

(GPS) IAPs to RWYs 14 and 32 has made this action necessary. The intended effect of this action is to provide adequate controlled airspace for Instrument Flight Rules operations at David City Municipal Airport, NE. The area will be depicted on appropriate aeronautical charts.

Class E airspace areas extending upward from 700 feet or more above the surface of the earth are published in Paragraph 6005 of FAA Order 7400.9N, Airspace Designations and Reporting Points, dated September 1, 2005, and effective September 15, 2005, which is incorporated by reference in 14 CFR 71.1. of the same Order. The Class E airspace designation listed in this document will be published subsequently in the Order.

The FAA has determined that this regulation only involves an established body of technical regulations for which frequent and routine amendments are necessary to keep them operationally current. Therefore, this regulation—(1) is not a “significant regulatory action” under Executive Order 12866; (2) is not a “significant rule” under DOT Regulatory Policies and Procedures (44 FR 11034; February 26, 1979); and (3) does not warrant preparation of a Regulatory Evaluation as the anticipated impact is so minimal. Since this is a routine matter that will only affect air traffic procedures and air navigation, it is certified that this rule, when promulgated, will not have a significant economic impact on a substantial number of small entities under the criteria of the Regulatory Flexibility Act.

This rulemaking is promulgated under the authority described in Subtitle VII, Part A, Subpart I, Section 40103. Under that section, the FAA is charged with prescribing regulations to assign the use of the airspace necessary to ensure the safety of aircraft and the efficient use of airspace. This regulation is within the scope of that authority since it contains aircraft executing instrument approach procedures to David City Municipal Airport.

#### List of Subjects in 14 CFR Part 71

Airspace, Incorporation by reference, Navigation (Air).

#### Adoption of the Amendment

■ In consideration of the foregoing, the Federal Aviation Administration amends 14 CFR part 71 as follows:

### PART 71—DESIGNATION OF CLASS A, CLASS B, CLASS C, CLASS D, AND CLASS E AIRSPACE AREAS; AIRWAYS; ROUTES; AND REPORTING POINTS

■ 1. The authority citation for part 71 continues to read as follows:

**Authority:** 49 U.S.C. 106(g); 40113, 40120; E.O. 10854, 24 FR 9565, 3 CFR, 1959–1963 Comp., p. 389.

#### § 71.1 [Amended]

■ 2. The incorporation by reference in 14 CFR 71.1 of Federal Aviation Administration Order 7400.9N, dated September 1, 2005, and effective September 15, 2005, is amended as follows:

*Paragraph 6005 Class E airspace areas extending upward from 700 feet or more above the surface of the earth.*

\* \* \* \* \*

#### ACE NE #E5 David City, NE

David City Municipal Airport, NE  
(Lat. 41°13'51" N., long. 97°07'23" W.)

That airspace extending upward from 700 feet above the surface within a 6.8-mile radius of David City Municipal Airport.

\* \* \* \* \*

Issued in Kansas City, MO, on February 7, 2006.

**Elizabeth S. Wallis,**

*Acting Area Director, Western Flight Services Operations.*

[FR Doc. 06–1569 Filed 2–21–06; 8:45 am]

**BILLING CODE 4910–13–M**

### COMMODITY FUTURES TRADING COMMISSION

#### 17 CFR Part 4

#### RIN 3038–AC25

#### Commodity Pool Operator Electronic Filing of Annual Reports

**AGENCY:** Commodity Futures Trading Commission.

**ACTION:** Final rulemaking.

**SUMMARY:** The Commodity Futures Trading Commission (“Commission” or “CFTC”) is amending Commission rules to require that commodity pool annual financial reports submitted by commodity pool operators (“CPOs”) to the National Futures Association (“NFA”) be filed and affirmed electronically, in compliance with NFA’s electronic filing procedures. NFA petitioned the Commission to adopt this amendment after its implementation of a pilot program for electronic filing of commodity pool annual reports in 2005.

The amendment necessarily eliminates the requirement that the

commodity pool annual report filed with NFA be manually signed, and replaces it with a requirement that CPOs maintain for five years in their own business records a manually signed oath or affirmation with respect to each annual report along with documentation supporting the compilation of certain key financial balances required to be submitted to NFA.

In addition to mandating electronic filing, the Commission is also amending other provisions of its rules applicable to CPOs with respect to financial reporting to: (i) Explicitly state that commodity pool monthly and/or quarterly account statements distributed to participants must be prepared in accordance with generally accepted accounting principles; (ii) clarify that CPOs must file a notification of a change in a public accountant for a commodity pool with NFA; (iii) clarify that a reference to “segregation” with respect to a statement required to be made in an accountant’s letter refers to the prohibition on commingling of funds of a commodity pool with the assets of any other person; and (iv) require that notifications concerning CPOs’ election of fiscal years for commodity pools other than the calendar year or changes in fiscal year be filed solely with NFA and not the Commission.

These amendments with respect to commodity pool financial reporting do not impact the distribution of annual reports to pool participants, which may continue to be provided through hard-copy distribution via postal mail or electronically if the pool participant consents thereto. Also, these amendments do not change the requirements or process for CPOs to request that the Commission provide confidential treatment to commodity pool annual reports submitted to NFA, in response to requests from the public made under the Freedom of Information Act.

**DATES:** *Effective Date:* March 24, 2006.

#### FOR FURTHER INFORMATION CONTACT:

Thomas J. Smith, Deputy Director and Chief Accountant, at (202) 418–5430 or Jennifer C.P. Bauer, Special Counsel, at (202) 418–5472, Division of Clearing and Intermediary Oversight, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581. Electronic mail: (tsmith@cftc.gov) or (jbauer@cftc.gov).

#### SUPPLEMENTARY INFORMATION:

#### I. Background

Rule 4.22(c) requires a CPO to file with NFA and to provide to each participant an annual financial report, certified by an independent public

accountant, for each commodity pool that it operates within 90 days of the end of the pool's fiscal year or the permanent cessation of trading.<sup>1</sup> Also, Rule 4.7(b)(3) requires a CPO that has claimed an exemption from certain regulatory requirements pursuant to Rule 4.7 to file with NFA and to distribute to commodity pool participants an unaudited annual financial report in lieu of an audited annual financial report.<sup>2</sup>

Beginning with reports filed for the year ended December 31, 2004, the NFA implemented a pilot program permitting CPOs to voluntarily elect to file commodity pool annual reports through the use of an electronic filing system, the "EasyFile" system, accessed from the NFA's Web site.<sup>3</sup> The NFA pilot program required that the complete annual report for commodity pools, including the public accountant's opinion contained in certified statements, be submitted to NFA in the Portable Document Format ("PDF") file format. In addition to the electronic submission of the document in a PDF file format, participating CPOs were required to directly enter certain key financial statement balances or aggregated balances from the commodity pools' annual reports into the NFA's EasyFile system. The key financial statement balances filed electronically through the pilot program include all the data elements that NFA staff currently manually enter into the FACTS 2000 database from the information contained in hard copy annual reports, as well as several data elements that NFA staff added after consultation with members of the commodity pool industry, certified public accountants ("CPAs") that serve the commodity pool industry, and Commission staff. NFA's FACTS 2000 database serves as the primary means by which NFA and Commission staff access commodity pool financial information.

NFA requested that the Commission provide CPOs participating in the pilot program with relief from the requirement of Rule 4.22(h) that the annual report filed with NFA include a manually signed oath or affirmation, as NFA implemented an electronic version

of the oath or affirmation applicable to both the document submitted in PDF file format and the key financial statement balances directly entered into the EasyFile system. The Commission's Division of Clearing and Intermediary Oversight issued exemptive relief in January 2005 to CPOs participating in the pilot program from the requirement that their pools' annual reports submitted to NFA be manually signed under Rule 4.22(j).<sup>4</sup> On August 26, 2005, the NFA petitioned the Commission to formally amend Rules 4.22 and 4.7 to eliminate the requirement that CPOs file manually signed pool annual reports with NFA, and to further require CPOs to file such annual reports with NFA electronically using the EasyFile system implemented in the pilot program.

Mandatory electronic filing of commodity pool annual reports is anticipated to benefit both the Commission and NFA by increasing the quality of the financial data from commodity pool annual reports that will be collected in FACTS 2000 and be available to the Commission. Direct data entry by the CPO or its CPA, who are most familiar with the information being submitted, and system-enforced edit and validation checks,<sup>5</sup> which are part of the electronic filing system, should enhance the integrity and quality of data collected. Also, NFA's guidance for the classification of the key data elements in the pilot program should increase the uniformity of data available in FACTS 2000, when utilized by all CPOs with respect to applicable commodity pool annual report filings.

Pursuant to the effectiveness of these amendments, submission of annual reports in compliance with the NFA's electronic filing procedures, which require authentication through the use of user ids, passwords and specific permissions managed by designated Security Managers<sup>6</sup> of CPOs, will replace the requirement that a manually signed oath or affirmation be submitted to NFA with a commodity pool's annual report. The user interface and system security for NFA's CPO electronic filing system are patterned after NFA's

existing EasyFile system for IBs' unaudited financial reports. Similar to EasyFile for IBs, the CPO's Security Manager can establish users and assign them abilities to enter data and/or submit the report and data in the NFA electronic filing system.

By these amendments CPOs will be required to maintain in their business records a manually signed oath or affirmation along with their commodity pool annual reports, and also sufficient documentation to support the compilation of the key balances from the annual report. Therefore, NFA may verify or corroborate the information submitted electronically if necessary.

## II. Comments

NFA was the only entity to file a comment letter on the proposed amendments. NFA supported the proposed amendments and stated that "mandatory participation [in electronic filing] should dramatically increase \* \* \* efficiencies without imposing any undue hardships on our CPO Members." NFA also commented in support of the additional amendments proposed with respect to commodity pool financial reporting other than mandatory electronic filing, with one recommendation regarding the notification of changes in commodity pool certified public accountants. NFA commented that these required notifications to both the NFA and the Commission should only be submitted to NFA by CPOs, as they would be available to the Commission in the FACTS 2000 database. The Commission agrees with this comment and has changed the amendment to reflect that for CPOs, such notification must be made solely to NFA. NFA will alert the Commission whenever a notification indicates a disagreement with CPAs or other non-routine circumstances.

## III. Amendments

Rule 4.22(c) requires that a registered CPO file with NFA an annual report for each pool that it operates within 90 days of the end of the pool's fiscal year or the permanent cessation of trading. The Commission is amending Rule 4.22(c) and Rule 4.7(b)(3) to specifically require that the commodity pool annual reports be submitted to NFA electronically through NFA's established electronic filing procedures. Further, the Commission is amending Rule 4.22(h), pursuant to which each such report, including those provided under Rule 4.7 and Rule 4.12(b), must contain an oath or affirmation that, to the best of the knowledge and belief of the person making the oath or affirmation, the information contained in the document

<sup>1</sup> The rules of the Commission cited in this release may be found at 17 CFR Ch. I (2005).

<sup>2</sup> CPOs operating pools offered solely to qualified eligible participants ("QEPs") pursuant to Rule 4.7 may claim relief from the certification requirement of Rule 4.22(d) with respect to the exempt pools' financial statements. See Rule 4.7(b)(3).

<sup>3</sup> NFA initially adopted the EasyFile electronic filing system for financial reporting by introducing brokers ("IBs") in 2004. The Commission approved NFA's rules adopting EasyFile for IBs on June 28, 2004.

<sup>4</sup> CFTC Letter No. 05-01 may be accessed at <http://www.cftc.gov/tm/letters/05letters/tm05-01.htm>.

<sup>5</sup> For example, the system will prompt the user for a correction if the components listed as assets do not total to the amount entered for total assets, or if certain types of trading assets and liabilities are reported in the balance sheet but there are no gains or losses reported in the income statement with respect to such assets.

<sup>6</sup> The Security Manager procedure is part of NFA's existing electronic system for registration processing. The Commission adopted rule amendments in 2002 to enable NFA to utilize an online system for registration functions. See 67 FR 38,869 (June 6, 2002).

is accurate and complete. The amendment shall require the oath or affirmation on annual reports filed with NFA to be made through the use of electronic filing procedures. The Commission is also deleting Rule 4.22(j) and adding a provision to Rule 4.23(a) requiring CPOs to maintain in their books and records a manually signed oath or affirmation for all annual reports and account statements, and to maintain records of the key financial balances submitted to NFA that clearly demonstrate how such balances were derived.

Rule 4.7(b)(2) requires that an account statement signed and affirmed by the CPO be prepared and distributed to pool participants no less frequently than quarterly within 30 calendar days after the end of the reporting period. The account statement must indicate: (1) The net asset value of the exempt pool as of the end of the reporting period; (2) the change in net asset value from the end of the previous reporting period; and (3) the net asset value per outstanding unit of participation in the exempt pool as of the end of the reporting period. The Commission is amending Rule 4.7(b)(2) to clarify that the account statement provided to participants must be presented and computed in accordance with generally accepted accounting principles as are other financial reports required in Part 4 of the Commission's Rules. By making this requirement explicit, the Commission is ensuring that established professional standards are the basis of such calculations.

Rule 4.22(d) requires that the certification of commodity pool annual reports by independent accountants be made in accordance with the certification requirements of Rule 1.16 that are applicable to the financial statements of FCMs and IBs, with specific exceptions. Rule 4.22(d) does not exempt CPOs from Rule 1.16(g), which requires written notification to be given to the NFA and to the Commission of changes in the entity's independent accountant. In order to make clear that this requirement applies to CPOs, the Commission is amending Rule 4.22(d) to specifically state that Rule 1.16(g) is also applicable to CPOs with respect to notifications of changes in the independent accountants engaged for the certification of commodity pool financial statements, except that such notification may be made solely to NFA. By clarifying this, the Commission will be assured that NFA receives proper notice of the circumstances of any changes of independent accountants, which NFA will report to the Commission if indicative of

disagreements with auditors or similar circumstances of concern with respect to the commodity pool.

Rule 4.22(f)(1) provides a mechanism for CPOs that cannot distribute annual reports for pools within the required timeframe without substantial undue hardship to file applications of extensions of time with NFA. In the context of requesting such an extension, the application to NFA must be accompanied by a letter from the pool's independent public accountant. One of the items that must be addressed in the letter is whether the independent accountant has any indication from the audit work in process to indicate that the CPO is not meeting "segregation" requirements. In response to some perceived confusion by the use of the term "segregation", the Commission is amending Rule 4.22(f)(1)(ii)(B) to clarify that this does not refer to the segregation requirements of Rule 1.20 applicable to FCMs, but instead refers to the prohibition on commingling of funds of a commodity pool with the assets of any other person contained in Rule 4.20(c).<sup>7</sup>

Rules 4.22(g)(2) and (3) require notifications to be made to the Commission concerning CPOs' election of fiscal years for commodity pools other than the calendar year or subsequent changes in fiscal year-ends. The Commission is amending these Rules so that such notifications are solely required to be filed with NFA and not the Commission, consistent with other financial reporting filings that are now made to NFA directly as a result of functions the Commission has authorized NFA to perform.<sup>8</sup> NFA is hereby authorized to maintain and serve as official custodian of these notifications as well as the notifications of changes in certified public accountant for commodity pools.

<sup>7</sup> The language originally proposed was "the segregation requirements of § 4.20(c)" showing the intent of the reference to reflect Rule 4.20 and not FCM segregation requirements contained in Commission Rule 1.20. 45 FR 51,600 at 51,610 (August 4, 1980).

<sup>8</sup> By order dated December 11, 2002, the Commission authorized NFA to: (1) Receive and review annual financial reports required to be filed by CPOs pursuant to Rules 4.7(b)(3) and 4.22(c), including annual financial reports required to be filed by CPOs that have claimed relief pursuant to Rule 4.12(b) with respect to qualifying pools, and to review such reports for compliance with the Act and the Commission rules thereunder and to provide notice of deficiencies; (2) receive and grant or deny applications filed pursuant to Rule 4.22(f)(1) for extensions of time to distribute annual financial reports; and (3) process notices of claims of extension of time to distribute and file annual financial reports filed pursuant to Rule 4.22(f)(2). In addition, the Commission authorized NFA to maintain and to serve as the official custodian of such records. 67 FR 77,470 (December 18, 2002).

#### IV. Related Matters

##### A. Regulatory Flexibility Act

The Regulatory Flexibility Act ("RFA"), 5 U.S.C. 601 *et. seq.*, requires that agencies, in proposing rules, consider the impact of those rules on small businesses. The Commission previously has established certain definitions of "small entities" to be used by the Commission in evaluating the impact of its rules on such entities in accordance with the RFA.<sup>9</sup> The Commission has determined previously that registered CPOs are not small entities for the purpose of the RFA.<sup>10</sup> The proposed amendments to Rule 4.7 and Rule 4.22 would apply only to registered CPOs. Therefore, the Chairman, on behalf of the Commission, hereby certifies, pursuant to 5 U.S.C. 605(b), that the action taken herein will not have a significant economic impact on a substantial number of small entities.

##### B. Paperwork Reduction Act

This rulemaking alters the method of collection for a required collection of information under Part 4 of the Commissions Rules. As required by the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)), the Commission submitted a copy of this section to the Office of Management and Budget (OMB) for its review. No comments were received in response to the Commission's invitation in the notice of proposed rulemaking to comment on any change in the potential paperwork burden associated with these rule amendments.

##### C. Cost-Benefit Analysis

Section 15(a) of the Act, as amended by Section 119 of the CFMA, requires the Commission to consider the costs and benefits of its action before issuing a new Rule under the Act. By its terms, Section 15(a) as amended does not require the Commission to quantify the costs and benefits of a new Rule or to determine whether the benefits of the Rule outweigh its costs. Rather, Section 15(a) simply requires the Commission to "consider the costs and benefits" of its action.

Section 15(a) of the Act further specifies that costs and benefits shall be evaluated in light of five broad areas of market and public concern: protection of market participants and the public; efficiency, competitiveness, and financial integrity of futures markets; price discovery; sound risk management practices; and other public interest

<sup>9</sup> 47 FR 18618 (April 30, 1982).

<sup>10</sup> 47 FR at 18619.

considerations. Accordingly, the Commission could in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding its costs, a particular rule was necessary or appropriate to protect the public interest or to effectuate any of the provisions or to accomplish any of the purposes of the Act.

The Commission's proposal contained an analysis of its consideration of these costs and benefits and solicited public comment thereon. 70 FR at 74244. No comments were received with respect to the analysis of the Commission's consideration. Therefore, pursuant to such consideration, the Commission has decided to adopt these amendments as discussed above.

#### List of Subjects in 17 CFR Part 4

Advertising, Commodity futures, Consumer protection, Reporting and recordkeeping requirements.

■ In consideration of the foregoing, 17 CFR Chapter I is amended as follows:

#### PART 4—COMMODITY POOL OPERATORS AND COMMODITY TRADING ADVISORS

■ 1. The authority citation for part 4 continues to read as follows:

**Authority:** 7 U.S.C. 1a, 2, 4, 6b, 6c, 6l, 6m, 6n, 6o, 12a, and 23.

■ 2. Section 4.7 is amended by revising paragraphs (b)(2) and (b)(3) to read as follows:

**§ 4.7 Exemption from certain Part 4 requirements for commodity pool operators with respect to offerings to qualified eligible persons and for commodity trading advisors with respect to advising qualified eligible persons.**

\* \* \* \* \*

(b) \* \* \*

(2) *Periodic reporting relief.* Exemption from the specific requirements of §§ 4.22(a) and (b); *Provided*, That a statement signed and affirmed in accordance with § 4.22(h) is prepared and distributed to pool participants no less frequently than quarterly within 30 calendar days after the end of the reporting period. This statement must be presented and computed in accordance with generally accepted accounting principles and indicate:

(i) The net asset value of the exempt pool as of the end of the reporting period;

(ii) The change in net asset value from the end of the previous reporting period; and

(iii) The net asset value per outstanding unit of participation in the exempt pool as of the end of the reporting period.

(3) *Annual report relief.* (i) Exemption from the specific requirements of §§ 4.22(c) and (d); *Provided*, That within 90 calendar days after the end of the exempt pool's fiscal year, the commodity pool operator electronically files with the National Futures Association and distributes to each participant in lieu of the financial information and statements specified by those sections, an annual report for the exempt pool, affirmed in accordance with § 4.22(h) which contains, at a minimum:

\* \* \* \* \*

■ 3. Section 4.22 is amended by:

■ a. Revising paragraph (c) introductory text;

■ b. Revising paragraph (d) introductory text;

■ c. Revising paragraph (f)(1)(ii)(B);

■ d. Revising paragraphs (g)(2) and (3);

■ e. Revising paragraph (h); and

■ f. Removing paragraph (j), to read as follows:

#### § 4.22 Reporting to pool participants.

\* \* \* \* \*

(c) Except as provided in paragraph (c)(6) of this section, each commodity pool operator registered or required to be registered under the Act must distribute an Annual Report to each participant in each pool that it operates, and must electronically submit a copy of the Report and key financial balances from the Report to the National Futures Association pursuant to the electronic filing procedures of the National Futures Association, within 90 calendar days after the end of the pool's fiscal year or the permanent cessation of trading, whichever is earlier, but in no event longer than 90 days after funds are returned to pool participants; *Provided, however*, That if during any calendar year the commodity pool operator did not operate a commodity pool, the pool operator must so notify the National Futures Association within 30 calendar days after the end of such calendar year. The Annual Report must be affirmed pursuant to paragraph (h) of this section and must contain the following:

\* \* \* \* \*

(d) The financial statements in the Annual Report must be presented and computed in accordance with generally accepted accounting principles consistently applied and must be certified by an independent public accountant. The requirements of § 1.16(g) of this chapter shall apply with respect to the engagement of such

independent public accountants, except that any related notifications to be made may be made solely to the National Futures Association, and the certification must be in accordance with § 1.16 of this chapter, except that the following requirements of that section shall not apply:

\* \* \* \* \*

(f) \* \* \*

(1) \* \* \*

(ii) \* \* \*

(B) Do you have any indication from the part of your audit completed to date that would lead you to believe that the commodity pool operator was or is not meeting the recordkeeping requirements of this part 4 or was or is not complying with the § 4.20(c) prohibition on commingling of property of any pool with the property of any other person?

\* \* \* \* \*

(g)(1) \* \* \*

(2) If a commodity pool operator elects a fiscal year other than the calendar year, it must give written notice of the election to all participants and must file the notice with the National Futures Association within 90 calendar days after the date of the pool's formation. If this notice is not given, the pool operator will be deemed to have elected the calendar year as the pool's fiscal year.

(3) The commodity pool operator must continue to use the elected fiscal year for the pool unless it provides written notice of any proposed change to all participants and files such notice with the National Futures Association at least 90 days before the change and the National Futures Association does not disapprove the change within 30 days after the filing of the notice.

(h)(1) Each Account Statement and Annual Report, including an Account Statement or Annual Report provided pursuant to § 4.7(b) or 4.12(b), must contain an oath or affirmation that, to the best of the knowledge and belief of the individual making the oath or affirmation, the information contained in the document is accurate and complete; *Provided, however*, That it shall be unlawful for the individual to make such oath or affirmation if the individual knows or should know that any of the information in the document is not accurate and complete.

(2) Each oath or affirmation must be made by a representative duly authorized to bind the pool operator, and

(i) for the copy of a commodity pool's Annual Report submitted to the National Futures Association, such representative shall satisfy the required oath or affirmation through compliance

with the National Futures Association's electronic filing procedures, and

(ii) for a commodity pool Account Statement or Annual Report distributed to participants, a facsimile of the manually signed oath or affirmation of such representative may be used so long as the manually signed original is retained in accordance with § 4.23.

(3) For each manually signed oath or affirmation, there must be typed beneath the signed oath or affirmation:

(i) The name of the individual signing the document;

(ii) The capacity in which he is signing;

(iii) The name of the commodity pool operator for whom he is signing; and

(iv) The name of the commodity pool for which the document is being distributed.

\* \* \* \* \*

■ 4. Section 4.23 is amended by adding a new paragraph (a)(12) to read as follows:

#### § 4.23 Recordkeeping.

\* \* \* \* \*

(a) \* \* \*

(12) A manually signed copy of each Account Statement and Annual Report provided pursuant to § 4.22, 4.7(b) or 4.12(b), and records of the key financial balances submitted to the National Futures Association for each commodity pool Annual Report, which records must clearly demonstrate how the key financial balances were compiled from the Annual Report.

\* \* \* \* \*

Issued in Washington, DC, on February 16, 2006 by the Commission.

Jean A. Webb,

Secretary of the Commission.

[FR Doc. 06-1615 Filed 2-21-06; 8:45 am]

BILLING CODE 6351-01-P

## DEPARTMENT OF THE TREASURY

### Internal Revenue Service

#### 26 CFR Part 1

[TD 9251]

RIN 1545-BE71

#### Special Rules Regarding Certain Section 951 Pro Rata Share Allocations

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

**ACTION:** Final regulations.

**SUMMARY:** This document contains final regulations under section 951(a) of the Internal Revenue Code (Code) regarding a United States shareholder's pro rata

share of a controlled foreign corporation's (CFC's) subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, and previously excluded subpart F income withdrawn from foreign base country shipping operations. These regulations are intended to ensure that a CFC's earnings and profits for a taxable year attributable to a section 304 transaction will not be allocated in a manner that results in the avoidance of Federal income tax. These regulations are also intended to ensure that earnings and profits of a CFC are not allocated to certain preferred stock in a manner inconsistent with the economic interest that such stock represents.

**DATES:** *Effective Date:* These regulations are effective February 22, 2006.

*Applicability Date:* For dates of applicability, see § 1.951-1(e)(3)(v), (e)(4)(ii) and (e)(7).

#### FOR FURTHER INFORMATION CONTACT:

Jefferson VanderWolk, (202) 622-3810 (not a toll-free number).

#### SUPPLEMENTARY INFORMATION:

##### Background

On August 6, 2004, the IRS published in the **Federal Register** a notice of proposed rulemaking (REG-129771-04, 2004-36 I.R.B. 453) under section 951 of the Code. After consideration of comments received, the proposed regulations were modified and adopted as final with the publication of T.D. 9222 on August 25, 2005 (70 FR 49864). In response to comments, the IRS published at the same time in the **Federal Register** a notice of proposed rulemaking (REG-129782-05, 70 FR 49894) under section 951 of the Code. No written comments were received in response to that notice of proposed rulemaking. No public hearing was requested or held on the notice of proposed rulemaking. The proposed regulations are adopted as final regulations with the modifications discussed below.

##### Explanation of Changes

Section 1.951-1(e) defines pro rata share for purposes of section 951(a) of the Code. The general rule, set forth in § 1.951-1(e)(3)(i), provides for the allocation of current earnings and profits to different classes of stock on the basis of the respective amounts of such earnings and profits that would be distributed with respect to each class if such earnings and profits were distributed on the last day of the CFC's taxable year on which it is a CFC.

Section 1.951-1(e)(3)(v) provides a special rule that modifies the general

rule regarding the allocation of a CFC's current earnings and profits to more than one class of stock. The special rule applies where a CFC has earnings and profits and subpart F income for its taxable year attributable to a transaction described in section 304 of the Code and that transaction is part of a plan a principal purpose of which is to avoid Federal income taxation by allocating the subpart F income resulting from the section 304 transaction disproportionately to a tax-indifferent party. Pursuant to the rule, such earnings and profits are allocated to each class of stock of the CFC in accordance with the value of such class relative to all other classes.

Several practitioners noted in oral comments that proposed § 1.951-1(e)(6), *Example 9*, which illustrates the application of proposed § 1.951-1(e)(3)(v), presented facts whose characterization under other Code sections could be unclear under the circumstances. In response to these comments, the IRS and Treasury Department have revised the example in order to limit the issues presented.

A comment on the rules originally proposed on August 6, 2004, requested guidance to eliminate inappropriate distortions between subpart F inclusions and economic realization that taxpayers may achieve if accumulated but unpaid dividends with respect to preferred stock are not discounted to present value for purposes of determining the hypothetical distribution. As a partial response to that comment, proposed § 1.951-1(e)(4)(ii) provided a special rule requiring accumulated but unpaid dividends with respect to mandatorily redeemable cumulative preferred stock be taken into account at present value for purposes of the hypothetical distribution. Comments were requested regarding the treatment of cumulative preferred stock that does not have a mandatory redemption date or that is subject to a shareholder-level agreement, such as a purchase option. In addition, the preamble stated that the IRS and the Treasury Department anticipated that any such rules would be effective for taxable years of a controlled foreign corporation beginning on or after January 1, 2006. No further comments were received beyond the original comment.

The IRS and Treasury Department agree with the commentator that accrued but unpaid dividends generally present possibilities for distortion between subpart F income inclusions and economic income realization. These distortions are similar to those that can arise from stock with discretionary