

plan years beginning on or after January 1, 2009.

Steven T. Miller,

Acting Deputy Commissioner for Services and Enforcement.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-101258-08]

RIN 1545-BH66

Guidance Under Sections 642 and 643 (Income Ordering Rules)

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed amendments providing guidance under Internal Revenue Code (Code) section 642(c) with regard to the Federal tax consequences of an ordering provision in a trust, a will, or a provision of local law that attempts to determine the tax character of the amounts paid to a charitable beneficiary of the trust or estate. The proposed regulations also make conforming amendments to the regulations under section 643(a)(5). The proposed regulations affect estates, charitable lead trusts (CLTs) and other trusts making payments or permanently setting aside amounts for a charitable purpose. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by September 16, 2008. Outlines of topics to be discussed at the public hearing scheduled for October 8, 2008, at 10 a.m., must be received by September 18, 2008.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-101258-08), 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:LPD:PR (REG-101258-08), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC; or sent electronically via the Federal eRulemaking Portal at <http://www.regulations.gov> (IRS REG-101258-08). The public hearing will be held in the IRS Auditorium, Internal Revenue

Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT:

Concerning the proposed regulations, Vishal Amin, at (202) 622-3060; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Richard Hurst, at (202) 622-2949 (TDD telephone) (not toll-free numbers) or e-mail at Richard.A.Hurst@ircounsel.treas.gov.

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR part 1 under section 642 of the Code. Section 642 was added to the Code under the Internal Revenue Code of 1954 (68A Stat. 215). Section 642(c) of the Code provides that an estate or trust (other than a trust meeting the specifications of subpart B) shall be allowed a deduction in computing its taxable income any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid for a purpose specified in section 170(c) (determined without regard to section 170(c)(2)(A)).

The regulations under § 1.642(c)-3 provide guidance concerning adjustments and other special rules for computing the charitable contributions deduction. The regulations under § 1.643(a)-5 provide guidance concerning rules for computing the amount of tax-exempt income included in distributable net income. These proposed regulations clarify the existing regulations under §§ 1.642(c)-3(b) and 1.643(a)-5(b). Section 1.642(c)-3(b)(2) provides that, in determining whether an amount of income paid to a charitable beneficiary includes particular items of income not included in gross income (for example, tax exempt income), provisions in the governing instrument will control if they specifically provide as to the source out of which amounts are to be paid to the charitable beneficiary. In the absence of specific provisions in the governing instrument or in local law, the amount of income distributed to each charitable beneficiary is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes.

Section 1.643(a)-5(b) provides rules for reducing the amount of tax-exempt interest includable in distributable net income when tax-exempt interest is deemed to be included in income paid, permanently set aside, or to be used for the purposes specified in section 642(c).

As similarly provided in § 1.642(c)-3(b), § 1.643(a)-5(b) provides “[i]f the governing instrument specifically provides as to the source out of which amounts are paid, permanently set aside, or to be used for such charitable purposes, the specific provisions control. In the absence of specific provisions in the governing instrument, an amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes.”

The IRS and the Treasury Department believe that the current regulations under §§ 1.642(c)-3(b) and 1.643(a)-5(b) require that such a specific provision in a governing instrument or in local law that identifies the source(s) of the amounts to be paid, permanently set aside or used for a purpose specified in section 642(c) must have economic effect independent of income tax consequences in order for the specific provision in the governing instrument or in local law to be respected for Federal tax purposes. This belief is based on the structure and provisions of Subchapter J as a whole, as well as on an analysis of the existing regulations with their interrelated cross-references. Section 1.642(c)-3(b) and § 1.643(a)-5(b) refer to examples in §§ 1.662(b)-2 and 1.662(c)-4 to illustrate the rules of §§ 1.642(c)-3(b) and 1.643(a)-5(b). Section 1.662(b)-2 provides that, in determining the character of amounts distributed to a beneficiary when a charitable contribution is made, “* * * the principles contained in §§ 1.652(b)-1 and 1.662(b)-1 generally apply.” Section 1.652(b)-1 provides that “[i]n determining the gross income of a beneficiary, the amounts includable under § 1.652(a)-1 have the same character in the hands of the beneficiary as in the hands of the trust.” Section 1.652(b)-2(a) elaborates on the general principle in § 1.652(b)-1 by providing that the amount distributed to a beneficiary and includible in gross income under § 1.652(a)-1 generally consists of the same proportion of each class of items included in the trust's distributable net income (DNI) as the total of each such class bears to the total DNI. These principles are repeated in § 1.662(b)-1. In addition, § 1.652(b)-2(b) defines the exception to this rule by providing that “[t]he terms of the trust are considered specifically to allocate different classes of income to different beneficiaries only to the extent that the allocation is required in the trust instrument, and only to the extent that it has economic effect independent of

the income tax consequences of the allocation.”

Section 1.681(a)-2(b)(2) provides guidance on the method of allocating gross income to unrelated business income that is not deductible under section 642(c). This regulation provides that “[u]nless the facts clearly indicate to the contrary * * *” the payment to charity consists of the same ratio of unrelated business income as the ratio of unrelated business income to all of the trust’s taxable income. Examples given in this regulation confirm that a specific allocation of income items will be recognized when such specific allocation has economic effect independent of its tax consequences, such as when the amount of the charitable distribution will be dependent upon the amount of the class of income.

Explanation of Provisions

The IRS and the Treasury Department believe that the chain of references discussed above requires that a specific provision of the governing instrument or a provision under local law has economic effect independent of income tax consequences in order to be respected for Federal income tax purposes, and that this principle applies throughout Subchapter J. To make this concept clearer and easier to understand, the proposed regulations amend the regulations under section 642(c) to add the principle of economic effect directly into the language of the regulation itself, rather than being incorporated by reference to other regulation provisions. Thus, the proposed regulation will amend the regulations under section 642(c) to confirm that a provision in a governing instrument or in local law that specifically provides as to the source out of which amounts are to be paid, permanently set aside or used for a purpose specified in section 642(c) must have economic effect independent of income tax consequences in order to be respected for Federal tax purposes. If such provision does not have economic effect independent of income tax consequences, income distributed for a purpose specified in section 642(c) will consist of the same proportion of each class of the items of income as the total of each class bears to the total of all classes. See § 1.642(c)-3(b)(2).

As an example, CLTs pay an annuity or unitrust amount to a charity for a determinable period, measured by a term of years or by reference to the life of one or more individuals. See section 170(f)(2)(B). At the end of the term, the remainder passes to one or more non-charitable beneficiaries. CLTs may earn

various types of income (such as ordinary income, capital gains, unrelated business tax income and tax-exempt income) in any given taxable year. Some trust instruments attempt to source the payments to charity so as to maximize the tax benefits to the trust and beneficiaries. For example, the governing documents might include a provision directing that the charity’s annuity or unitrust payment be made first out of ordinary income and capital gains in order to minimize the trust’s tax liability. Thus, the trust attempts to retain the unrelated business taxable income and tax-exempt income (for which no section 642(c) deduction may be claimed or for which the deduction is limited by section 681). Such a provision in the governing instrument does not have economic effect independent of the income tax consequences, because the amount paid to the charitable beneficiary is not dependent upon the type of income it is allocated. Rather, such amount is the same regardless of the source of the income. An annuity payment is a fixed amount from year to year, and a unitrust amount is based upon a predetermined percentage of the trust’s value. Thus, the amount of each type of income the trust earns is irrelevant to the amount the charity is entitled to receive.

Accordingly, a provision under local law or in the governing instrument of a CLT that provides that the payment to charity (eligible for a deduction under section 642(c)) is deemed to consist of particular classes of income, determined on a non-pro rata basis, will not be respected because such a provision does not have economic effect independent of income tax consequences. Instead, such a payment to a charity will consist of the same proportion of each class of the items of income of the trust as the total of each class bears to the total of all classes. See § 1.642(c)-3(b)(2). This proposed amendment to the regulation serves only to confirm the economic effect requirement of the current regulations.

The proposed regulations also similarly clarify the corresponding language in § 1.643(a)-5(b).

Finally, the proposed regulations remove § 1.642(c)-3(b)(4) because the provisions of section 116 were repealed by the Tax Reform Act of 1986 (Pub. L. 99-514).

Proposed Effective/Applicability Date

The regulations, as proposed, apply to trusts and estates for taxable years beginning after the date final regulations are published in the **Federal Register**.

Special Analyses

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

Comments and Public Hearing

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

A public hearing has been scheduled for October 8, 2008, at 10 a.m. in the auditorium of the Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments by September 16, 2008, and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by September 16, 2008. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of

the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Vishal R. Amin, Office of the Chief Counsel (Passthroughs and Special Industries).

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.642(c)–3 is amended by:

1. Revising the paragraph heading of paragraph (b) and add a heading to paragraph (b)(1).
2. Revising paragraph (b)(2).
3. Adding a heading to paragraph (b)(3).
4. Removing paragraph (b)(4).

The revisions and additions read as follows:

§ 1.642(c)–3 Adjustments and other special rules for determining unlimited charitable contributions deduction.

* * * * *

(b) *Determination of amounts deductible under section 642(c) and the character of such amounts—(1) Reduction of charitable contributions deduction by amounts not included in gross income.* * * *

(2) *Determination of the character of an amount deductible under section 642(c).* In determining whether the amounts of income so paid, permanently set aside, or used for a purpose specified in section 642(c)(1), (2), or (3) include particular items of income of an estate or trust, whether or not included in gross income, a provision in the governing instrument or in local law that specifically provides the source out of which amounts are to be paid, permanently set aside, or used for such a purpose controls for Federal tax purposes to the extent such provision has economic effect independent of income tax consequences. See § 1.652(b)–2(b). In the absence of such specific provisions in the governing instrument or in local law, the amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of

income of the estate or trust as the total of each class bears to the total of all classes. See § 1.643(a)–5(b) for the method of determining the allocable portion of exempt income and foreign income. This paragraph (b)(2) is illustrated by the following example:

Example. A charitable lead annuity trust has the calendar year as its taxable year, and is to pay an annuity of \$10,000 annually to an organization described in section 170(c). A provision in the trust governing instrument provides that the \$10,000 annuity should be deemed to come first from ordinary income, second from short-term capital gain, third from fifty percent of the unrelated business taxable income, fourth from long-term capital gain, fifth from the balance of unrelated business taxable income, sixth from tax-exempt income, and seventh from principal. This provision in the governing instrument does not have economic effect independent of tax consequences because the amount to be paid to charity is not dependent upon the type of income from which it is to be paid. Accordingly, the amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the trust as the total of each class bears to the total of all classes.

(3) *Other examples.* * * *

* * * * *

Par. 3. Section 1.643(a)–5 is amended by revising the text of paragraph (b) to read as follows:

§ 1.643(a)–5 Tax-exempt interest.

* * * * *

(b) If the estate or trust is allowed a charitable contributions deduction under section 642(c), the amounts specified in paragraph (a) of this section and § 1.643(a)–6 are reduced by the portion deemed to be included in income paid, permanently set aside, or to be used for the purposes specified in section 642(c). If the governing instrument or local law specifically provides as to the source out of which amounts are paid, permanently set aside, or to be used for such charitable purposes, the specific provision controls for Federal tax purposes to the extent such provision has economic effect independent of income tax consequences. See § 1.652(b)–2(b). In the absence of specific provisions in the governing instrument, an amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. For illustrations showing the determination of the character of an amount deductible under section 642(c), see *Examples 1*

and 2 of § 1.662(b)–2 and § 1.662(c)–4(e).

Linda E. Stiff,

Deputy Commissioner for Services and Enforcement.

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DEPARTMENT OF COMMERCE

Patent and Trademark Office

37 CFR Part 1

[Docket No.: PTO–P–2008–0023]

RIN 0651–AC28

Fiscal Year 2009 Changes to Patent Cooperation Treaty Transmittal and Search Fees

AGENCY: United States Patent and Trademark Office, Commerce.

ACTION: Notice of proposed rulemaking.

SUMMARY: The United States Patent and Trademark Office (Office) is proposing to revise the rules of practice to adjust the transmittal and search fees for international applications filed under the Patent Cooperation Treaty (PCT). The Office is proposing to adjust the PCT transmittal and search fees to recover the estimated average cost to the Office of processing PCT international applications and preparing international search reports and written opinions for PCT international applications.

DATES: Written comments must be received on or before August 18, 2008. No public hearing will be held.

ADDRESSES: Comments should be sent by electronic mail message over the Internet addressed to AC28.comments@uspto.gov. Comments may also be submitted by mail addressed to: Mail Stop Comments—Patents, Commissioner for Patents, P.O. Box 1450, Alexandria, VA 22313–1450, or by facsimile to (571) 273–0459, marked to the attention of Boris Milef, Office of the Deputy Commissioner for Patent Examination Policy. Although comments may be submitted by mail or facsimile, the Office prefers to receive comments via the Internet.

Comments may also be sent by electronic mail message over the Internet via the Federal eRulemaking Portal. See the Federal eRulemaking Portal Web site (<http://www.regulations.gov>) for additional instructions on providing comments via the Federal eRulemaking Portal.

The comments will be available for public inspection at the Office of the Commissioner for Patents, located in