless the participant's wages for the preceding calendar year from that other employer also exceeded that wage threshold.

(c) *Treatment of pre-tax catch-up contributions that are required to be designated Roth contributions*—(1) *General rule.* Subject to paragraph (c)(3) of this section, a pre-tax elective deferral in excess of an applicable limit described in §1.414(v)-1(b)(1) that, in accordance with paragraph (a)(2) of this section, is a catch-up contribution only if it is a designated Roth contribution does not cause an applicable employer plan to fail to satisfy any requirement of the Internal Revenue Code if the failure to be a designated Roth contribution is corrected in accordance with paragraph (c)(2) of this section.

(2) *Correction of section 414(v)(7) failures*—(i) *In general*. For purposes of this paragraph (c), if an elective deferral that exceeds a statutory limit, employer-provided limit, or ADP limit (as such terms are defined in §1.414(v)-1(b)(1)) fails to be a catch-up contribution under section 414(v)(1) because the elective deferral is not a designated Roth contribution, then the failure to satisfy section 414(v)(7) is referred to as a "section 414(v)(7) failure" and may be corrected in accordance with this paragraph (c)(2). A plan may provide for either of the correction methods described in paragraphs (c)(2)(ii) and (iii) of this section, but with respect to a plan year, the plan must apply the same correction method for all participants with elective deferrals in excess of the same applicable limit.

(ii) *Permitted correction on Form W-2*. A plan may correct a section 414(v)(7) failure by transferring the catch-up contribution (adjusted for earnings and losses) from the participant's pre-tax account to the participant's designated Roth account and reporting the contribution (not adjusted for earnings and losses) as an elective deferral that is a designated Roth contribution on the participant's Form W-2 (Wage and Tax Statement) for the year in which the elective deferral was originally excluded from the participant's gross income. However, this correction method may be used only if the participant's Form W-2 for that year has not been filed or furnished to the participant.

(iii) *Permitted correction by in-plan Roth rollover*. As an alternative to the correction method permitted under paragraph (c)(2)(ii) of this section, a plan may correct a section 414(v)(7) failure by directly rolling over the catch-up contribution (adjusted for earnings and losses) from the participant's pre-tax account to the participant's designated Roth account, in accordance with section 402A(c)(4)(E), and reporting the amount of the in-plan Roth rollover on Form 1099-R (Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.) for the year of the rollover.

(3) *General correction requirements*—(i) *Practices and procedures*. For a plan to be eligible to use either of the correction methods described under paragraph (c)(2) of this section with respect to an elective deferral that is a catch-up contribution because it exceeds a statutory limit described in §1.414(v)-1(b)(1)(i), the plan sponsor or plan administrator must have in place practices and procedures designed to result in compliance with section 414(v)(7) at the time the elective deferral is made. As part of these practices and procedures, the plan must provide that the elective deferrals of a participant who is subject to the Roth catch-up requirement under paragraph (a)(2) of this section, but who has not made an affirmative election to make catch-up contributions as designated Roth contributions nor made designated Roth contributions equal to the applicable dollar catch-up limit earlier in a calendar year, are automatically treated as designated Roth contributions after the participant's pre-tax elective deferrals made during the calendar year equal the section 401(a)(30) limit on elective deferrals for the taxable year that begins in the calendar year. Similarly, the elective deferrals of such a participant who has not made an affirmative election to make catch-up contributions as designated Roth contributions nor made designated Roth contributions equal to the applicable dollar catch-up limit earlier in the limitation year must be automatically treated as designated Roth contributions after the participant's pre-tax elective deferrals result in the participant's annual additions for the limitation year exceeding the section 415(c) limit for the limitation year.

(ii) *Reliance on Form W-2*. A plan sponsor or plan administrator does not fail to have in place practices and procedures in accordance with paragraph (c)(3)(i) of this section merely because a plan determines the applicability of the section 414(v)(7)(A) Roth catch-up requirement to a participant on the basis of a timely-filed Form W-2 with respect to the participant.

(iii) *Deadlines for corrections of section 414(v)(7) failures under paragraph (c)(2) of this section*—(A) *Elective deferrals in excess of a statutory limit*. If the section 414(v)(7) failure arises with respect to an elective deferral

that is a catch-up contribution because it exceeds the section 401(a)(30) limit on elective deferrals, the deadline to complete all corrective steps required under paragraph (c)(2) of this section in order to avoid a qualification failure is April 15 of the calendar year following the calendar year for which the elective deferral was made. If the section 414(v)(7) failure arises with respect to an elective deferral that is a catch-up contribution because it results in the participant's annual additions for the limitation year exceeding the section 415(c) limit, the deadline to complete the corrective steps required under paragraph (c)(2) of this section in order to avoid a qualification failure is the deadline that applies under §1.415(c)-1(b)(6) for allocating amounts to the limitation year for which the elective deferral was made.

(B) *Elective deferrals in excess of an employer-provided limit.* If the section 414(v)(7) failure arises with respect to an elective deferral that is a catch-up contribution because it exceeds an employer-provided limit as described in §1.414(v)-1(b)(1)(ii), the deadline to complete the corrective steps required under paragraph (c)(2) of this section in order to avoid a qualification failure is the date that is 2½ months (6 months, in the case of an applicable employer plan that includes an eligible automatic contribution arrangement within the meaning of section 414(w)) after the close of the plan year for which the catch-up contribution was made.

(C) *Elective deferrals in excess of the ADP limit*. If the section 414(v)(7) failure arises with respect to an elective deferral that is a catch-up contribution because it exceeds the ADP limit, the deadline to complete the corrective steps required under paragraph (c)(2) of this section in order to avoid a qualification failure is the date that is 2½ months (6 months, in the case of an applicable employer plan that includes an eligible automatic contribution arrangement within the meaning of section 414(w)) after the close of the plan year for which the excess contribution was made.

(d) *Examples*. The following examples illustrate the application of this section. For purposes of these examples, assume that the participant's elective deferrals under all plans of the employer do not exceed the participant's section 415(c)(3) compensation, the participant's annual additions for a limitation year do not exceed the section 415(c) limit, the taxable year of the participant is the calendar year, the plan includes a qualified Roth contribution program, and the plan year is the calendar year (except as specifically provided). Assume further that this section applies to contributions in taxable years beginning in 2026, the section 401(a)(30) limit on elective deferrals for 2026 is $24,000, the applicable dollar catch-up limit for 2026 that is applicable to each participant in the examples is $8,000, and the Roth catch-up wage threshold to be applied to 2025 FICA wages for determining applicability of the Roth catch-up requirement under section 414(v)(7)(A) for a plan year beginning in 2026 is $150,000.

(1) *Example 1*: *Application of Roth catch-up wage threshold*—(A) *Facts*. In January 2025, Participant A became an employee of an accounting firm that is structured as a partnership. Through October 2025, A had $151,000 of FICA wages from the accounting firm. In November 2025, Participant A became a partner in the accounting firm, and, for 2025, Participant A had a $30,000 distributive share of partnership income from the accounting firm, all of which was self-employment income. Participant A is a partner with the accounting firm for all of 2026.

(B) *Analysis*. Although Participant A is a partner with the accounting firm for the last two months of 2025 and for all of 2026 (and thus has self-employment income rather than FICA wages for that period), Participant A had more than $150,000 in FICA wages from the accounting firm for 2025. Thus, Participant A is subject to section 414(v)(7)(A) for 2026, and if Participant A makes elective deferrals in excess of an applicable limit for 2026 under a plan sponsored by the accounting firm, those elective deferrals must be designated Roth contributions.

(2) *Example 2: Application of Roth catch-up wage threshold*—(A) *Facts*. The facts are the same as in paragraph (d)(1) of this section (*Example 1*), except that Participant A became a partner of the accounting firm in May 2025, and had FICA wages from the firm of $60,000 before becoming partner. In addition, for 2025, Participant A had a $150,000 distributive share of partnership income from the accounting firm, all of which was self-employment income.

(B) *Analysis*. Although Participant A had total compensation of $210,000 for the services Participant A performed for the accounting firm in 2025, only $60,000 of that amount were FICA wages. Because Participant A did not have more than $150,000 of FICA wages from the accounting firm for 2025, any elective deferrals in excess of an applicable limit that Participant A makes for 2026 under a plan sponsored by the accounting firm are not required to be designated Roth contributions.

(3) *Example 3: Application of section 414(v)(7)(B) to a plan with a plan year other than the calendar year*—(A) *Facts*. Participant B participates in an applicable employer plan sponsored by Employer E. The plan year begins on July 1 and ends on June 30. Participant B had $155,000 in wages within the meaning of section 3121(a) from Employer E for calendar year 2025, and is a catch-up eligible participant for calendar year 2026. For the plan year beginning July 1, 2026, and ending June 30, 2027, the plan allows all catch-up eligible participants to make catch-up contributions and requires that any elective deferrals in excess of an applicable limit made by catch-up eligible participants who are subject to the requirements of section 414(v)(7)(A) be designated Roth contributions.

(B) *Analysis*. Because Participant B's FICA wages from Employer E for calendar year 2025 exceeded $150,000, Participant B is subject to the requirements of section 414(v)(7)(A) for the first half of the plan year beginning July 1, 2026, and any catch-up contributions that Participant B makes under the plan during that period must be designated Roth contributions. Because Participant B is permitted to make catch-up contributions that are designated Roth contributions under the plan for the plan year beginning July 1, 2026 (after Participant B reaches an applicable limit (as defined in §1.414(v)-1(b)(1)), all catch-up eligible participants under the plan must be permitted to make catch-up contributions that are designated Roth contributions for the plan year.

(4) *Example 4: Plans with more than one employer sponsoring the plan*—(A) *Facts*. Employer F and Employer G are members of a controlled group of corporations within the meaning of section 414(b). Participant C was hired by Employer F on January 1, 2025, and remained employed by Employer F through October 31, 2025. Effective November 1, 2025, Participant C transferred to Employer G and was employed by Employer G for the remainder of 2025. Participant C is employed by Employer G for all of 2026, the year in which Participant C attains age 55. Employer F reported $155,000 of FICA wages on a Form W-2 for Participant C for 2025. Employer G reported $35,000 of FICA wages on a Form W-2 for Participant C for 2025. Employers F and G are participating employers in a section 401(k) plan, Plan P. Participant C becomes eligible to participate in Plan P on January 1, 2026, and all of Participant C's elective deferrals for 2026 are made from compensation paid by Employer G.

(B) *Analysis*. Employers F and G are common law employers of Participant C during different portions of 2025, and, under paragraph (b)(3) of this section, they are both employers sponsoring the plan. Because Participant C's FICA wages from Employer G in 2025 did not exceed $150,000, Participant C is not subject to the requirements of section 414(v)(7)(A) with respect to elective deferrals that are made from compensation paid by Employer G in 2026. Accordingly, Participant C is not required to designate any catch-up contributions made for 2026 under Plan P as designated Roth contributions. This is the case even though Participant C had wages from Employer F (an employer sponsoring the plan) that exceeded $150,000 for 2025.

(5) *Example 5: Correction of section 414(v)(7) failure*—(A) *Facts*. Participant D, who attains age 55 in 2026, participates in a section 401(k) plan, Plan Q, sponsored by Employer H. Plan Q does not limit elective deferrals except as necessary to comply with sections 401(a)(30) and 415(c). Plan Q does not provide catch-up eligible participants with a separate election for elective deferrals that are in excess of the section 401(a)(30) limit and provides that such a participant is permitted to defer amounts in excess of the section 401(a)(30) limit on elective deferrals up to the applicable dollar catch-up limit for the year. For 2025, Participant D had $151,000 in wages (within the meaning of section 3121(a)) from Employer H. For 2026, Participant D elects to defer $1,250 into Participant D's account in Plan Q for each of 24 pay periods. Employer H has in place practices and procedures that are designed to prevent section 414(v)(7) failures and to result in compliance with the section 414(v)(7) Roth catch-up requirement at the time an elective deferral is made, and Plan Q provides for a deemed Roth catch-up election as described in paragraph (c)(3)(i) of this section. Nonetheless, Employer H discovers that all of Participant D's elective deferrals under Plan Q during 2026 (a total of $30,000) were pre-tax elective deferrals.

(B) *Analysis*. Because Participant D had over $150,000 in wages from Employer H for 2025, under section 414(v)(7)(A), Participant D's catch-up contributions under Plan Q for 2026 (that is, the elective deferrals that exceed the section 401(a)(30) limit) are required to be designated Roth contributions. Thus, $6,000 of Participant D's elective deferrals for 2026 (that is, the elective deferrals in excess of the section 401(a)(30) limit of $24,000) are required to be designated Roth contributions. To keep these contributions in the plan, Employer H must correct the section 414(v)(7) failure with respect to $6,000 of Participant D's pre-tax elective deferrals for 2026, using one of the methods set forth under paragraph (c)(2) of this section, by April 15, 2027 (the deadline under paragraph (c)(3)(iii)(A) of this section).

(6) *Example 6: Designated Roth contributions that can satisfy the section 414(v)(7) Roth catch-up requirement*—(A) *Facts*. The facts are the same as in paragraph (d)(5) of this section (*Example 5*), except that the first $5,000 of the $30,000 total elective deferrals Participant D makes for 2026 are designated Roth contributions. (Thus, during each of the first 4 pay periods in 2026, Participant D makes $1,250 of elective deferrals that are designated Roth contributions, and then subsequently makes $25,000 in pre-tax elective deferrals ratably over the remaining 20 pay periods.) Participant D reaches the section 401(a)(30) limit on elective deferrals during the twentieth pay period of 2026 and does not make any designated Roth contributions after reaching the section 401(a)(30) limit on elective deferrals in 2026.

(B) *Analysis*. In accordance with paragraph (b)(1) of this section, the $5,000 in elective deferrals that are designated Roth contributions that Participant D made at the beginning of 2026 can be taken into account for purposes of satisfying Participant D's Roth catch-up requirement under section 414(v)(7). Thus, the portion of Participant D's pre-tax elective deferrals that are required to be corrected is $1,000 ($6,000 of elective deferrals that are in excess of the section 401(a)(30) limit, minus $5,000 of elective deferrals that were made as designated Roth contributions within the taxable year), and Employer H must correct the section 414(v)(7) failure with respect to only $1,000 of Participant D's pre-tax elective deferrals. To keep the $1,000 in the plan, Employer H must correct the section 414(v)(7) failure using one of the methods set forth under paragraph (c)(2) of this section, by April 15, 2027 (the deadline under paragraph (c)(3)(iii)(A) of this section).

(e) *Applicability dates*—(1) *Statutory applicability date*. Section 414(v)(7) applies to contributions in taxable years beginning after December 31, 2023.

(2) *Regulatory applicability dates*—(i) *General rule*. Except as provided in paragraphs (e)(2)(ii) and (iii) of this section, this section applies to contributions in taxable years beginning after [DATE SIX MONTHS AFTER DATE OF PUBLICATION OF FINAL RULE].

(ii) *Collectively bargained plans*. In the case of an applicable employer plan maintained pursuant to one or more collective bargaining agreements, paragraphs (a) through (d) of this section shall not apply until the first taxable year described in paragraph (e)(2)(i) of this section, or, if later, the first taxable year beginning after the date on which the last collective bargaining agreement related to the plan that is in effect on December 31, 2025, terminates (determined without regard to any extension to those agreements).

(iii) *Early implementation permitted*. A plan is permitted to apply the rules of this section to contributions in any taxable year beginning after December 31, 2023.

Douglas W. O'Donnell,
Deputy Commissioner.

(Filed by the Office of the Federal Register January 10, 2025, 8:45 a.m., and published in the issue of the Federal Register for January 13, 2025, 90 FR 2645)

Notice of Proposed Rulemaking

Source of Income from Cloud Transactions

REG-107420-24

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed rules for determining the source of income from cloud transactions for purposes of the international provisions of the Internal Revenue Code. These proposed rules would generally affect taxpayers who earn gross income from engaging in cloud transactions.

DATES: Written or electronic comments and requests for a public hearing must be received by April 14, 2025.

ADDRESSES: Commenters are strongly encouraged to submit public comments electronically. Submit electronic submissions via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG-107420-24) by following the online instructions for submitting comments. Requests for a public hearing must be submitted as prescribed in the "Comments and Requests for a Public Hearing" section. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment received to its public docket, whether submitted electronically or in hard copy. Send hard copy submissions to: CC:PA:01:PR (REG-107420-24), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:01:PR (REG-107420-24), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Christopher E. Fulle at (202) 317-5367 or Michelle L. Ng at (202) 317-6989 (not toll-free numbers); concerning submissions of comments and requests for a public hearing, contact the Publications and Regulations branch at (202) 317-6901 (not a toll-free number) or by email to *publichearings@irs.gov* (preferred).

SUPPLEMENTARY INFORMATION:

Authority

The proposed regulations are issued under the express delegation of authority under section 7805 of the Internal Revenue Code (Code). Section 7805(a) directs the Secretary of the Treasury or her delegate to prescribe all needful rules and regulations for the enforcement of that section and others in the Code, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

Background

Proposed regulations published in the ***Federal Register*** (84 FR 40317) in 2019 (REG-130700-14) (the 2019 proposed regulations) set forth proposed rules for identifying and classifying cloud transactions, and the preamble to the 2019 proposed regulations requested comments on rules for sourcing income from cloud transactions. Comments received addressed the necessity of developing specific rules for sourcing gross income from cloud transactions and provided recommendations on the content of such rules. This notice of proposed rulemaking, which is being published with the final regulations for identifying and classifying cloud transactions (TD 10022) (the 2025 final regulations) that are being published in the Final Rules section of this same issue of the ***Federal Register*** (90 FR 2977), proposes rules for sourcing gross income from cloud transactions.

Explanation of Provisions

I. *Source of Gross Income from Cloud Transactions*

A. *Overview of comments received*

The Treasury Department and the IRS received more than a dozen comments in response to the request for comments on administrable rules for sourcing income from cloud transactions in a manner consistent with sections 861 through 865. Comments were split almost evenly with regard to whether specific sourcing rules are needed in this area, with a narrow majority expressing support for such guidance. Of this majority, several comments recommended that services income from cloud transactions be sourced according to the location of the assets and personnel used in providing the service. A number of these comments explained that this approach would align with the result in *Piedras Negras Broadcasting Co. v. Comm'r*, 43 B.T.A. 297 (1941), *nonacq.*, 1941-2 C.B. 22, *aff'd*, 127 F. 2d. 260 (5th Cir. 1942), in which the income of a radio broadcasting corporation was determined to be foreign source because its broadcasting facilities and employees were located in Mexico, even though the corporation broadcasted programs primarily to listeners located in the United States and received almost all of its income from advertisers located in the United States. Other comments voiced the need for specific rules for sourcing income from cloud transactions, but did not recommend a particular sourcing approach, with one comment suggesting that the location of the cloud service provider's assets and personnel and the location of the end-user could be evaluated in developing the rules. Another comment proposed that given the challenges of sourcing cloud transactions when the operations, employees, and customers are dispersed, the sourcing rules could provide taxpayers with the option to source the income to the place where the contract is executed. While almost half of the comments received stated that regulations for sourcing income from cloud transactions are unnecessary because existing statutory, regulatory, and case law provides sufficient guidance, an overwhelming majority of those comments recommended that if issued, the regulations should take into account the location of the assets and people that contribute to the delivery of the cloud service.

Many of the comments discussed whether the sourcing determination should be made by taking into account solely the assets and personnel of the taxpayer that recognizes the income from the performance of the cloud service (the taxpayer-by-taxpayer approach), or whether taxpayers should be required to look through to the activities and personnel of other related legal entities that contribute to the provision of the service (the unitary approach). Nearly all comments on this issue stated that income from cloud transactions should be sourced on a taxpayer-by-taxpayer basis. Comments explained that the taxpayer-by-taxpayer approach is administrable and supported by the principles of *Miller v. Comm'r*, 73 T.C.M. 2319 (1997), *aff'd without published decision*, 166 F.3d 1218 (9th Cir. 1998), in which income that a foreign corporation received for performing research and development services was held to be foreign source notwithstanding that the performance of those services was subcontracted to certain related and unrelated entities, including a wholly-owned U.S. subsidiary. One comment suggested that a taxpayer-by-taxpayer rule for sourcing services income from cloud transactions could be supplemented with anti-abuse provisions requiring the income to be sourced on a look-through or unitary basis in limited circumstances. However, another comment asserted that sourcing services income from cloud transactions on a look-through or unitary basis should be required, explaining that this approach more accurately reflects the economic realities of the transaction because it accounts for the contributions made by members of the multinational group to the provision of the service. That comment also expressed the concern that sourcing on a taxpayer-by-taxpayer basis could cause U.S. source income to be understated with respect to commonly-used structures in which the development, enhancement, maintenance, protection, and exploitation functions are performed primarily by U.S. entities but the services income is recorded by a foreign entity that contracts directly with the end-users to whom the cloud transaction is provided.

B. *Need for proposed regulations*

The development and advancement of cloud technologies has transformed both the value that businesses deliver to customers and the way that value is delivered, giving rise to cloud-based business models and cloud transactions. The 2025 final regulations classify a cloud transaction (within the definition of §1.861-19(b)) as the provision of services. *See* §1.861-19(c)(1). Under the source rules of the Code, which were designed in the context of more traditional modes of com-

merce, gross income from the provision of services is sourced to the place where the service is performed. *See* sections 861(a)(3) and 862(a)(3). The Code does not provide guidance on how to determine the place of performance for specific types of service transactions, including cloud transactions. Further, while section 863(b)(1) specifies that income from services rendered partly within and partly without the United States is treated as derived partly from each source, there is no statutory guidance prescribing how to source the services income, including income from cloud transactions, in such circumstances. The distinctive attributes of cloud transactions, including the network-based and increasingly automated nature of the service delivery and the role of intangible property (such as proprietary software and other proprietary digital content) in ensuring the functionality, reliability, and performance of the service, raise questions regarding how to determine the place of performance of a cloud transaction.

The proposed regulations, which would establish specific sourcing rules that interpret the place of performance in the context of a cloud transaction, are therefore necessary to provide clarity and certainty to both taxpayers and the IRS. To determine the place of performance, the proposed sourcing rules would take into account the location of the employees and assets, including both tangible and intangible assets, that contribute to the provision of the cloud transaction. The Treasury Department and the IRS are of the view that, because of the technical nature of a cloud transaction, the place of performance for purposes of sourcing gross income is the place where the resources and personnel responsible for the development, management, and delivery of the service are located because this is where the key activities in the provision of the service occur, as opposed to ancillary activities such as marketing, sales, and contracting. This approach is consistent with case law on the sourcing of income involving analogous traditional business models where services are provided from a location that differs from the customers' location, specifically, the *Piedras Negras* case. *See* 43 BTA at 297, *aff'd*, 127 F.2d at 260. In line with the approach in *Piedras Negras*, the proposed rules do not consider the location of the customer or end-user, as it merely reflects the place where the service is consumed, not where the performance actually takes place as prescribed by sections 861(a)(3) and 862(a)(3). Similarly, the location where a contract for a cloud transaction is executed should not dictate the source of the resulting gross income because that location may not bear any connection to where the service is performed.

The proposed cloud transaction sourcing rules would apply on a taxpayer-by-taxpayer basis and therefore, in determining the gross income of an entity that recognizes the services income, would take into account solely the assets and personnel of the legal entity. The Treasury Department and the IRS agree that this approach is administrable and practical. By focusing on the economic contributions that the contracting entity makes to the performance of the cloud transaction, the taxpayer-by-taxpayer approach provides a clear, straightforward way of determining the source of gross income from the transaction, while allowing for appropriate deductions from that gross income in respect of amounts paid or accrued to affiliated or unaffiliated contributors to the provision of the cloud services, leading to reduced complexity in tax compliance and enforcement. This approach is also generally consistent with the current approach for sourcing other categories of income, including non-cloud services income such as gross income from certain sales of inventory that is sourced to the location of production activity under §1.863-3(c)(1)(ii). Further, this approach would not impede the IRS's ability to assert common law principles, such as the economic substance doctrine, the step transaction doctrine, and the rules of agency, or existing statutory and regulatory provisions, such as the section 482 rules, to ensure that the Federal income tax consequences more properly reflect the economic realities of the transaction, including the contributions to a cloud transaction made by affiliates of the taxpayer. Notwithstanding the above, the Treasury Department and the IRS will continue to study the implications of applying the taxpayer-by-taxpayer approach in the context of sourcing gross income from services generally, and may refine or propose revisions to the approach if they determine that this is necessary to adequately account for the interdependencies and collaboration across entities in a multinational group, and consequently, to ensure a fair and accurate representation of where services are performed.

C. *Explanation of proposed rules for sourcing gross income from cloud transactions*

The proposed regulations state that gross income from a cloud transaction is sourced as services income under section 861(a)(3) or 862(a)(3), as appropriate, according to where the service is performed. Proposed §1.861-19(d)(1). The place of performance of a cloud transaction is established through a formula composed of a fraction that relies on three factors: the intangible property factor, the personnel factor, and the tangible property factor (within the meaning of proposed §1.861-19(d)(2), (d)(3), and (d)(4), respectively). *Id*.

As discussed in detail in Parts I.C.1 through 3 of this Explanation of Provisions, the intangible property factor is intended to reflect the contribution of intangible property to the provision of the cloud transaction; the personnel factor is intended to reflect the contribution of certain employees to the provision of the cloud transaction; and the tangible property factor is intended to reflect the contribution of tangible property to the provision of the cloud transaction. Each factor is determined by taking into account certain worldwide expenses by the entity that, in the view of the Treasury Department and the IRS, properly represent the contributions made by or through the relevant personnel and assets to the performance of the cloud transaction. Together, these factors make up the denominator of the fraction. The numerator of the fraction is determined by summing up the portion of each factor that is from sources within the United States.

Under the proposed regulations, the gross income from a cloud transaction multiplied by the fraction yields the portion of the gross income that is from sources within the United States. Proposed §1.861-19(d)(1). The portion of the gross income that remains is gross income from sources without the United States. *Id*.

1. Intangible Property Factor

a. Determination of the intangible property factor

The Treasury Department and the IRS consider intangible property to be a significant contributor to the performance of cloud transactions. Intangible property, such as software, algorithms, data processing applications, and other proprietary technologies, often plays a crucial role in the performance of a cloud transaction, including by shaping the unique features of the service and ensuring the service's functionality, reliability, and delivery. This role of intangible property is becoming particularly important as cloud transactions are becoming increasingly automated, requiring less and less contribution from personnel and tangible property to deliver value to customers. In such cases, the intangible property itself may be the main force that is effectively performing the service. It would be difficult and burdensome, however, to ascertain the precise value or contribution of an item of intangible property to the performance of a cloud transaction given the challenges inherent in isolating the specific impact of various intangibles on the cloud transaction's overall performance. The Treasury Department and the IRS are of the view that certain research and experimental expenses, amortization, and royalties incurred during the taxable year in which the cloud transaction is performed could serve as an administrable proxy for reflecting the contribution of intangible property to the performance of the cloud transaction. These expenses serve as the foundation for the intangible property factor.

Specifically, the intangible property factor is the sum of specified research or experimental expenditures (as defined under section 174(b)) incurred during the taxable year that are associated with the cloud transaction as well as royalty and certain amortization expenses incurred during the taxable year to the extent they are for intangible property directly used to provide the cloud transaction (collectively, "intangible property costs"). Proposed §1.861-19(d)(2)(i). Intangible property costs include payments to third-party and related-party research and experimentation providers. Because specified research or experimental expenditures are used as a proxy for current use of existing self-developed intangible property, those expenditures are taken into account as they are incurred, regardless of whether and when they are deductible, in order to match the timing of when compensation is paid to employees performing research or experimentation activities. As discussed in Part I.C.1.b. of this Explanation of Provisions, the intangible property factor is sourced based on this compensation; therefore the Treasury Department and the IRS are of the view that taking the specified research or experimental expenditures in the year when incurred provides an administrable rule that recognizes the economic contribution of the intangible property and avoids taxpayers having to trace section 174(a)(2)(B) amortization deductions back to the year in which incurred. However, royalty and amortization expenses are taken into account for the intangible property factor when deductible because that is the most administrable proxy for measuring the economic contribution existing licensed or acquired intangible property makes to a cloud transaction.

In computing the intangible property factor, the Treasury Department and the IRS recognize that some specified research or experimental expenditures may not be directly traceable to a single transaction because intangible property developed through research and experimentation conducted in a taxable year may not be monetized in cloud transactions until a future year. In light of this, and consistent with the approach taken for allocating and apportioning deductions for such expenditures, the proposed regulations provide that the specified research or experimental expenditures to be taken into account with respect to a cloud transaction from which the gross income is being sourced are those associated with all cloud transactions provided in that taxable year that are in the same product line as the cloud transaction. *Id.*; *cf.* §1.861-17(b) (recognizing that research and experimentation is an inherently speculative activity, which when successful ultimately results in the creation of intangible income, and allocating expenditures for such activity to gross intangible income earned in the year of the expenditure). The Treasury Department and the IRS are of the view that the current-year approach in the proposed rules serves as a workable, reliable, and appropriate proxy for existing intangible property in the same product line. Under the proposed regulations, cloud transactions are considered to be in the same product line if they are within the same Corresponding Index Entry under a North American Industry Classification System (NAICS) code number. Proposed §1.861-19(d)(8). The proposed regulations also include a consistency requirement to prevent taxpayers from changing Corresponding Index Entry and NAICS code numbers absent a change in facts. *Id*. The intangible property factor focuses on work done in the same product line as the cloud transaction to balance between specificity and practicality. The factor aims to capture the contribution of intangible property to the performance of a cloud transaction, so a factual relationship between the specified research or experimentation expenditures and the cloud transaction being tested needs to exist. At the same time, the Treasury Department and the IRS are aware that it is not necessarily possible to precisely determine the product or products that will benefit from a research and experimentation process at an early stage. To prevent duplication, the proposed regulations require expenses that would be included in the intangible property factor for multiple cloud transactions in a taxable year to be allocated among those transactions (taking into account the aggregation rule described in Part I.C.4 of this Explanation of Provisions) based on the relative gross income earned from each transaction. Proposed §1.861-19(d)(2)(i). Any intangible property costs that support cloud transactions in general but that do not relate to any specific cloud transaction should be allocated in the same manner.

b. Determination of the portion of the intangible property factor from U.S. sources

Once the intangible property factor is determined, the portion of this factor that is attributable to sources within the United States must be identified for inclusion in the numerator. Given the non-physical nature of intangible property, its location

when used in providing a service may be challenging to ascertain. Under the proposed rules, the portion of the intangible property factor that is from sources within the United States is determined based on the extent to which certain of the taxpayer's employees perform services in the United States, determined by leveraging the principles of §1.861-4(b)(2)(ii)(E) (relating to sourcing compensation from labor or personal services on a time basis). The employees considered for this purpose are those whose primary function is to perform research and experimentation activities associated with cloud transactions in the same product line as the cloud transaction the gross income of which is being sourced. Proposed §1.861-19(d)(2)(ii). The proposed regulations provide that the employee's primary function is the set of tasks to which they are assigned to spend the majority of their working time. Proposed §1.861-19(d)(5). In order to account for amounts paid to third-party research and experimentation providers, amortization, and royalties, the fraction determined by the compensation that has been paid to the research and experimentation personnel is applied to the total research and experimental expense determined under §1.861-19(d)(2)(i). *See* proposed §1.861-19(d)(2)(ii).

The Treasury Department and the IRS are of the view that the location of research and experimentation personnel is a logical and accurate proxy for the location of intangible property that contributes to the performance of a cloud transaction for a number of reasons. First, the research and experimentation personnel contribute to the creation, design, and refinement of the intangible property either through their own efforts or by managing and facilitating research and experimentation work carried out by third parties. Therefore, the value of the intangible property used to provide the cloud transaction depends on their personal efforts and expertise. Additionally, while intangible property does not have a physical form that can be easily located, the place where research and experimentation personnel operate is tangible and verifiable. Relatedly, taxpayers generally know or should know the location of their research and experimentation personnel, and thus, relying on the location of these personnel would avoid a burdensome compliance process that might otherwise be required to determine the location of intangible property used to provide cloud transactions. For similar reasons, in determining gross income of a taxpayer, the rule does not look to research and experimentation personnel other than those of the taxpayer, and uses the taxpayer's own personnel as a proxy for all research and experimentation personnel working on the relevant intangible property.

The determination of which research and experimentation employees should be taken into account focuses on the employees whose primary function is the performance of research and experimentation activities, without limiting the analysis to nonmanagerial employees or first-line managers who undertake these activities. This is because research and experimentation typically involves contributions from personnel across various levels of the organization, including senior leadership and technical staff, as an idea for a product or service moves from concept to design, implementation, and testing. Accordingly, focusing solely on nonmanagerial employees or first-line managers could result in missing key contributors to the research and experimentation activities associated with a cloud transaction, including individuals within the organizational structure who oversee or engage in higher-level experimentation efforts.

2. Personnel Factor

a. Determination of the personnel factor and the portion from U.S. sources

The Treasury Department and the IRS are of the view that while the underlying technology and infrastructure are important in providing a cloud transaction to customers, the employees who manage, operate, and maintain these systems are also fundamental to the provision of the service. Accordingly, the efforts of personnel employed by the taxpayer who directly contribute to the provision of the cloud transaction must be taken into account in sourcing gross income from that cloud transaction. To properly reflect the contribution of these personnel to the provision of the cloud transaction, the personnel factor is composed of the compensation paid to the taxpayer's employees whose primary function is to directly contribute to the provision of the cloud transaction. *See* proposed §1.861-19(d)(3)(i). However, to avoid double counting income, compensation that is paid to research and experimentation personnel described in proposed §1.861-19(d)(2) is excluded. *Id.*

As explained in Part I.C.1.b of this Explanation of Provisions, an employee's primary function is the set of tasks to which they are assigned to spend the majority of their working time. Proposed §1.861-19(d)(5). The proposed regulations provide a rule to account for situations in which an employee's primary function is to directly contribute to more than one cloud transaction. In those cases, all of the employee's compensation must be allocated among those cloud transactions based on the relative amount of time the employee spends contributing to each transaction. Proposed §1.861-19(d)(3)(i). To illustrate the application of these rules, if an employee spends 30 percent of their working time on Cloud Transaction 1, 30 percent of their working time on Cloud Transaction 2, and 40 percent of their working time not on cloud transactions, that employee's primary function would be working on cloud transactions because a majority of their working time (60 percent) is spent on cloud transactions. Consequently, all of this employee's compensation would be allocated among Cloud Transaction 1 and Cloud Transaction 2 based on the relative amount of time the employee spends contributing to each of the two cloud transactions. However, where an employee contributes to multiple cloud transactions simultaneously, their compensation must be allocated among those transactions based on the relative gross income earned from each transaction because it would be impossible to use a time-based allocation in such cases. *Id.*

Similar to the determination of the numerator of the intangible property factor, which is the portion of that factor from sources within the United States, the proposed regulations provide the numerator of the personnel factor, which is the portion of that factor from sources within the United States, is equal to the part of the personnel factor that is paid for services performed in the United States using the

principles of §1.861-4(b)(2)(ii)(E). Proposed §1.861-19(d)(3)(ii).

b. Direct contribution to the provision of the cloud transaction

The proposed regulations set forth rules that define which employees are considered to directly contribute to the provision of the cloud transaction and which employees are not considered to do so. Under proposed §1.861-19(d)(3)(iii), personnel directly contribute to the provision of a cloud transaction to the extent they personally perform technical or operational activities for the provision of the cloud transaction, or to the extent they are managers who directly support or immediately supervise such technical or operational personnel. Proposed §1.861-19(d)(3)(iii) provides a non-exhaustive list of the functions that fall within the meaning of "technical and operational activities." These functions are the conduct of scientific, engineering, or technical activities for the configuration, delivery, or maintenance of the cloud transaction; the provision of monitoring, diagnostics, or incident response with respect to the cloud transaction's performance, reliability, efficiency, or security; the management of the cloud transaction's infrastructure; the delivery of end-user support with respect to the cloud transaction; and the conduct of any similar functions. *Id*. Further, under proposed §1.861-19(d)(3)(iv), personnel are not considered to directly contribute to the provision of the cloud transaction to the extent they conduct business strategy, leadership, legal or compliance, marketing, communications, sales, business development, finance, accounting, clerical, human resources or administrative duties, or similar functions.

Proposed §1.861-19(d)(3)(iii) and (iv) are intended to identify the individuals that generally have the hands-on, day-to-day involvement in the software, infrastructure, and processes that enable the cloud transaction to be provided to the customer and to function as intended. The Treasury Department and the IRS are of the view that the individuals who personally perform the technical and operational work and the immediate managers who direct and supervise that work are essential to the performance of the service, and therefore, their contributions must be included. By contrast, employees in higher-level management or executive positions who are responsible for setting the strategic direction of the business and making high-level decisions are too far removed from the hands-on, day-to-day work that ensures the delivery of any particular cloud transaction to the customer. Therefore, while their roles are important to the overall business, they do not directly contribute to the provision of the transaction itself and are not accounted for as part of the personnel factor. The Treasury Department and the IRS are of the view that this distinction properly interprets the statutory requirement to source gross income from a service to the place where the service is performed.

3. Tangible Property Factor

a. Determination of the tangible property factor and the portion from U.S. sources

Cloud transactions depend on physical infrastructure and hardware, such as servers and networking equipment. For this reason, the Treasury Department and the IRS are of the view that tangible property that directly supports the provision of a cloud transaction must be taken into account in determining the source of gross income from a cloud transaction. Under the proposed regulations, the tangible property factor, which is intended to represent the contribution of the tangible property to the performance of the cloud transaction, is the sum of the depreciation and rental expense for the taxable year for tangible property owned or leased by the taxpayer, to the extent the property is directly used to provide the cloud transaction. *See* proposed §1.861-19(d)(4)(i). To eliminate double counting, the proposed regulations require any depreciation or rental expense that would be included in the tangible property factor for multiple cloud transactions in a taxable year to be allocated among those transactions based on the relative gross income earned from each transaction. The portion of the tangible property factor that is from sources within the United States and comprises the numerator is equal to the part of the tangible property factor attributable to property located within the United States.

b. Determination of the depreciation expense

For purposes of computing the tangible property factor, depreciation expense for a taxable year is determined by dividing the adjusted depreciable basis (as defined in §1.168(b)-1(a)(4)) of the tangible property by the applicable recovery period as though the alternative depreciation system in section 168(g)(2) applied for the entire period the property has been in service. Proposed §1.861-19(d)(4)(iii). The Treasury Department and the IRS are of the view that the determination must be made without taking into account tax incentives intended to accelerate the recovery of costs in order to provide an allocation of depreciation that more closely reflects the asset's actual economic life. Thus, the proposed regulations explicitly state that the depreciation expense is computed without regard to the election to expense certain depreciable property under section 179 and without regard to any additional first-year depreciation provision (for example, section 168(k)).

4. Aggregation Rule

The proposed regulations include an aggregation rule, set forth in proposed §1.861-19(d)(7), that is intended to enhance the administrability of these regulations and to alleviate the compliance burden on taxpayers associated with the regulations. The rule allows a taxpayer to aggregate substantially similar cloud transactions and source the gross income from those transactions as if they were one transaction. However, the rule also prohibits a taxpayer from aggregating substantially similar cloud transactions if the taxpayer knows, or has reason to know, that doing so would materially distort the source of gross income from any cloud transaction.

For example, assume a cloud provider offers two distinct but substantially similar cloud transactions, Service 1 and Service 2, that are not in the same product line (within the meaning of proposed §1.861-19(d)(8)). Further, assume the cloud provider incurs significantly more research and experimentation costs associated with Service 2 as compared to those incurred for Service 1, and all of the research and experimentation

personnel of the cloud provider are located in the United States at all times. This leads a significantly larger percentage of the income from Service 2 to be sourced within the United States as compared to that of Service 1. Aggregating Service 1 and Service 2 would cause a materially larger amount of gross income from Service 1 to be sourced within the United States than if the income were sourced without aggregating Service 1 with Service 2. Therefore, under the proposed regulations, the cloud provider cannot aggregate Service 1 and Service 2 to source the gross income from these transactions.

5. Anti-Abuse Rule

In order to prevent taxpayers from circumventing the purpose of the proposed regulations – to attribute the source of gross income from a cloud transaction to the place where the transaction is performed – the proposed regulations would provide an anti-abuse rule. That anti-abuse rule, included in proposed §1.861-19(d)(9), would provide that if the taxpayer has entered into or structured one or more transactions with a principal purpose of reducing its U.S. tax liability in a manner inconsistent with the purpose of the proposed regulations, appropriate adjustments will be made so that the source of the taxpayer's gross income reflects the location where the cloud transaction is performed.

II. *Request for Comments*

Comments are requested on all aspects of the proposed regulations, including the following topics:

(1) whether there are appropriate and administrable ways to determine the portion of the intangible property factor from sources within and without the United States other than by relying on the location of research and experimental personnel;
(2) whether and to what extent companies presently track specified research or experimental expenditures by product line;
(3) whether there is a practicable and verifiable way to precisely link the contribution of intangible property developed in one year to a cloud transaction provided in a later year;
(4) whether relative gross income is an appropriate allocation method in cases in which the same cost or expense would be included in a factor for multiple cloud transactions during a taxable year;
(5) whether additional operating costs incurred with respect to tangible property directly used in the provision of the cloud transaction, such as electricity costs associated with cloud transactions, should be included in the tangible property factor, and if so, how to capture the costs that contribute to the performance of the cloud transaction in an administrable manner; and
(6) whether a special rule is needed to source the gross income of resellers of cloud transactions, for example, whether assets and employees other than those described in the proposed regulations better reflect the reseller's role in the cloud transaction.

Proposed Applicability Date

The regulations are proposed to apply to taxable years beginning on or after the date of publication of the Treasury decision adopting these regulations as final regulations in the ***Federal Register***.

Special Analyses

I. *Regulatory Planning and Review—Economic Analysis*

Pursuant to the Memorandum of Agreement, Review of Treasury Regulations under Executive Order 12866 (June 9, 2023), tax regulatory actions issued by the IRS are not subject to the requirements of section 6 of Executive Order 12866, as amended. Therefore, a regulatory impact assessment is not required.

II. *Paperwork Reduction Act*

This proposed rulemaking does not impose or revise any information collections subject to 44 U.S.C. Chapter 35.

III. *Regulatory Flexibility Act*

The Regulatory Flexibility Act requires consideration of the regulatory impact on small businesses. It is hereby certified that these proposed regulations, if adopted, will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act (5 U.S.C. chapter 6).

These proposed regulations would set forth specific rules for sourcing income from cloud transactions. Specifically, the proposed regulations provide guidance on sourcing such income based on three factors that are broadly consistent with existing case law on sourcing income from analogous transactions. Although data are not readily available to estimate the economic impact of the proposed regulations, the Treasury Department and the IRS project that any economic impact of the proposed regulations would be minimal for businesses regardless of size. This is because the proposed regulations adopt an approach that is broadly consistent with the general principles of existing law and reflect current industry practice. Therefore, the proposed rules are not expected to materially alter taxpayer behavior and therefore the Treasury Department and the IRS expect no material economic impact.

For the reasons stated, a regulatory flexibility analysis under the Regulatory Flexibility Act is not required. Notwithstanding the above, the Treasury Department and the IRS invite comments on the impact the proposed rules would have on small entities.

IV. *Section 7805(f)*

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.

V. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or Tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dol-

lars, updated annually for inflation. The proposed regulations do not include any Federal mandate that may result in expenditures by State, local, or Tribal governments, or by the private sector in excess of that threshold.

VI. *Executive Order 13132: Federalism*

Executive Order 13132 (entitled *Federalism*) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or preempts State law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. The proposed regulations do not have federalism implications, do not impose substantial direct compliance costs on State and local governments, and do not preempt State law within the meaning of the Executive Order.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the **ADDRESSES** heading. All comments will be available at www.regulations.gov.

A public hearing will be scheduled if requested in writing by any person that timely submits comments. Requests for a public hearing are also encouraged to be made electronically. 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 proposed regulations are Christopher E. Fulle and Michelle L. Ng of the Office of the Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, the Treasury Department and IRS propose to amend 26 CFR part 1 as follows:

PART 1--INCOME TAXES

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

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

Par. 2. Section 1.861-19, as added in a final rule published elsewhere in this issue of the ***Federal Register***, effective January 14, 2025, is amended as follows:

a. Revise the section heading and paragraph (a);

b. Redesignate paragraphs (d), (e), and (f) as paragraphs (e), (f), and (g), respectively;

c. Add new paragraph (d);

d. For each paragraph listed in the following table, remove the language in the "Remove" column and add in its place the language in the "Add" column.

Paragraph	Remove	Add
newly redesignated (e), first sentence	paragraph (d)	paragraph (e)
newly redesignated (e)(2)(i), first sentence	paragraph (d)(1)(i)	paragraph (e)(1)(i)
newly redesignated (e)(2)(ii), first sentence	paragraph (d)(1)	paragraph (e)(1)
newly redesignated (e)(5)(i), first sentence	paragraph (d)(4)	paragraph (e)(4)
newly redesignated (e)(6)(i), first sentence	paragraph (d)(5)(i)	paragraph (e)(5)(i)
newly redesignated (e)(6)(ii)(A), first sentence	paragraph (d)(5)(ii)	paragraph (e)(5)(ii)
newly redesignated (g), first sentence	paragraph (e)	paragraph (f)

e. Add paragraphs (e)(12) and (13); and

f. Revise newly redesignated paragraph (f).

The revisions and additions read as follows:

§1.861-19 Classification of, and source of gross income from, cloud transactions.

(a) *In general*. This section provides rules for classifying and sourcing gross income from cloud transactions (as defined in paragraph (b) of this section). The rules of this section apply for purposes of Internal Revenue Code sections 59A, 245A, 250, 267A, 367, 404A, 482, 679, and 1059A; subchapter N of chapter 1; chapters 3 and 4; and sections 842 and 845 (to the extent involving a foreign person), and apply with respect to transfers to foreign trusts not covered by section 679.

* * * * *

(d) *Source of income from a cloud transaction*--(1) *In general*. Gross income from a cloud transaction is sourced as services income under section 861(a)(3) or 862(a)(3), as appropriate, according to where the service is performed. The place of performance of the cloud transaction is based on the intangible property factor described in paragraph (d)(2) of this section, the personnel factor described in paragraph (d)(3) of this section, and the tangible property factor described in paragraph (d)(4) of this section. To determine gross income from a cloud transaction from sources within the United States, gross income from the cloud transaction is

multiplied by a fraction, the numerator of which is the sum of the portion of each of the intangible property factor, personnel factor, and tangible property factor that is from sources within the United States as calculated in paragraphs (d)(2)(ii), (3)(ii), and (4)(ii) of this section, and the denominator of which is the sum of the intangible property factor, personnel factor, and tangible property factor as calculated in paragraphs (d)(2)(i), (3)(i), and (4)(i) of this section. See paragraph (e)(12) of this section (*Example 12*). Any remaining gross income from a cloud transaction is gross income from sources without the United States.

(2) *Intangible property factor*--(i) *Total*. For purposes of paragraph (d)(1) of this section, the intangible property factor with respect to any cloud transaction performed by the taxpayer in a taxable year is equal to the sum of the taxpayer's specified research or experimental expenditures (as defined in section 174(b) and regardless of whether and when the expenses are deductible) for that taxable year that are associated with cloud transactions in the same product line as the cloud transaction performed and the taxpayer's amortization (other than amounts capitalized under section 174(a)(2)(A) and amortized under section 174(a)(2)(B)) and royalty expense for intangible property for the taxable year to the extent directly used to provide the cloud transaction. If the same cost or expense would be included by a taxpayer in the intangible property factor for more than one cloud transaction during a taxable year, such cost or expense is allocated among each such cloud transaction based on the relative gross income earned from each cloud transaction.

(ii) *Portion from sources within the United States*. With respect to a cloud transaction provided in a taxable year, the portion of the intangible property factor from sources within the United States is determined using a formula based on the location of all of the taxpayer's employees whose primary function is to perform research and experimentation activities associated with cloud transactions in the same product line in that taxable year (the research and experimentation personnel). The formula is as follows: applying the principles of §1.861-4(b)(2)(ii)(E) (relating to sourcing income from labor or personal services on a time basis), divide the sum of the total compensation paid to the research and experimentation personnel for services performed within the United States by the sum of the total compensation paid to the research and experimentation personnel, and multiply the resulting quotient by the intangible property factor described in paragraph (d)(2)(i) of this section.

(3) *Personnel factor*--(i) *Total*. For purposes of paragraph (d)(1) of this section, the personnel factor with respect to a cloud transaction performed in a taxable year is equal to the sum of the total compensation paid to all of the taxpayer's employees in that taxable year whose primary function is to directly contribute to the provision of the cloud transaction, excluding compensation amounts that are paid to research and experimentation personnel described in paragraph (d)(2) of this section. If, however, an employee's primary function is to directly contribute to multiple cloud transactions, then all of such employee's compensation is allocated among the cloud transactions that the employee directly contributes to as part of their primary function based on the relative amount of time the employee spends contributing to each cloud transaction. If an employee contributes to multiple cloud transactions simultaneously, then that employee's compensation is allocated among those cloud transactions based on the relative gross income earned from each cloud transaction.

(ii) *Portion from sources within the United States*. With respect to a cloud transaction, the portion of the personnel factor described in paragraph (d)(3)(i) of this section that is from sources within the United States is equal to the part of that factor paid for services performed in the United States, as determined using the principles of §1.861-4(b)(2)(ii)(E) (relating to sourcing income from labor or personal services on a time basis).

(iii) *Personnel considered to directly contribute to the provision of the cloud transaction*. Personnel are considered to directly contribute to the provision of the cloud transaction to the extent they personally perform technical or operational activities for the provision of the cloud transaction, or to the extent they are a manager who directly supports or immediately supervises such technical or operational personnel. Such technical or operational activities are the conduct of scientific, engineering, or technical activities for the configuration, delivery, or maintenance of the cloud transaction; the provision of monitoring, diagnostics, or incident response with respect to the cloud transaction's performance, reliability, efficiency, or security; the management of the cloud transaction's infrastructure; the delivery of end-user support with respect to the cloud transaction; and the conduct of any similar functions.

(iv) *Personnel not considered to directly contribute to the provision of the cloud transaction*. Personnel are not considered to directly contribute to the provision of the cloud transaction to the extent they conduct business strategy, leadership, legal or compliance, marketing, communications, sales, business development, finance, accounting, clerical, human resources or administrative duties, or similar functions.

(4) *Tangible property factor*--(i) *Total*. For purposes of paragraph (d)(1) of this section, the tangible property factor with respect to a cloud transaction performed in a taxable year is equal to the sum of the depreciation expense for that taxable year for tangible property owned by the taxpayer and rental expense for that taxable year for tangible property leased by the taxpayer, in each case to the extent directly used to provide the cloud transaction. If any depreciation expense or rental expense would be included in the tangible property factor for more than one cloud transaction during the taxable year, such depreciation expense or rental expense is allocated among the cloud transactions based on relative gross income earned from each cloud transaction.

(ii) *Portion from sources within the United States*. The portion of the tangible property factor described in paragraph (d)(4)(i) of this section from sources within the United States is equal to the part of that factor attributable to property located within the United States.

(iii) *Determination of depreciation expense*. For purposes of paragraph (d)(4) of this section, depreciation expense for a taxable year is determined by dividing the adjusted depreciable basis (as defined in §1.168(b)-1(a)(4)) of the tangible prop-

erty by the applicable recovery period as though the alternative depreciation system set forth in section 168(g)(2) applied for the entire period that such property has been in service, without regard to the election to expense certain depreciable property under section 179 and without regard to any additional first-year depreciation provision (for example, section 168(k)).

(5) *Primary function*. For purposes of this section, an employee's primary function is the set of tasks to which they are assigned to spend the majority of their working time.

(6) *Employee*. For purposes of this section, the term employee has the meaning given to it in §31.3121(d)-1(c).

(7) *Aggregation rule*. For purposes of applying this paragraph (d), a taxpayer may aggregate substantially similar cloud transactions unless it knows or has reason to know that doing so would materially distort the source of gross income from any cloud transaction.

(8) *Product line*. For purposes of this section, a product line is defined as all products within the same Corresponding Index Entry under a North American Industry Classification System (NAICS) code number. Once a taxpayer selects a Corresponding Index Entry and NAICS code number for the first taxable year for which this section applies, it must continue to use that Corresponding Index Entry and NAICS code number in following years unless the taxpayer establishes to the satisfaction of the Commissioner that, due to changes in the relevant facts, a change in Corresponding Index Entry and NAICS code number is appropriate.

(9) *Anti-Abuse Rule*. The purpose of this paragraph (d) is to attribute the source of the taxpayer's gross income from a cloud transaction to the location where the cloud transaction is performed. Therefore, if the taxpayer has entered into or structured one or more transactions with a principal purpose of reducing its U.S. tax liability in a manner inconsistent with the purpose of this paragraph (d), appropriate adjustments will be made so that the source of the taxpayer's gross income reflects the location where the cloud transaction is performed.

(e) * * *

(12) *Example 12*: *Sourcing gross income from a cloud transaction*--(i) *Facts*. (A) Corp A provides customers on-demand network access to Program Y in exchange for a monthly fee. All of the transactions with customers are substantially similar to one another. Customers must be connected to the Internet to access the functionality of Program Y.

(B) Corp A has employees whose primary function (as determined under paragraph (d)(5) of this section) is to conduct research and experimentation associated with developing new versions of Program Y and other products in the same product line (as determined under paragraph (d)(8) of this section). Corp A paid $160x in compensation to such employees, of which $80x was paid for services performed within the United States as determined in accordance with the principles of §1.861-4(b)(2)(ii)(E). Besides employee compensation, Corp A spent an additional $200x for research and experimentation costs associated with developing new versions of Program Y and other products in the same product line. Corp A did not take any amortization deductions with respect to intellectual property used to provide Program Y.

(C) Corp A paid $400x in compensation to employees whose primary function was to directly contribute (as determined under paragraphs (d)(3)(iii) and (iv) of this section) to Corp A's provision of Program Y to customers, of which $100x was paid for services performed in the United States as determined in accordance with the principles of §1.861-4(b)(2)(ii)(E). None of these employees were research and experimentation personnel (as defined in paragraph (d)(2)(ii) of this section).

(D) Corp A hosts Program Y on servers it owns that are located both within and without the United States. These servers are used only to host Program Y. Corp A deducted $140x for depreciation expense attributable to these servers, $80x of which was attributable to the servers located within the United States, and $60x of which was attributable to the servers located without the United States. These depreciation deductions are in accordance with the rules of section 168(g)(2).

(E) Corp A earned $800x of gross income from providing customers access to Program Y. Corp A does not know or have reason to know that any of the costs, functions or assets described in this paragraph are disproportionately allocated to certain transactions or groups of transactions among all of the transactions that generated $800x of gross income.

(ii) *Analysis*. (A) Under paragraph (b) of this section, each transaction between Corp A and a customer is a cloud transaction because Corp A provides on-demand network access to Program Y. Under paragraph (c)(1) of this section, each cloud transaction is classified as the provision of services. Under paragraph (d)(7) of this section, because all of these transactions are substantially similar and Corp A does not know or have reason to know that there is any disproportionate allocation of costs, functions or assets among them, all of the transactions may be considered in the aggregate for purposes of applying paragraph (d) of this section.

(B) Under paragraph (d)(1) of this section, the source of Corp A's $800x of gross income from providing access to Program Y to customers is determined based on the intangible property factor described in paragraph (d)(2) of this section, the personnel factor described in paragraph (d)(3) of this section, and the tangible property factor described in paragraph (d)(4) of this section.

(C) Under paragraph (d)(2) of this section, the intangible property factor is equal to $360x because Corp A paid $160x in compensation to employees whose primary function was to conduct research and experimentation associated with developing new versions of Program Y and other products in the same product line, and incurred $200x in other research and experimentation costs associated with developing new versions of Program Y and other products in the same product line. $80x/$160x of such compensation, or 50%, is paid to employees for research and experimentation services performed with respect to Program Y and other products in the same product line in the United States. Corp A's $360x intangible property factor is multiplied by the same quotient to determine that $180x is from sources within the United States pursuant to paragraph (d)(2)(ii) of this section.

(D) Under paragraph (d)(3) of this section, the personnel factor is equal to $400x because Corp A paid $400x in compensation to employees whose primary function was to directly contribute to the provision of Program Y to customers and none of these employees were research and experimentation personnel (as defined in paragraph (d)(2)(ii) of this section). Pursuant to paragraph (d)(3)(ii) of this section, $100x of the personnel factor is from sources within the United States because Corp A paid $100x in compensation to employees for services performed in the United States that directly contributed to the provision of Program Y to customers.

(E) Under paragraph (d)(4) of this section, the tangible property factor is equal to $140x because Corp A deducted $140x in depreciation expense for tangible property directly used to provide Program Y to customers under the method described in section 168(g)(2). $80x of the tangible property factor is from sources within the United States because this amount of the $140x depreciation expense is attributable to tangible property located within the United States.

(F) The sum of the intangible property factor ($360x), the personnel factor ($400x), and the tangible property factor ($140x) is equal to $900x. The sum of these factors from sources within the United States is $360x ($180x with respect to the intangible property factor, $100x with respect to the personnel factor, and $80x with respect to the tangible property factor). Accordingly, Corp A's $800x of gross income from providing Program Y to customers for the taxable year is multiplied by the quotient of $360x/$900x pursuant to paragraph (d)(1) of this section to determine that $320x is from sources within the United States. Pursuant to paragraph (d)(1) of this section, the remaining $480x ($800x - $320x) is from sources without the United States.

(13) *Example 13*: *Sourcing gross income from multiple cloud transactions*--(i) *Facts*. (A) The facts are the same as in paragraph (e)(12) of this section (*Example 12*), except that Corp A also provides customers on-demand network access to software platform Z in exchange for a monthly fee, and Corp A hosts software platform Z on the same servers it uses to host Program Y (which generate more depreciation than in *Example 12*). All of the transactions for software platform Z customers are substantially similar to one another. Customers must be connected

to the Internet to access the functionality of software platform Z.

(B) Corp A has employees whose primary function (as determined under paragraph (d)(5) of this section) is to conduct research and experimentation associated with developing new versions of software platform Z and other products in the same product line. The software platform Z product line is not the same as the Program Y product line under the definition in paragraph (d)(8) of this section. Corp A paid $200x in compensation to such employees, all of which was paid for services performed in the United States as determined in accordance with the principles of §1.861-4(b)(2)(ii)(E). Corp A also has employees whose primary function as determined under paragraph (d)(5) of this section is to conduct research and experimentation associated with developing functionality for new versions of both Program Y and software platform Z. Corp A paid $100x in compensation to such employees, all of which was paid for services performed in the United States as determined in accordance with the principles of §1.861-4(b)(2)(ii)(E). Corp A did not have any other research and experimentation costs associated with software platform Z.

(C) Corp A paid $100x in compensation to employees whose primary function was to directly contribute (as determined under paragraphs (d)(3)(iii) and (iv) of this section) to Corp A's provision of software platform Z to customers, and that entire amount was paid for services performed in the United States as determined in accordance with the principles of §1.861-4(b)(2)(ii)(E). None of these employees were research and experimentation personnel (as defined in paragraph (d)(2)(ii) of this section). Corp A also paid $80x in compensation to employees whose primary function was to directly contribute (as determined under paragraphs (d)(3)(iii) and (iv) of this section) to Corp A's provision of both Program Y and software platform Z to customers, and that entire amount was paid for services performed in the United States as determined in accordance with the principles of §1.861-4(b)(2)(ii)(E). These employees spent half their time contributing to software platform Z transactions and half their time contributing to Program Y transactions. None of these employees were research and experimentation personnel (as defined in paragraph (d)(2)(ii) of this section).

(D) Corp A hosts software platform Z on servers it owns that are located both within and without the United States. These servers are used to host both Program Y and software platform Z. Corp A deducted $180x for depreciation expense attributable to these servers, $120x of which was attributable to the servers located within the United States, and $60x of which was attributable to the servers located without the United States. These depreciation deductions are in accordance with the rules of section 168(g)(2).

(E) Corp A earned $800x of gross income from providing customers access to software platform Z. Corp A does not know or have reason to know that any of the costs, functions or assets described in this paragraph are disproportionately allocated to certain transactions or groups of transactions among all of the transactions that generated $800x of gross income.

(ii) *Analysis*. (A) Under paragraph (b) of this section, each transaction between Corp A and a customer for software platform Z is a cloud transaction because Corp A provides on-demand network access to software platform Z. Under paragraph (c)(1) of this section, each cloud transaction is classified as the provision of services. Under paragraph (d)(7) of this section, because all of these software platform Z transactions are substantially similar and Corp A does not know or have reason to know that there is any disproportionate allocation of costs, functions or assets among them, all of the software platform Z transactions may be considered in the aggregate for purposes of applying paragraph (d) of this section.

(B) Under paragraph (d)(1) of this section, the source of Corp A's $800x of gross income from providing access to software platform Z to customers is determined based on the intangible property factor described in paragraph (d)(2) of this section, the personnel factor described in paragraph (d)(3) of this section, and the tangible property factor described in paragraph (d)(4) of this section.

(C) Under paragraph (d)(2) of this section, the intangible property factor is equal to $250x. Corp A paid $200x in compensation to employees whose primary function was to conduct research and experimentation associated with developing new versions of software Platform Z and other products in the same product line. Corp A also paid $100x in compensation to employees whose primary function was to conduct research and experimentation developing functionality for new versions of both Program Y and software platform Z, of which Corp A allocates $50x to software Platform Z and $50x to Program Y based on Corp A's relative gross income from Program Y and software platform Z transactions in the taxable year. $250x/$250x of such compensation, or 100%, is paid to employees for research and experimentation services performed in the United States with respect to software Platform Z and other products in the same product line. Corp A's $250x intangible property factor is multiplied by the same quotient to determine that $250x is from sources within the United States pursuant to paragraph (d)(2)(ii) of this section.

(D) Under paragraph (d)(3) of this section, the personnel factor is equal to $140x. Corp A paid $100x in compensation to employees whose primary function was to directly contribute to the provision of software platform Z to customers and none of these employees were research and experimentation personnel (as defined in paragraph (d)(2)(ii) of this section). Corp A also paid $80x in compensation to employees whose primary function was to directly contribute to the provision of both Program Y and software platform Z (and none of these employees were research and experimentation personnel (as defined in paragraph (d)(2)(ii) of this section)), and Corp A allocated $40x to software platform Z and $40x to Program Y based on the relative amount of time these employees spent contributing to Program Y and software platform Z transactions in the taxable year. $140x/$140x of such compensation, or 100%, is paid to employees for services performed in the United States that directly contributed to the provision of software platform Z to customers.

(E) Under paragraph (d)(4) of this section, the tangible property factor is equal to $90x. Corp A deducted $180x in depreciation expense for tangible property directly used to provide both Program Y and software platform Z transactions under the method described in section 168(g)(2), of which $120x is from sources within the United States because this amount is attributable to tangible property located within the United States. Based on Corp A's relative gross income from Program Y and software platform Z transactions in the taxable year, Corp A reasonably allocates $90x to software platform Z, of which $60x is from sources within the United States and $90x to Program Y, of which $60x is from sources within the United States.

(F) The sum of the intangible property factor ($250x), the personnel factor ($140x), and the tangible property factor ($90x) is equal to $480x. The sum of these factors from sources within the United States is $450x ($250x with respect to the intangible property factor, $140x with respect to the personnel factor, and $60x with respect to the tangible property factor). Accordingly, Corp A's $800x of gross income from providing software platform Z to customers for the taxable year is multiplied by the quotient of $450x/$480x pursuant to paragraph (d)(1) of this section to determine that $750x is from sources within the United States. Pursuant to paragraph (d)(1) of this section, the remaining $50x ($800x - $750x) is from sources without the United States.

(f) *Applicability date*--(1) *In general*. Except as otherwise provided in this paragraph (f), this section applies to taxable years beginning on or after January 14, 2025. Paragraphs (d), (e)(12) and (13) of this section apply to taxable years beginning on or after the date of publication of the Treasury decision adopting those paragraphs as final regulations in the *Federal Register*.

(2) *Early application*. Except for paragraphs (d), (e)(12) and (13) of this section, a taxpayer can apply this section to taxable years beginning on or after August 14, 2019 and all subsequent taxable years not described in paragraph (f)(1) (early application years) if--

(i) The taxpayer also applies §1.861-18 to the early application years;

(ii) This section and §1.861-18 are applied to the early application years by all persons related to the taxpayer (within the meaning of sections 267(b) and 707(b));

(iii) The period of limitations on assessment for each early application year of the taxpayer and all related parties (within the meaning of sections 267(b) and 707(b)) is open under section 6501; and

(iv) The taxpayer would not be required under this section to change its method of accounting as a result of such election.

* * * * *

Douglas W. O'Donnell,
Deputy Commissioner.

(Filed by the Office of the Federal Register January 10, 2025, 8:45 a.m., and published in the issue of the Federal Register for January 14, 2025, 90 FR 3075)

Notice of Proposed Rulemaking

Multi-Year Reporting Requirements for Corporate Separations and Related Transactions

REG-116085-23

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that would require multi-year tax reporting for corporate separations and related transactions. The information to be reported under these proposed regulations would establish the taxpayer's position that the corporate separation and related transactions qualify for nonrecognition treatment under subchapter C of the Internal Revenue Code. The proposed regulations would affect corporations and their shareholders and security holders. Proposed regulations regarding certain matters relating to corporate separations, incorporations, and reorganizations qualifying for nonrecognition of gain or loss are published elsewhere in the Proposed Rules section of this issue of the ***Federal Register***.

DATES: Written or electronic comments and requests for a public hearing must be received by March 17, 2025.

ADDRESSES: Commenters are strongly encouraged to submit public comments on these proposed regulations and the related form and instructions electronically via the Federal eRulemaking Portal at *https://www.regulations.gov* (indicate IRS and REG-116085-23) by following the online instructions for submitting comments. Requests for a public hearing must be submitted as prescribed in the "Comments and Requests for a Public Hearing" section. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comments to the IRS's public docket. Send paper submissions to CC:PA:01:PR (REG-116085-23), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Barrett D. Cappadonna at (202) 317-6975 (not a toll-free number); concerning submissions of comments and requests for a hearing, contact the Publications and Regulations branch at (202) 317-6901 (not a toll-free number) or by email to *publichearings@irs.gov* (preferred).

SUPPLEMENTARY INFORMATION:

Authority

This document contains proposed regulations under section 355 of the Internal Revenue Code (Code) that would amend the Income Tax Regulations (26 CFR part 1) by substantially revising the information reporting requirements of §1.355-5 (proposed regulations). The proposed regulations are issued under the express delegation of section 7805(a) of the Code, which authorizes the Secretary to "prescribe all needful rules and regulations for the enforcement of [the Code], including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue."

Background

I. *Overview of Section 355*

Section 355(a)(1) provides that, if certain requirements are met, a distribution of stock, or stock and securities, of one or more controlled corporations by a distributing corporation to the distributing corporation's shareholders, or to the distributing corporation's shareholders and security holders, may be received by the distributees without the distributees recognizing gain or loss or including any amount in income (section 355 transaction). Section 355(c) generally provides that no gain or loss is recognized to a distributing corporation upon a distribution of qualified property that is not in pursuance of a plan of reorganization (section 355(c) distribution). Section 355(c)(2)(B) defines "qualified property" as any stock or securities in a controlled corporation. If, in addition to the distribution of qualified property, the distributing corporation distributes other property in the section 355 transaction and the fair market value of that other property exceeds the distributing corporation's adjusted basis in that other property, gain is recognized to the distributing corporation as if the property were sold to the distributee at its fair market value. *See* section 355(c)(2)(A).

Taxpayers also may carry out a section 355 transaction as part of a transaction that qualifies as a reorganization under section 368(a)(1)(D) or (G) of the Code and to which neither section 354 of the Code nor so much of section 356 of the Code as relates to section 354 applies (divisive reorganization). A transfer by a distributing corporation of part of its assets to a controlled corporation is a divisive reorganization if, immediately after the transfer, one or more of the distributing corporation's shareholders (including persons who were shareholders immediately before the transfer) have control (as defined in section 368(c)) of the controlled corporation and if, pursuant to the plan of reorganization, stock or securities of the controlled corporation are distributed in a transaction that qualifies under section 355.

Section 361(c) of the Code generally provides that no gain or loss is recognized to a distributing corporation upon a distribution of qualified property in pursuance of a plan of reorganization. Section 361(c)(2)(B) defines "qualified property" as (i) any stock, right to acquire stock, or obligation (including a security) of the distributing corporation, or (ii) any stock, right to acquire stock, or obligation (including a security) of a controlled corporation received by the distributing corporation as part of the divisive reorganization. If, in addition to the distribution of qualified property, the distributing corporation distributes other property as part of a divisive reorganization and the fair market value of that other property exceeds the distributing corporation's adjusted basis in that other property, gain is recognized to the distributing corporation as if the property

were sold to the distributee at its fair market value. *See* section 361(c)(2)(A).

II. *Current Reporting Requirements for Section 355 Transactions*

Section 1.355-5(a)(1) currently requires the distributing corporation to report a section 355 transaction to the IRS by including a statement with the distributing corporation's Federal income tax return for the year of the section 355 transaction (§1.355-5(a) statement). The §1.355-5(a) statement must include: (i) the name and employer identification number (if any) of the controlled corporation; (ii) the name and taxpayer identification number (if any) of every "significant distributee" (as defined in §1.355-5(c)(1)); (iii) the date of the section 355 transaction; (iv) the aggregate fair market value and basis, determined immediately before the section 355 transaction, of the stock, securities, or other property (including money) distributed by the distributing corporation; and (v) the date and control number of any private letter ruling(s) issued by the IRS in connection with the section 355 transaction.

If the distributing corporation is a controlled foreign corporation within the meaning of section 957 of the Code (CFC), each United States shareholder (within the meaning of section 951(b) of the Code) with respect to the CFC must include a §1.355-5(a) statement on or with its return. *See* §1.355-5(a)(1). If the distributing corporation transfers assets to a controlled corporation in a transaction described in a divisive reorganization, then the distributing corporation (or, if the distributing corporation is a CFC, each United States shareholder) also must include the statement required by §1.368-3(a) on or with its return for the year of the section 355 transaction. *See* §1.355-5(a)(2).

Section 1.355-5(b) currently imposes requirements similar to those in §1.355-5(a) upon significant distributees. More specifically, §1.355-5(b)(1) requires every significant distributee to include a statement on or with the significant distributee's return for the year in which the section 355 transaction is received (§1.355-5(b) statement). The §1.355-5(b) statement must include: (i) the names and employer identification numbers (if any) of the distributing and controlled corporations; (ii) the date of the section 355 transaction; (iii) the aggregate basis, determined immediately before the section 355 transaction, of any stock or securities transferred by the significant distributee in the transaction; and (iv) the aggregate fair market value, determined immediately before the section 355 transaction, of the stock, securities, or other property (including money) received by the significant distributee in the section 355 transaction. If a significant distributee is a CFC, each United States shareholder with respect to the CFC must include this statement on or with the United States shareholder's return.

Section 1.355-5(d) currently imposes substantiation requirements. More specifically, §1.355-5(d) requires taxpayers to retain their permanent records (specifically including information regarding the amount, basis, and fair market value of all property distributed or exchanged in the section 355 transaction, and relevant facts regarding any liabilities assumed or extinguished as part of the section 355 transaction) and make those records available to any authorized IRS officers and employees. *See* §1.6001-1(e).

Explanation of Provisions

The Treasury Department and the IRS are of the view that enhancing the reporting requirements for section 355 transactions would improve the IRS's ability to administer section 355 (and related provisions of the Code) to ensure that transactions intended to qualify under section 355 (and such related provisions) satisfy the requirements for nonrecognition treatment. Accordingly, these proposed regulations would revise §1.355-5 to require all covered filers, as defined in proposed §1.355-5(b)(1), to file with the IRS an annual report with regard to each section 355 transaction (Form 7216, *Multi-Year Reporting Related to Section 355 Transactions*) that would be attached to the covered filer's Federal income tax return.

For purposes of the proposed regulations, the term "section 355 transaction" includes both divisive reorganizations and section 355(c) distributions. The term "covered filer" would include, with regard to any section 355 transaction: (i) a distributing corporation or a person that, immediately before the first distribution, was a United States shareholder (within the meaning of section 951(b)) with respect to a controlled foreign corporation (within the meaning of section 957 of the Code, but determined without applying subparagraphs (A), (B), and (C) of section 318(a)(3) of the Code) that is the distributing corporation; (ii) a controlled corporation or a person that, immediately before the first distribution, was a United States shareholder with respect to a controlled foreign corporation that is the controlled corporation; (iii) a significant distributee or a person that, immediately before the first distribution, was a United States shareholder with respect to a controlled foreign corporation that is a significant distributee; or (iv) any other person required by the Commissioner of Internal Revenue (Commissioner) to file Form 7216 (or any successor form) in instructions, guidance, or publications published in the Internal Revenue Bulletin (*see* §§601.601(d)(2) and 601.602 of this chapter). The term "covered filer" also would include any successor (within the meaning of section 381(a) of the Code) to an entity described in the preceding sentence. The proposed regulations also would revise the definition of a "significant distributee" in current §1.355-5(c)(1)(i) by raising the ownership threshold for non-publicly traded stock from one percent to five percent.

However, the term "covered filer" would be defined to encompass solely taxpayers required to file certain specified Federal income tax returns. These returns would be limited to: (i) Form 1040, *U.S. Individual Income Tax Return*; (ii) Form 1040-NR, *U.S Nonresident Alien Income Tax Return*; (iii) Form 1065, *U.S. Return of Partnership Income*; (iv) Form 1120, *U.S. Corporation Income Tax Return*; (v) Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*; (vi) Form 1120-S, *U.S. Income Tax Return for an S Corporation*; and (vii) any other form listed in instructions, guidance, or publications published in the Internal Revenue Bulletin (*see* §§601.601(d)(2) and 601.602 of this chapter). Accordingly, a taxpayer that is not required to file one of these specified Federal income tax returns (such as

an estate, a trust, or a regulated investment company (as defined in section 851(a) of the Code)) would not be required to file Form 7216. The Treasury Department and the IRS request comments as to whether taxpayers required to file additional types of Federal income tax returns should be required to file Form 7216.

Each covered filer would be required to file Form 7216 with regard to each section 355 transaction for the required reporting period. For this purpose, the term "required reporting period" would mean the period (i) beginning in the covered filer's taxable year in which the first distribution occurs, and (ii) ending in the fifth taxable year of the covered filer after the taxable year in which the control distribution occurs. The five-year required reporting period would apply to a covered filer (or its successor) even in cases where the covered filer (or its successor) ceases to be a United States shareholder with respect to a relevant corporation and is no longer required to file Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations*, with respect to such corporation.

Consistent with current §1.355-5(d), the proposed regulations would require that, under §1.6001-1(e), a covered filer must retain its permanent books and records and make those books and records available for inspection by any authorized IRS officers and employees. In addition, the proposed regulations would provide that, in connection with the section 355 transaction, the covered filer's books and records, as relevant to the section 355 transaction, will be considered to be complete and accurate if they contain all information necessary to document and substantiate satisfaction of the requirements under section 355.

The proposed regulations would significantly enhance the IRS's ability to identify section 355 transactions that pose the highest risk of potential Federal income tax noncompliance and abuse. These proposed regulations also would help effectuate a broader effort by the Treasury Department and the IRS to close the portion of the Federal tax gap (that is, the difference between all Federal taxes that are owed and those that are collected) due to such potential noncompliance and abuse.

Because the enhanced reporting requirements in these proposed regulations would augment the IRS's ability to identify section 355 transactions with the highest risk of potential noncompliance and abuse, the Treasury Department and the IRS are of the view that additional flexibility can be provided in the substantive rules applicable to section 355 transactions (for example, by affording taxpayers additional time to carry out a plan of distribution). Proposed regulations that would provide guidance regarding certain matters relating to corporate separations, incorporations, and reorganizations qualifying, in whole or in part, for nonrecognition of gain or loss are published elsewhere in the Proposed Rules section of this issue of the ***Federal Register***.

The proposed reporting requirements would apply to all types of section 355 transactions with a covered filer. Specifically, the proposed regulations would apply to (i) section 355 transactions within an affiliated group (as defined in section 1504(a)(1) of the Code, without regard to the exceptions in section 1504(b)) (internal section 355 transaction), and (ii) section 355 transactions in which stock or securities of a controlled corporation are distributed to a distributing corporation shareholder or security holder that is not a member of the distributing corporation's affiliated group (external section 355 transaction). To reflect the differences between internal section 355 transactions and external section 355 transactions (including the different statutory requirements and potential for Federal income tax noncompliance or abuse), the proposed regulations would impose, through the annual Form 7216, different reporting requirements for each type of section 355 transaction.

These proposed regulations are consistent with the recommendations set forth in the Treasury Inspector General for Tax Administration (TIGTA) report titled "A Strategy Is Needed to Assess the Compliance of Corporate Mergers and Acquisitions With Federal Tax Requirements," Ref. No. 2019-30-050 (Sept. 5, 2019). In that report, TIGTA recommended that the Commissioner determine whether merger and acquisition (M&A) tax forms, and information provided on those forms, could be used as a compliance tool within a larger strategy to assess risk and ensure that corporate M&A transactions are compliant with the Code. These proposed regulations would enable the IRS to collect information on section 355 transactions from taxpayers engaging in those transactions and utilize that information to identify potential noncompliance with section 355 and other related provisions of the Code.

Special Analyses

I. *Regulatory Planning and Review*

Pursuant to the Memorandum of Agreement, Review of Treasury Regulations under Executive Order 12866 (June 9, 2023), tax regulatory actions issued by the IRS are not subject to the requirements of section 6 of Executive Order 12866, as amended. Therefore, a regulatory impact assessment is not required.

II. *Paperwork Reduction Act*

The Paperwork Reduction Act of 1995 (44 U.S.C. 3501 - 3520) (PRA) requires that a Federal agency obtain the approval of the Office of Management and Budget (OMB) before collecting information from the public, whether such collection of information is mandatory, voluntary, or required to obtain or retain a benefit. A Federal agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collections of information in these proposed regulations contain reporting and recordkeeping requirements that are necessary to identify potential noncompliance with the requirements of section 355 and related sections of the Code. These collections of information generally would be used by the IRS for tax compliance purposes and by taxpayers to facilitate proper reporting and compliance.

The recordkeeping requirements within this proposed regulation are considered general tax records under §1.6001-1. These records are required for the IRS to validate that taxpayers have met the requirements under section 355

and related sections of the Code. For PRA purposes, general tax records are already approved by OMB under control numbers 1545-0123 for business filers and 1545-0074 for individual filers.

The reporting requirements outlined in §1.355-5 will be covered within the form and instructions for IRS Form 7216 (or any successor form). This form will be approved under 1545-0123 for business filers and 1545-0074 for individual filers. The IRS will be submitting the form to OMB for approval under these OMB control numbers in accordance with the PRA procedures in 5 CFR 1320.10.

III. *Regulatory Flexibility Act*

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these proposed regulations would not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these proposed regulations primarily would affect corporations that are publicly traded corporations, which tend to be larger businesses. Specifically, the Research, Applied Analytics, and Statistics Division of the IRS estimates that approximately 110 small businesses with gross receipts under $25 million would be subject to collection of information in these regulations annually. In addition, the collection of information in these proposed regulations is an incremental, additional obligation on small entities to a currently existing collection of information. Moreover, the economic impact of these proposed regulations will not be significant.

Therefore, these proposed regulations would not create significant additional obligations for, or impose any meaningful economic impact on, a substantial number of small entities. Accordingly, the Secretary certifies that the proposed regulations would not have a significant economic impact on a substantial number of small entities and a regulatory flexibility analysis is not required.

Pursuant to section 7805(f) of the Code, the proposed regulations have been submitted to the Chief Counsel for the Office of Advocacy of the Small Business Administration for comment on its impact on small business.

IV. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or Tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. These proposed regulations do not include any Federal mandate that may result in expenditures by State, local, or Tribal governments, or by the private sector, in excess of that threshold.

V. *Executive Order 13132: Federalism*

Executive Order 13132 (Federalism) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or preempts State law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. This proposed rule does not have federalism implications and does not impose substantial direct compliance costs on State and local governments or preempt State law within the meaning of the Executive order.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in the preamble under the **ADDRESSES** heading. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. All commenters are strongly encouraged to submit comments electronically. The Treasury Department and the IRS will publish for public availability any comment submitted electronically or on paper to its public docket on *https://www.regulations.gov*.

A public hearing will be scheduled if requested in writing by any person who timely submits electronic or written comments. Requests for a public hearing also are encouraged to be made electronically. If a public hearing is scheduled, notice of the date and time for the public hearing will be published in the ***Federal Register***.

Drafting Information

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

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, the Treasury Department and the IRS propose to amend 26 CFR part 1 as follows:

PART 1–INCOME TAXES

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

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

* * * * *

Par. 2. Section 1.355-5 is revised to read as follows:

§1.355-5 Information reporting and record retention requirements.

(a) *Reporting of transaction information*—(1) *Annual reporting form*—(i) *In general*. For each taxable year of the required reporting period, a covered filer must file annually with the IRS a complete and accurate Form 7216, *Multi-Year Reporting Related to Section 355 Transactions* (or as provided in publications, forms, instructions, or other guidance), with regard to a section 355 transaction.

(ii) *Manner of filing form*. A covered filer must file Form 7216 (or any successor form)—

(A) With the specified Federal income tax return of the covered filer for the taxable year (*see* section 6011 of the Code and §1.6011-1); and

(B) In the manner prescribed by the Commissioner in instructions, guidance,

or publications published in the Internal Revenue Bulletin (*see* §§601.601(d)(2) and 601.602 of this chapter).

(2) [Reserved]

(3) [Reserved]

(b) *Definitions*. The following definitions apply for purposes of this section:

(1) *Covered filer*—(i) *In general*. The term *covered filer* means a taxpayer that is required to file a specified Federal income tax return and that is—

(A) A distributing corporation or a person that, immediately before the first distribution, was a United States shareholder (within the meaning of section 951(b) of the Code) with respect to a controlled foreign corporation (within the meaning of section 957 of the Code, but determined without applying subparagraphs (A), (B), and (C) of section 318(a)(3)) that is the distributing corporation;

(B) A controlled corporation or a person that, immediately before the first distribution, was a United States shareholder with respect to a controlled foreign corporation that is the controlled corporation;

(C) A significant distributee or a person that, immediately before the first distribution, was a United States shareholder with respect to a controlled foreign corporation that is a significant distributee; or

(D) Any other person required by the Commissioner to file Form 7216 (or any successor form) in accordance with instructions, guidance, or publications published in the Internal Revenue Bulletin (*see* §§601.601(d)(2) and 601.602 of this chapter).

(ii) *Successors*. The term *covered filer* includes any successor (within the meaning of section 381(a) of the Code) to an entity described in paragraph (b)(1)(i) of this section.

(2) *Required reporting period*. The term *required reporting period* means the period—

(i) Beginning in the taxable year of the covered filer during which the first distribution occurs; and

(ii) Ending in the fifth taxable year of the covered filer after the taxable year in which the control distribution occurs.

(3) *Significant distributee*. The term *significant distributee* means:

(i) A holder of stock of a distributing corporation that—

(A) Receives stock of a controlled corporation in a section 355 transaction; and

(B) Owned at least five percent (by vote or value) of the total outstanding stock of the distributing corporation immediately before the first distribution.

(ii) A holder of securities of a distributing corporation that—

(A) Receives stock or securities of a controlled corporation in a section 355 transaction; and

(B) Owned securities in the distributing corporation with a basis of at least $1,000,000 immediately before the first distribution.

(4) *Specified Federal income tax return*. The term *specified Federal income tax return* means—

(i) Form 1040, *U.S. Individual Income Tax Return*;

(ii) Form 1040-NR, *U.S. Nonresident Alien Income Tax Return*;

(iii) Form 1065, *U.S. Return of Partnership Income*;

(iv) Form 1120, *U.S. Corporation Income Tax Return*;

(v) Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*;

(vi) Form 1120-S, *U.S. Income Tax Return for an S Corporation*; or

(vii) Any other form listed in instructions, guidance, or publications published in the Internal Revenue Bulletin (*see* §§601.601(d)(2) and 601.602 of this chapter).

(c) *Substantiation information*. Under §1.6001-1(e), a covered filer must retain its permanent books and records and make those books and records available for inspection by any authorized IRS officers and employees. In connection with the section 355 transaction, the covered filer's books and records, as relevant to the section 355 transaction, will be considered to be complete and accurate if they contain all information necessary to document and substantiate satisfaction of the requirements under section 355.

(d) *Applicability date*—(1) *In general*. Except as provided in paragraph (d)(2) of this section, the rules of this section apply to taxable years ending after [date of publication of final regulations in the ***Federal Register***] with respect to section 355 transactions occurring after January 16, 2025. For rules applicable to prior taxable years, *see* §1.355-5 as in effect and contained in 26 CFR part 1, as revised April 1, 2024.

(2) [Reserved]

Douglas W. O'Donnell,
Deputy Commissioner.

(Filed by the Office of the Federal Register January 13, 2025, 4:15 p.m., and published in the issue of the Federal Register for January 16, 2025, 90 FR 4687)

Notice of Proposed Rulemaking

Certain Employee Remuneration in Excess of $1,000,000 under Internal Revenue Code Section 162(m)

REG-118988-22

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document sets forth proposed regulations under section 162(m) of the Internal Revenue Code, which limits the deduction for certain employee remuneration in excess of $1,000,000 for Federal income tax purposes. These proposed regulations implement the amendments made to section 162(m) by the American Rescue Plan Act of 2021. These proposed regulations would affect publicly held corporations.

DATES: Written or electronic comments and requests for a public hearing must be received by March 17, 2025.

ADDRESSES: Commenters are strongly encouraged to submit public comments electronically. Submit electronic submissions via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG-118988-22) by following the online instructions for submitting comments. Requests for a public hearing must be submitted as prescribed in the "Com-

ments and Requests for a Public Hearing" section of this preamble. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comments submitted to the IRS's public docket. Send paper submissions to: CC:PA:01:PR (REG-118988-22), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, D.C. 20044.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Ilya Enkishev at (202) 317-5600; concerning submissions of comments and/or requests for a public hearing, contact the Publications and Regulations Section of the Office of Associate Chief Counsel (Procedure and Administration) by email at publichearings@irs.gov (preferred) or by telephone at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Authority

These proposed regulations are issued under the express delegation of authority under section 7805 of the Code. Section 7805(a) directs the Secretary of the Treasury or her delegate to prescribe all needful rules and regulations for the enforcement of the Code, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

Background

This document sets forth proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 162(m). Section 162(m)(1) disallows a deduction by any publicly held corporation for applicable employee remuneration that is otherwise deductible with respect to any covered employee to the extent that such remuneration for the taxable year exceeds $1,000,000.[1] Section 162(m) was added to the Internal Revenue Code (Code) by section 13211(a) of the Omnibus Budget Reconciliation Act of 1993 (Pub. L. 103-66, 107 Stat. 312, 469). Proposed regulations under section 162(m) were published in the ***Federal Register*** by the Treasury Department and the IRS on December 20, 1993 (58 FR 66310) (1993 proposed regulations). On December 2, 1994, the Treasury Department and the IRS published in the ***Federal Register*** amendments to the proposed regulations (59 FR 61884) (1994 proposed regulations). On December 20, 1995, the Treasury Department and the IRS published in the ***Federal Register*** final regulations under section 162(m) (TD 8650) (60 FR 65534) (1995 regulations).

In 2017, section 162(m) was amended by section 13601 of the Tax Cuts and Jobs Act (TCJA) (Pub. L. 115-97, 131 Stat. 2054, 2155 (2017)). Specifically, section 13601 of TCJA amended the definitions of covered employee, publicly held corporation, and applicable employee remuneration in section 162(m). On December 20, 2019, the Treasury Department and the IRS published in the ***Federal Register*** proposed regulations relating to the TCJA amendments (84 FR 70356). On December 30, 2020, the Treasury Department and the IRS published in the ***Federal Register*** final regulations (TD 9932) relating to the TCJA amendments (85 FR 86481) (the current regulations).

Section 162(m)(3) provides the definition of "covered employee." Specifically, section 162(m)(3) defines the term "covered employee" as an "employee of the taxpayer" if (1) the employee is the principal executive officer (PEO) or principal financial officer (PFO) of the taxpayer at any time during the taxable year, or was an individual acting in such a capacity, (2) the total compensation of the employee for the taxable year is required to be reported to shareholders under the Securities Exchange Act of 1934 (Exchange Act) by reason of the employee being among the three highest compensated officers for the taxable year (other than the PEO and PFO), or (3) the individual was a covered employee of the taxpayer (or any predecessor) for any preceding taxable year beginning after December 31, 2016. Section 162(m)(3) also contains flush language providing that a covered employee includes any employee of the taxpayer whose total compensation for the taxable year places the individual among the three highest compensated officers for the taxable year (other than any individual who is the PEO or PFO of the taxpayer at any time during the taxable year, or was an individual acting in such a capacity) even if the compensation of the officer is not required to be reported to shareholders under the Exchange Act.

In 2021, section 162(m) was amended by section 9708 of the American Rescue Plan Act of 2021 (ARP) (Pub. L. 117-2, 135 Stat. 4, 206) to expand the definition of covered employee for taxable years beginning after December 31, 2026. The ARP amended the definition of "covered employee" in section 162(m)(3) by adding section 162(m)(3)(C),[2] which includes any employee who is among the five highest compensated employees for the taxable year other than the PEO or PFO (as identified in section 162(m)(3)(A)) or the three highest compensated executive officers for the taxable year (as identified in section 162(m)(3)(B)). This amendment is effective for taxable years beginning after December 31, 2026. These proposed regulations (proposed regulations) would provide guidance on this amendment.

Explanation of Provisions

I. *Definition of Employee*

These proposed regulations would provide that, for purposes of determining whether an employee is one of the five highest compensated employees as defined in new section 162(m)(3)(C), the term "employee" means an "employee" as defined in section 3401(c). In general, under section 3401(c) and the corresponding regulations, the term "employee" includes a common law employee and an officer of a corporation. Accordingly, for purposes of section 162(m)(3)(C), the term "employee" would include, but not be limited to, executive officers.[3]

[1] As a result, for example, such disallowed amounts generally may not be capitalized. See §§1.263(a)-1(b) and 1.263A-1(c)(2).

[2] The addition of section 162(m)(3)(C) resulted in pre-ARP section 162(m)(3)(C) being redesignated as section 162(m)(3)(D).

[3] This interpretation is consistent with the description of section 162(m)(3)(C) by the Joint Committee on Taxation in *General Explanation of the Tax Legislation Enacted in the 117th Congress*. JCS-1-23, 129 (Dec. 2023).

The text of section 162(m)(3)(C) does not exclude an individual who is a covered employee as defined in section 162(m)(3)(D). Accordingly, these proposed regulations would provide that a covered employee by reason of section 162(m)(3)(C) includes an individual who is both one of the five highest compensated employees for the current taxable year (regardless of whether the individual is employed on the last day of the taxable year) and also a covered employee on the basis of being a covered employee for a preceding taxable year (as provided in section 162(m)(3)(D)).

II. *Determination of the Five Highest Compensated Employees*

These proposed regulations would use "compensation" as defined in paragraph (c)(3) of the current regulations (that is, compensation that would (but for section 162(m)) be allowable as a deduction) to determine whether an employee is one of the five highest compensated employees as defined in new section 162(m)(3)(C). The Treasury Department and the IRS expect this approach to be easily administrable because taxpayers currently track compensation to determine their tax liability for the taxable year.

Because section 162(m)(3)(B) determines the three highest compensated employees based on the total compensation required to be disclosed under the Exchange Act for executive officers, the Treasury Department and the IRS considered using this approach to determine the five highest compensated employees for purposes of section 162(m)(3)(C). These proposed regulations would not adopt this approach because, unlike the statutory text of section 162(m)(3)(B), section 162(m)(3)(C) does not reference compensation disclosure under the Exchange Act. Furthermore, unlike the covered employees defined in section 162(m)(3)(B), the five highest compensated employees under section 162(m)(3)(C) are not limited to executive officers.

Like the 1995 regulations, §1.162-33(c)(1)(ii) of the current regulations defines the term "publicly held corporation" to include an affiliated group of corporations, as defined in section 1504 (without regard to section 1504(b)) (affiliated group) that includes a corporation that is a publicly held corporation.[4] This definition was needed in the 1995 regulations because, among other things, the executive officers to whom section 162(m) applied could include officers of subsidiaries,[5] and their remuneration could come from subsidiaries, as well, so failure to include members of the affiliated group would have thwarted Congress's intent to deny a deduction for all compensation of a covered employee in excess of $1 million per year.[6] The definition also confirmed that each member of the affiliated group is potentially a "taxpayer" within the meaning of section 162(m)(3).

The Treasury Department and the IRS are now similarly concerned that a publicly held corporation may employ many of its highest compensated employees at subsidiaries, and may even attempt to alter the composition of its five highest compensated employees (as defined in section 162(m)(3)(C)) by transferring highly compensated employees to a subsidiary or by adopting a holding company structure, thereby thwarting Congress's intent to expand significantly the number of covered employees whose compensation is subject to section 162(m).[7] Accordingly, these proposed regulations would provide that any employee of any corporation in the affiliated group may be one of the five highest compensated employees of the publicly held corporation regardless of whether the employee is an employee of or performs services for the publicly held corporation, as defined in §1.162-33(c)(1)(i).

Consistent with the rule in the current regulations for affiliated groups that contain more than one publicly held corporation (as defined in §1.162-33(c)(1)(i)), these proposed regulations would provide that in such an affiliated group, each publicly held corporation has its own set of five highest compensated employees (as defined in section 162(m)(3)(C)). Because, as explained in the preceding paragraph, those individuals may be employees of a corporation in the affiliated group that is not a publicly held corporation, the affiliated group is divided into smaller affiliated groups for this purpose, each consisting of a publicly held corporation and certain affiliated non-publicly held corporations, if any. These proposed regulations provide rules for dividing up the affiliated group for this purpose.

Similar to the current regulations, these proposed regulations would provide that, if an employee of a publicly held corporation (as defined in §1.162-33(c)(1)(i)) is paid compensation by more than one member of an affiliated group, then compensation paid to the employee by each member of the affiliated group is aggregated in determining whether the employee is one of the five highest compensated employees. These proposed regulations would provide rules similar to the rules in the current regulations, but reflecting the rules described in the preceding paragraphs, for situations in which an individual performs services for members of an affiliated group that contains more than one publicly held corporation, and might also contain one or more corporations that are not publicly held corporations. Specifically, these proposed regulations would provide that whether the individual is one of the five highest compensated employees of a publicly held corporation is determined separately with respect to each publicly held corporation in the group, excluding compensation taken into account with respect to another publicly held corporation of the affiliated group. Section 1.162-33(c)(2)(i)(D)(4) of the proposed regulations also explains how that determination is made.

For purposes of section 162(m), an affiliated group includes a foreign corporation. Pursuant to the 1995 regulations and the current regulations, compensation includes remuneration paid by a mem-

[4] These proposed regulations take the same approach as the current regulations of using "publicly held corporation" to mean the affiliated group (as defined in §1.162-33(c)(1)(ii)) of which the corporation that is a publicly held corporation (as defined in §1.162-33(c)(1)(i)) is a part, and distinguishing between the two only where necessary.

[5] See 17 C.F.R. §229.402, Instructions to Item 402(a)(3).

[6] See H.R. Conf. Rep. No. 103-213, at 585 (1993) ("Unless specifically excluded, the deduction limitation applies to all remuneration for services.").

[7] See, for example, the Joint Committee on Taxation estimate that the amendment would raise $7.8 billion through Fiscal Year 2031. JCX-14-21, 3 (March 9, 2021).

ber of an affiliated group that is a foreign corporation to the extent it is otherwise allowable as a deduction under chapter 1 of the Code. Accordingly, such compensation would be taken into account under these proposed regulations, among other things, to determine whether an individual is one of the five highest compensated employees. Compensation and other expenses of a foreign corporation normally may be taken as a deduction by the foreign corporation in computing its U.S. income tax, and thus may be actually be disallowed by section 162(m), only if they are incurred in connection with a trade or business carried on in the United States.[8] However, if the foreign corporation is a controlled foreign corporation as defined in section 957,[9] a pro rata share of certain types of income less associated deductions may be taken into account by a United States shareholder of the corporation under subpart F (sections 951 through 965). To assist taxpayers with compliance, section 1.162-33(c)(3)(iii) of the proposed regulations would add an explicit rule to the definition of compensation regarding remuneration paid by a controlled foreign corporation that is a member of a publicly held corporation's affiliated group. This rule is not a substantive change to the 1995 regulations and the current regulations. Comments are requested on the application of these proposed rules to controlled foreign corporations, and whether these proposed rules should apply to controlled foreign corporations that are not members of an affiliated group.

These proposed regulations would also provide that an "employee" of a publicly held corporation includes an individual who, under section 3401(c), is an "employee" of a person other than the publicly held corporation (such as a related but unaffiliated organization or certified professional employer organization) but nevertheless functions as an employee of the publicly held corporation in that the individual performs substantially all the individual's services during the taxable year for the publicly held corporation. Consequently, these proposed regulations would provide that, in such circumstance, to the extent allowable as a deduction to the publicly held corporation, amounts paid to the individual or to a third party to obtain the services performed by the individual are considered "compensation." Absent such a rule, the adoption of the section 3401(c) definition by these proposed regulations could permit avoidance of section 162(m) through the use of third-party payors, which is not a concern under sections 162(m)(3)(A) and (B) due to their inclusion of all individuals acting as executive officers and the application of the executive compensation disclosure rules under the Exchange Act.

III. *Amendment to the Current Regulations*

These proposed regulations also include a technical correction that would amend the reference to Example 22 in the conclusion to the facts in Example 23 (section 1.162-33(c)(1)(vi)(W)(*2*)) in the current regulations. The correct reference is to Example 20 of the current regulations. These proposed regulations would make that correction.

Proposed Applicability Date

These regulations generally are proposed to apply to compensation that is otherwise deductible for taxable years beginning after the later of December 31, 2026, or the date of publication of the Treasury decision adopting these rules as final regulations in the ***Federal Register***. The amendment to the conclusion of Example 23 in section 1.162-33(c)(1)(vi)(W)(*2*)) of the current regulations is proposed to apply to taxable years ending on or after January 16, 2025.

Statement of Availability of IRS Documents

For copies of recently issued revenue procedures, revenue rulings, notices and other guidance published in the Internal Revenue Bulletin, please visit the IRS website at *www.irs.gov* or contact the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402.

Special Analyses

I. *Regulatory Planning and Review*

Pursuant to the Memorandum of Agreement, Review of Treasury Regulations under Executive Order 12866 (June 9, 2023), tax regulatory actions issued by the IRS are not subject to the requirements of section 6 of Executive Order 12866, as amended. Therefore, a regulatory impact assessment is not required.

II. *Regulatory Flexibility Act*

Pursuant to the Regulatory Flexibility Act (RFA) (5 U.S.C. chapter 6), it is hereby certified that these proposed regulations would not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that section 162(m)(1) applies only to publicly held corporations (for example, corporations that list securities on a national securities exchange and are rarely small entities) and only impacts those publicly held corporations that compensate certain employees in excess of $1,000,000 in a taxable year.

III. *Section 7805(f)*

Pursuant to section 7805(f), this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

IV. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or Tribal government, in the aggregate, or by the private sector, of $100 million in 1995

[8] See section 882(c)(1).

[9] In relevant part, section 957(a) defines a controlled foreign corporation as a foreign corporation of which more than 50% (vote or value) is owned by United States shareholders as defined in section 951(b). Publicly held corporations as defined in section 162(m)(2) can be treated as United States shareholders.

dollars, updated annually for inflation. This proposed rule does not include any Federal mandate that may result in expenditures by State, local, or Tribal governments, or by the private sector in excess of that threshold.

V. *Executive Order 13132: Federalism*

Executive Order 13132 (entitled "Federalism") prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or preempts State law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. This proposed rule does not have federalism implications, does not impose substantial direct compliance costs on State and local governments, and does not preempt State law within the meaning of the Executive order.

Comments and Requests for a Public Hearing

Before these proposed amendments to the regulations are adopted as final regulations, consideration will be given to comments that are submitted timely to the IRS as prescribed in the preamble under the "**ADDRESSES**" section. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. All comments submitted will be made available at www.regulations.gov or upon request.

A public hearing will be scheduled if requested in writing by any person who timely submits electronic or written comments. Requests for a public hearing are also encouraged to be made electronically by sending an email to *publichearings@irs.gov*. If a public hearing is scheduled, notice of the date and time for the public hearing will be published in the ***Federal Register***.

Drafting Information

The principal author of these regulations is Ilya Enkishev, Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes). However, other personnel from the Treasury Department and the IRS participated in the development of these regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, the Treasury Department and the IRS propose to amend 26 CFR part 1 as follows:

PART 1—INCOME TAXES

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

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

* * * * *

Par. 2. Section 1.162-33 is amended by:

a. Revising paragraphs (c)(1)(vi)(W)(*2*) and (c)(2)(i)(C);
b. Adding paragraphs (c)(2)(i)(D) and (c)(2)(vii)(CC) through (EE);
c. Redesignating paragraphs (c)(3)(iii) and (iv) as paragraphs (c)(3)(v) and (vi);
d. Adding new paragraphs (c)(3)(iii) and (iv) and adding paragraphs (c)(3)(vi)(D) and (E);
e. Revising paragraph (h)(2)(ii)(C); and
f. Adding paragraphs (h)(2)(ii)(F) and G.

The revisions and additions read as follows:

§1.162-33 Certain employee remuneration in excess of $1,000,000 not deductible for taxable years beginning after December 31, 2017.

* * * * *

(c) * * *

(1) * * *

(vi) * * *

(W) * * *

(*2*) *Conclusion*. The result is the same as in paragraph (c)(1)(vi)(T) of this section (*Example 20*). Even though Corporations P, Q, and R each are publicly held corporations, they comprise an affiliated group. Because Employee C is a covered employee of both Corporations P and Q, the amount disallowed as a deduction is prorated separately between Corporations P and R and between Corporations Q and R.

* * * * *

(2) * * *

(i) * * *

(C) Any individual who was a covered employee of the publicly held corporation (or any predecessor of a publicly held corporation, within the meaning of paragraph (c)(2)(ii) of this section) for any preceding taxable year beginning after December 31, 2016, other than an individual who was a covered employee in that year solely on account of paragraph (c)(2)(i)(D) of this section. For taxable years beginning prior to January 1, 2018, covered employees are identified in accordance with the rules in §1.162-27(c)(2).

(D) The five highest compensated employees of the publicly held corporation for the taxable year regardless of whether the individual is serving at the end of the publicly held corporation's taxable year, other than any individual described in paragraph (c)(2)(i)(A) or (B) of this section, determined in accordance with the rules in this paragraph (c)(2)(i)(D). See paragraph (c)(3)(iv) of this section for a special rule treating certain employees of a person other than the publicly held corporation as employees of the publicly held corporation.

(*1*) *Compensation*. The amount of compensation used to identify the five most highly compensated employees for the taxable year for purposes of paragraph (c)(2)(i)(D) of this section is the amount of compensation as defined in paragraph (c)(3) of this section, provided that, in determining compensation for purposes of applying this paragraph (c)(2)(i)(D), references to "covered employee" or "covered employee (as defined in paragraphs (c)(2)(i) through (v) of this section)" in paragraph (c)(3) of this section shall be replaced with references to "employee."

(*2*) *Employee*. For purposes of this paragraph (c)(2)(i)(D), the term "employee" means an employee as defined in section 3401(c).

(*3*) *Determining the employees eligible to be the five highest compensated employees with respect to an affiliated group with one publicly held corporation*. In the

case of an affiliated group (as defined in paragraph (c)(1)(ii) of this section) that includes one publicly held corporation (as defined in paragraph (c)(1)(i) of this section), an employee of any member of the affiliated group is eligible to be one of the five highest compensated employees of the publicly held corporation regardless of whether the individual is an employee of the publicly held corporation itself or performs services for the publicly held corporation itself.

(*4*) *Determining the employees eligible to be the five highest compensated employees with respect to an affiliated group with more than one publicly held corporation*. In the case of an affiliated group (as defined in paragraph (c)(1)(ii) of this section) that includes more than one publicly held corporation (as defined in paragraph (c)(1)(i) of this section), the group of employees eligible to be the five highest compensated employees is determined separately with respect to the parent corporation (as defined below) and each publicly held corporation (as defined in paragraph (c)(1)(i) of this section) that is not the parent corporation (an additional publicly held corporation). For this purpose, the parent corporation is the highest corporation in the chain or chains of includible corporations (that comprise the affiliated group) that is a publicly held corporation as defined in paragraph (c)(1)(i) of this section. In the case of an affiliated group in which more than one member may be the parent corporation (such as where a common parent that is not publicly held owns multiple publicly held corporations), the affiliated group must choose which member to treat as the parent corporation for the taxable year. With respect to the parent corporation, an employee of any member of the affiliated group, excluding a member of an affiliated group of an additional publicly held corporation (as defined below), is eligible to be one of its five highest compensated employees regardless of whether the individual is an employee of the parent corporation itself or performs services for the parent corporation itself. Similarly, with respect to an additional publicly held corporation, any employee of the affiliated group of the additional publicly held corporation is eligible to be one of its five highest compensated employees regardless of whether the individual is an employee of the additional publicly held corporation itself or performs services for the additional publicly held corporation itself. For this purpose, an affiliated group of an additional publicly held corporation means, with respect to any corporation, the affiliated group which would be determined under section 1504(a) if such corporation were the common parent and if section 1504(b) did not apply. These rules similarly apply to all additional publicly held corporations, beginning at the bottom of each chain of corporations and proceeding up until all members of the affiliated group that may be so allocated have been allocated to one (and only one) affiliated group of an additional publicly held corporation. If the affiliated group includes only publicly held corporations (as defined in paragraph (c)(1)(i) of this section), the affiliated group used to determine the employees eligible to be each publicly held corporation's five highest compensated employees is that publicly held corporation itself.

(*5*) *Determining the five highest compensated employees in an affiliated group*. In determining whether an employee is one of the five highest compensated employees with respect to the parent corporation (as defined in paragraph (c)(2)(i)(D)(*4*) of this section) for the taxable year, compensation paid by each member of the affiliated group (as defined in paragraph (c)(1)(ii) of this section) in the taxable year, excluding any member of an affiliated group of an additional publicly held corporation (as defined in paragraph (c)(2)(i)(D)(*4*) of this section), is aggregated. In determining whether an employee is one of the five highest compensated employees with respect to a publicly held corporation (as defined in paragraph (c)(1)(i) of this section) in an affiliated group of an additional publicly held corporation, compensation paid by each member of the affiliated group of the additional publicly held corporation in the taxable year is aggregated.

(*6*) *Application of proration rules*. The proration rules in paragraph (c)(1)(ii)(B) of this section generally apply in the same way to covered employees determined under this paragraph (c)(2)(i)(D), except that a publicly held corporation or publicly held payor corporation refers to the portion of the affiliated group of which the publicly held corporation (as defined in paragraph (c)(1)(i) of this section) is a part, as determined under paragraph (c)(2)(i)(D)(*4*) of this section.

* * * * *

(vii) * * *

(CC) *Example 29 (Individual as one of the five highest compensated employees of a publicly held corporation that includes the affiliated group)*--(*1*) *Facts*. Corporation CO is a publicly held corporation for its 2026 and 2027 taxable years. Corporation CP is a foreign corporation and is a wholly-owned subsidiary of Corporation CO. Corporation CP is a controlled foreign corporation, but the only income it has is effectively connected with a U.S. trade or business. Corporation CO is a partner in Partnership CQ (a partnership for Federal tax purposes). Under the partnership agreement, Corporation CO has a 50% distributive share of the partnership's income, gain, loss, deductions, and credits. These allocations comply with section 704(b) and its regulations. Employee EO is an employee of Corporation CO. In 2026, Employee EO is a covered employee of Corporation CO because Employee EO is one of the three highest compensated executive officers of Corporation CO. In 2027, Employee EO is not an executive officer of Corporation CO but performs services for and receives compensation from Corporation CO for services as its employee. Furthermore, in 2027, Employee EO performs services for and receives compensation from Corporation CP and Partnership CQ (Employee EO is not a partner of Partnership CQ). In 2027, the total compensation paid to Employee EO is $3,600,000, of which Corporation CO pays $1,500,000, Corporation CP pays $900,000, and Partnership CQ pays $1,200,000. For the 2027 taxable year, the total compensation paid to any employee of Corporations CO and CP did not exceed $2,500,000.

(*2*) *Conclusion (Compensation paid by Corporation CO)*. The $1,500,000 in compensation paid by Corporation CO is taken into account to determine whether Employee EO is one of the five highest compensated employees of Corporation CO for its 2027 taxable year.

(*3*) *Conclusion (Compensation paid by Corporation CP)*. Corporations CO and CP are an affiliated group as defined in paragraph (c)(1)(ii) of this section. Therefore, the $900,000 in compensation paid by Corporation CP is taken into account to determine whether Employee EO is one of the five highest compensated employees of Corporation CO for its 2027 taxable year. Because a publicly held corporation includes an affiliated group for purposes of paragraph (c)(3) of this section, the result would be the same even if there were intermediary privately held subsidiaries between Corporations CO and CP as long as all these corporations comprised an affiliated group.

(*4*) *Conclusion (Compensation paid by Partnership CQ)*. Under paragraph (c)(3)(ii) of this section, Corporation CO's $600,000 distributive share of Partnership CQ's deduction (50% of $1,200,000) is compensation that is taken into account to determine whether Employee EO is one of the five highest compensated employees of Corporation CO for its

2027 taxable year. Because a publicly held corporation includes an affiliated group for purposes of paragraph (c)(3) of this section, the result would be the same even if there were an intermediary privately held subsidiary between Corporation CO and Partnership CQ (so that, instead of Corporation CO, an intermediary subsidiary was a partner in Partnership CQ), as long as Corporation CO and the intermediary subsidiary comprised an affiliated group.

(*5*) *Conclusion (Employee EO as a covered employee)*. Because the aggregate compensation taken into account with respect to Employee EO is $3,000,000 ($1,500,000 + $900,000 + $600,000), Employee EO is a covered employee of Corporation CO for its 2027 taxable year by reason of being one of its five highest compensated employees for the taxable year as provided in paragraph (c)(2)(i)(D) of this section (even though Employee EO is also a covered employee of Corporation CO for its 2027 taxable year by reason of being a covered employee for its 2026 taxable year (as provided in paragraph (c)(2)(i)(C) of this section)).

(*6*) *Conclusion (Amount disallowed as a deduction)*. Because the compensation paid by all affiliated group members is aggregated for purposes of section 162(m)(1), the aggregate compensation of $3,000,000 exceeds the limitation in section 162(m)(1) and $2,000,000 of the compensation paid to Employee EO is nondeductible. Corporations CO and CP each are treated as paying a ratable portion of the nondeductible compensation. Thus, two thirds of each corporation's payment will be nondeductible. Taking into account Corporation CO's $600,000 distributive share of the Partnership CQ's deduction, Corporation CO has an otherwise allowable deduction of $2,100,000 ($1,500,000 + $600,000). Therefore, Corporation CO has a nondeductible compensation expense of $1,400,000 ($2,100,000 x $2,000,000/$3,000,000). Corporation CP has an otherwise allowable deduction of $900,000, of which $600,000 ($900,000 x $2,000,000/$3,000,000) is a nondeductible compensation expense.

(DD) *Example 30 (Individual as one of the five highest compensated employees of a publicly held corporation that includes the affiliated group and affiliated groups of additional publicly held corporations)*--(*1*) *Facts*. Corporations CR, CT, and CV are publicly held corporations for their 2027 taxable years. Corporations CS and CU are privately held for their 2027 taxable years. Corporation CT is a subsidiary of Corporation CS, which is a subsidiary of Corporation CR. Corporation CV is a subsidiary of Corporation CU, which is a subsidiary of Corporation CT. Corporations CR, CS, CT, CU, and CV are members of an affiliated group. Employee EP is an employee of Corporations CR, CS, CU, and CV. In 2027, Employee EP performs services for and receives compensation from Corporations CR, CS, CU, and CV. The total compensation paid to Employee EP from the affiliated group members is $7,000,000 for the taxable year, of which Corporation CR pays $1,200,000, Corporation CS pays $1,800,000, Corporation CU pays $1,500,000, and Corporation CV pays $2,500,000.

(*2*) *Conclusion (Employee EP is eligible to be a covered employee of Corporation CR)*. Because Employee EP is an employee of Corporation CR, Employee EP is eligible to be one of the five highest compensated employees of Corporation CR. Even though Corporations CR, CS, CT, CU, and CV comprise an affiliated group as defined in paragraph (c)(1)(ii) of this section, because Corporations CT and CV are additional publicly held corporations of the affiliated group, the affiliated group contains affiliated groups of these additional publicly held corporations (as defined in paragraph (c)(2)(i)(D)(*4*) of this section). Compensation paid by the affiliated groups of these additional publicly held corporations is not taken into account to determine whether Employee EP is one of the five highest compensated employees of Corporation CR for its 2027 taxable year. Accordingly, Corporations CT and CU comprise an affiliated group of an additional publicly held corporation (Corporation CT), and compensation paid by Corporation CU is not taken into account to determine whether Employee EP is one of the five highest compensated employees of Corporation CR for its 2027 taxable year. Furthermore, Corporation CV is an affiliated group of an additional publicly held corporation (Corporation CV), and compensation paid by Corporation CV is not taken into account to determine whether Employee EP is one of the five highest compensated employees of Corporation CR for its 2027 taxable year. Therefore, only the $1,200,000 in compensation paid by Corporation CR and the $1,800,000 paid by Corporation CS are taken into account to determine whether Employee EP is one of the five highest compensated employees of Corporation CR for its 2027 taxable year.

(*3*) *Conclusion (Employee EP is eligible to be a covered employee of Corporation CT)*. Because Corporation CT is a publicly held corporation, Corporations CT and CU comprise an affiliated group of an additional publicly held corporation (as defined in paragraph (c)(2)(i)(D)(*4*) of this section). Because an employee of any member of the affiliated group is eligible to be one of the five highest compensated employees of the publicly held corporation (regardless of whether the employee performs services for the publicly held corporation), Employee EP is eligible to be a covered employee of Corporation CT, even though Employee EP does not perform services for Corporation CT. Because only compensation paid by a member of the affiliated group of the additional publicly held corporation in the taxable year is taken into account to determine whether an individual is one of the five highest compensated employees with respect to the additional publicly held corporation, only compensation paid by Corporation CU is taken into account to determine whether Employee EP is one of the five highest compensated employees of Corporation CT for its 2027 taxable year. Accordingly, the $1,500,000 in compensation paid by Corporation CU is taken into account to determine whether Employee EP is one of the five highest compensated employees of Corporation CT for its 2027 taxable year.

(*4*) *Conclusion (Employee EP is eligible to be a covered employee of Corporation CV)*. Because Employee EP is an employee of Corporation CV, Employee EP is eligible to be one of the five highest compensated employees of Corporation CV. Because Corporation CV is a publicly held corporation, Corporation CV comprises an affiliated group of an additional publicly held corporation (as defined in paragraph (c)(2)(i)(D)(*4*) of this section). Because only compensation paid by a member of the affiliated group of the additional publicly held corporation in the taxable year is taken into account to determine whether an individual is one of the five highest compensated employees with respect to the additional publicly held corporation, only compensation paid by Corporation CV is taken into account to determine whether Employee EP is one of the five highest compensated employees of Corporation CV for its 2027 taxable year. Accordingly, the $2,500,000 in compensation paid by Corporation CV is taken into account to determine whether Employee EP is one of the five highest compensated employees of Corporation CV for its 2027 taxable year.

(*5*) *Conclusion (Employee EP as covered employee of Corporation CR)*. The $1,200,000 in compensation paid by Corporation CR and the $1,800,000 in compensation paid by Corporation CS are taken into account to determine whether Employee EP is one of the five highest compensated employees of Corporation CR for its 2027 taxable year. If, pursuant to paragraph (c)(2)(i)(D) of this section, Employee EP is a covered employee of Corporation CR, then Corporation CR's deduction for $1,200,000 and Corporation CS's deduction for $1,800,000 for the 2027 taxable year would be subject to the section 162(m)(1) limit. Because the compensation paid by the affiliated group members is aggregated for purposes of section 162(m)(1), the aggregate compensation of $3,000,000 exceeds the limitation in section 162(m)(1) and $2,000,000 of the compensation paid to Employee EP would be nondeductible. Corporations CR and CS each are treated as paying a ratable portion of the nondeductible compensation. Corporation CR has an otherwise allowable deduction of $1,200,000, of which $800,000 ($1,200,000 x $2,000,000/$3,000,000) would be a nondeductible compensation expense. Corporation CS has an otherwise allowable deduction of $1,800,000, of which $1,200,000 ($1,800,000 x $2,000,000/$3,000,000) would be a nondeductible compensation expense.

(*6*) *Conclusion (Employee EP as covered employee of Corporation CT)*. The $1,500,000 in compensation paid by Corporation CU is taken into account to determine whether Employee EP is one of the five highest compensated employees of Corporation CT for its 2027 taxable year. If, pursuant to paragraph (c)(2)(i)(D) of this section, Employee EP is a covered employee of Corporation CT, then Corporation CU's deduction for $1,500,000 for the 2027 taxable year would be subject to the section 162(m)(1) limit. Accordingly, pursuant to paragraph (c)(2)(i)(D)(*6*) of this section, Corporation CU would have a nondeductible compensation expense of $500,000.

(*7*) *Conclusion (Employee EP as covered employee of Corporation CV)*. The $2,500,000 in compensation paid by Corporation CV is taken into account to determine whether Employee EP is one of the five highest compensated employees of Corporation CV for its 2027 taxable year. If, pursuant to paragraph (c)(2)(i)(D) of this section, Employee EP is a covered employee of Corporation CV, then Corporation CV's deduction for $2,500,000 for the 2027 taxable year would be subject to the section 162(m)(1) limit. Accordingly, Corporation CV would have a nondeductible compensation expense of $1,500,000.

(EE) *Example 31 (Individual as one of the five highest compensated employees of a publicly held*

corporation that includes the affiliated group that chooses a parent corporation)--(*1*) *Facts*. Corporations CX and CY are publicly held corporations for their 2027 taxable years. Corporations CW and CZ are privately held corporations for their 2027 taxable years. Corporations CX and CY are subsidiaries of Corporation CW. Corporations CX and CY each directly own 50% (by vote and value) of Corporation CZ's only class of stock. In 2027, Employee EQ performs services for and receives compensation from Corporations CW, CX, CY, and CZ. The total compensation paid to Employee EQ from all corporations is $4,700,000 for the taxable year, of which Corporation CW pays $1,500,000, Corporation CX pays $900,000, Corporation CY pays $1,700,000, and Corporation CZ pays $600,000.

(*2*) *Conclusion (Employee EQ is eligible to be a covered employee of Corporations CX and CY)*. Because Employee EQ is an employee of Corporations CX and CY, Employee EQ is eligible to be one of the five highest compensated employees of these publicly held corporations. Because both Corporations CX and CY are the highest publicly held corporations in the chain of includible corporations that comprise an affiliated group (composed of Corporations CW, CX, CY, and CZ) as defined in paragraph (c)(1)(ii) of this section, the affiliated group may choose to treat either Corporation CX or CY as the parent corporation for the 2027 taxable year. If the affiliated group chooses to treat Corporation CX as the parent corporation, then only compensation paid by Corporations CW, CX, and CZ is taken into account to determine whether Employee EQ is one of the five highest compensated employees of Corporation CX for the 2027 taxable year. Because Corporation CY is an affiliated group of the additional publicly held corporation composed of one corporation (Corporation CY), only compensation paid by Corporation CY is taken into account to determine whether Employee EQ is one of the five highest compensated employees of Corporation CY. A similar analysis would apply if the affiliated group chose to treat Corporation CY as the parent.

(*3*) *Conclusion (Employee EQ as a covered employee of Corporation CX)*. The $1,500,000 in compensation paid by Corporation CW, the $900,000 paid by Corporation CX, and the $600,000 in compensation paid by Corporation CZ (that is, aggregate compensation of $3,000,000) are taken into account to determine whether Employee EQ is one of the five highest compensated employees of Corporation CX for its 2027 taxable year. If, pursuant to paragraph (c)(2)(i)(D) of this section, Employee EQ is a covered employee of Corporation CX, then Corporation CW's deduction for $1,500,000, Corporation CX's deduction for $900,000, and Corporation CZ's deduction for $600,000 for the 2027 taxable year would be subject to the section 162(m)(1) limit. Because the compensation paid by the affiliated group members is aggregated for purposes of section 162(m)(1), the aggregate compensation of $3,000,000 exceeds the limitation in section 162(m)(1) and $2,000,000 of the compensation paid to Employee EQ would be nondeductible. Corporations CW, CX, and CZ each are treated as paying a ratable portion of the nondeductible compensation. Corporation CW would have a nondeductible compensation expense of $1,000,000 ($1,500,000 x $2,000,000/$3,000,000). Corporation CX would have a nondeductible compensation expense of $600,000 ($900,000 x $2,000,000/$3,000,000). Corporation CZ would have a nondeductible compensation expense of $400,000 ($600,000 x $2,000,000/$3,000,000).

(*4*) *Conclusion (Employee EQ as a covered employee of Corporation CY)*. The $1,700,000 in compensation paid by Corporation CY is taken into account to determine whether Employee EQ is one of the five highest compensated employees of Corporation CY for its 2027 taxable year. If, pursuant to paragraph (c)(2)(i)(D) of this section, Employee EQ is a covered employee of Corporation CY, then Corporation CY's deduction for $1,700,000 for the 2027 taxable year would be subject to the section 162(m)(1) limit. Accordingly, Corporation CY would have a nondeductible compensation expense of $700,000.

(3) * * *

(iii) *Compensation paid by a controlled foreign corporation that is a member of an affiliated group*. For purposes of paragraph (c)(3)(i) of this section, compensation includes a publicly held corporation's pro rata share (as determined under the principles of sections 951(a)(2) and 951A(e)(1)) of the amounts that would be claimed by a controlled foreign corporation (as defined in section 957) that is a member of an affiliated group (as defined in paragraph (c)(1)(ii) of this section) as properly allocable to gross income included under sections 951(a)(1) and 951A(a) under sections 954(b)(5), 951A(c)(2)(A)(ii), and similar provisions, determined without regard to the disallowance of any such expenses by reason of section 162(m) and these regulations, for compensation expenses attributable to the remuneration paid by the controlled foreign corporation to a covered employee of a publicly held corporation for services performed by the covered employee.

(iv) *Amounts paid to individuals performing substantially all their services for a publicly held corporation*. Notwithstanding paragraph (c)(2)(i)(D)(*2*) of this section, for purposes of paragraph (c)(2)(i)(D) of this section, an employee of a publicly held corporation includes an individual who, pursuant to section 3401(c), is an employee of a person other than the publicly held corporation but performs substantially all the individual's services during the relevant taxable year for the publicly held corporation. Consequently, for purposes of paragraph (c)(3) of this section, compensation includes the aggregate amount allowable as a deduction to the publicly held corporation under chapter 1 of the Internal Revenue Code for the taxable year (determined without regard to section 162(m)(1)) to obtain the services performed by such individual, whether or not the particular services that give rise to the deduction were performed during the relevant taxable year. This rule applies regardless of how the amounts allowable as a deduction are paid or denominated, and regardless of whether the individual is compensated directly or by a third-party payor, including a related organization or certified professional employer organization under section 7705. The disallowance under paragraph (b) of this section likewise is applied to those amounts, however denominated, otherwise allowable as a deduction to obtain those services. Nothing in the previous sentence is intended to imply that such amounts paid to a third party for services by a covered employee, however denominated, are not already treated as remuneration for those services and thus compensation for purposes of paragraph (c)(3) of this section.

* * * * *

(D) *Example 4*--(*1*) *Facts*. Corporation U is a publicly held corporation for its 2027 taxable year and is not a member of an affiliated group. Corporation U has a services agreement with unrelated Corporation V. In Corporation U's 2027 taxable year, it pays $1,500,000 to Corporation V pursuant to the agreement in exchange for the services of an interim chief accountant (Individual E) in the same year. The $1,500,000 is otherwise deductible for Corporation U's 2027 taxable year. Individual E performs substantially all Individual E's services in 2027 for Corporation U.

(*2*) *Conclusion*. Pursuant to paragraph (c)(3)(iv) of this section, Individual E is treated as an employee of Corporation U for purposes of this section. The $1,500,000 paid to Corporation V by Corporation U in 2027 is compensation within the meaning of paragraph (c)(3) of this section and is taken into account to determine whether Individual E is a covered employee as one of the five highest compensated employees of Corporation U for its 2027 taxable year. If, pursuant to paragraph (c)(2)(i)(D) of this section, Individual E is a covered employee of Corporation U, then Corporation U's deduction for $1,500,000 for the 2027 taxable year is subject to the section 162(m)(1) limit. Because a publicly held corporation includes an affiliated group for purposes of paragraph (c)(3) of this section, the result would be the same even if Corporation U owned a privately held subsidiary, and Individual E performed substantially all Individual E's services for the subsidiary. In addition, the result would also be the same if Individual E performed substantially all Individual E's services for both Corporation U and its subsidiary, as long as Corporation U and its subsidiary comprised an affiliated group (regardless of whether Corporation U or its subsidiary paid the $1,500,000 to Corporation V). In such case, pursuant to paragraph (c)

(1)(ii) of this section, the amount disallowed as a deduction would be prorated between Corporation U and its subsidiary. Furthermore, the result would be the same even if Individual E were an employee of Corporation U (regardless of whether Individual E were also an employee of Corporation V).

(E) *Example 5*--(*1*) *Facts*. Corporation W is a publicly held corporation for its 2027 taxable year and is not a member of an affiliated group. Corporation W is a partner in Partnership X (a partnership for Federal tax purposes), that owns all the stock of Corporation Y. Under the partnership agreement, Corporation W has a 50% distributive share of the partnership's income, gain, loss, deductions, and credits. These allocations comply with section 704(b) and its regulations. Individual F is a partner of Partnership X. In 2027, Individual F performs services for the partnership, and the partnership pays $1,000,000 to Individual F as a guaranteed payment for these services. With respect to the $1,000,000 paid to Individual F, a deduction of $500,000 is allocated to Corporation W. Corporation W's $500,000 distributive share of the partnership's deduction is reported separately to Corporation W pursuant to §1.702-1(a)(8)(iii). Individual F is also an employee (within the meaning of section 3401(c)) of Corporation Y. In Corporation W's 2027 taxable year, it pays $8,000,000 to Corporation Y in exchange for Individual F's services. The $8,000,000 is otherwise deductible for Corporation W's 2027 taxable year. Individual F performs substantially all Individual F's services in 2027 for Corporation W.

(*2*) *Conclusion*. Pursuant to paragraph (c)(3)(iv) of this section, Individual F is treated as an employee of Corporation W for purposes of this section. The entire $8,000,000 paid to Corporation Y by Corporation W in 2027 is compensation within the meaning of paragraph (c)(3) of this section and is taken into account to determine whether Individual F is one of the five highest compensated employees of Corporation W for its 2027 taxable year. Because Corporation W's $500,000 distributive share of the partnership's deduction is attributable to the compensation paid by the partnership for services performed by Individual F (who is treated as an employee of Corporation W), the $500,000 is compensation within the meaning of paragraph (c)(3)(ii) of this section. Accordingly, Corporation W's $500,000 distributive share of the partnership's deduction is aggregated with Corporation W's deduction for $8,000,0000 paid to Corporation Y in determining whether Individual F is a covered employee as one of the five highest compensated employees of Corporation W for its 2027 taxable year. If, pursuant to paragraph (c)(2)(i)(D) of this section, Individual F is a covered employee of Corporation W, then Corporation W's deduction for $8,500,000 for its 2027 taxable year is subject to the section 162(m)(1) limit. Because a publicly held corporation includes an affiliated group for purposes of paragraph (c)(3) of this section, the result would be the same even if there were an intermediary privately held subsidiary between Corporation W and Partnership X (so that, instead of Corporation W, an intermediary subsidiary was a partner in Partnership X), as long as Corporation W and the intermediary subsidiary comprised an affiliated group, and as long as Individual F performed substantially all Individual F's services for the intermediary subsidiary. Furthermore, the result would also be the same if Individual F performed substantially all Individual F's services for both Corporation W and the intermediary subsidiary (regardless of whether Corporation W or the intermediary subsidiary paid the $8,000,000 to Corporation Y). In such case, pursuant to paragraph (c)(1)(ii) of this section, the amount disallowed as a deduction would be prorated between Corporation W and the intermediary subsidiary.

* * * * *

(h) * * *

(2) * * *

(ii) * * *

(C) *Definition of compensation*. The definition of compensation provided in paragraph (c)(3)(ii) of this section (relating to distributive share of partnership deductions for compensation paid) applies to any deduction for compensation that is paid after December 18, 2020. The definition of compensation in paragraph (c)(3)(ii) of this section does not apply to compensation paid pursuant to a written binding contract that is in effect on December 20, 2019, and that is not materially modified after that date. For purposes of paragraph (h)(2)(C) of this section, written binding contract and material modification have the same meanings as provided in paragraphs (g)(1) and (2) of this section. The definition of compensation provided in paragraphs (c)(3)(iii) and (iv) of this section and the examples in paragraphs (c)(3)(vi)(D) and (E) of this section apply to any deduction for compensation that is otherwise deductible for taxable years beginning after the later of December 31, 2026, or the date of publication of the Treasury decision adopting these rules as final regulations in the ***Federal Register***.

* * * * *

(F) *Five highest compensated employees*. Paragraph (c)(2)(i)(D) of this section (describing the five highest compensated employees of a publicly held corporation) and the examples in paragraphs (c)(2)(vii)(CC) through (EE) of this section apply to taxable years beginning after the later of December 31, 2026, or the date of publication of the Treasury decision adopting these rules as final regulations in the ***Federal Register***.

(G) *Amendment to paragraph (c)(1)(vi)(W)(2) of this section*. The amendment to paragraph (c)(1)(vi)(W)(*2*) of this section (*Example 23*) to reference paragraph (c)(1)(vi)(T) of this section (*Example 20*) is proposed to apply to taxable years ending on or after January 16, 2025.

Douglas W. O'Donnell,
Deputy Commissioner.

(Filed by the Office of the Federal Register January 14, 2025, 8:45 a.m., and published in the issue of the Federal Register for January 16, 2025, 90 FR 4691)

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 2024–27 through 2024–52 is in Internal Revenue Bulletin 2024–52, dated December 23, 2024.

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2024–27 through 2024–52 is in Internal Revenue Bulletin 2024–52, dated December 23, 2024.

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