allow for more effective utilization of airspace and would enhance the management of aircraft operations over the Houston terminal area. Specifically, the action would segregate departure traffic and facilitate the development of additional departure procedures from the greater Houston terminal area, thereby increasing departure capacity.

The Proposal

The FAA is proposing an amendment to Title 14 Code of Federal Regulations (14 CFR) part 71 to revise J–29 and J–101 over the South Central United States. Specifically, this action proposes to revise J–29 between the Humble, TX, VORTAC and the El Dorado, AR, VORTAC, and revise J–101 between the Lufkin, TX, VORTAC and Little Rock, AR, VORTAC. This action would allow for more effective utilization of airspace and would enhance the management of aircraft operations over the Houston terminal area.

Jet routes are published in paragraph 2004 of FAA Order 7400.9P, dated September 1, 2006 and effective September 15, 2006, which is incorporated by reference in 14 CFR 71.1. The jet routes listed in this document would be published subsequently in the Order.

The FAA has determined that this proposed regulation only involves an established body of technical regulations for which frequent and routine amendments are necessary to keep them operationally current. Therefore, this proposed regulation: (1) Is not a ''significant regulatory action'' under Executive Order 12866; (2) is not a ''significant rule'' under Department of Transportation (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 proposed 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.

Environmental Review

This proposal will be subject to the appropriate environmental analysis in accordance with FAA Order 1050.1E, Environmental Impacts: Policies and Procedures, prior to any FAA final regulatory action.

List of Subjects in 14 CFR Part 71

Airspace, Incorporation by reference, Navigation (air).

The Proposed Amendment

In consideration of the foregoing, the Federal Aviation Administration proposes to amend 14 CFR part 71 as follows:

PART 71—DESIGNATION OF CLASS A, B, C, D, AND E AIRSPACE AREAS; AIR TRAFFIC SERVICE ROUTES; AND REPORTING POINTS

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

Authority: 49 U.S.C. 106(g), 40103, 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 FAA Order 7400.9P, Airspace Designations and Reporting Points, dated September 1, 2006, and effective September 15, 2006, is amended as follows:

Paragraph 2004 Jet Routes.

* * * * *

J–29 [Revised]

From the INT of the United States/Mexican Border and the Corpus Christi, TX, 229° radial via Corpus Christi; Palacios, TX; Humble, TX; El Dorado, AR; Memphis, TN; Pocket City, IN; INT Pocket City 051° and Rosewood, OH, 230° radials; Rosewood; DRYER, OH; Jamestown, NY; Syracuse, NY; Plattsburgh, NY; Bangor, ME; to Halifax, Canada; excluding the portions within Mexico and Canada.

* * * * *

J–101 [Revised]

From Humble, TX, Lufkin, TX; Little Rock, AR; St. Louis, MO; Spinner, IL; Pontiac, IL; Joliet, IL; Northbrook, IL; Badger, WI; Green Bay, WI; to Sault Ste Marie, MI.

* * * * *

Issued in Washington, DC, on May 29, 2007.

Paul Gallant,

Acting Manager, Airspace and Rules Group.

[FR Doc. E7–11046 Filed 6–6–07; 8:45 am]

BILLING CODE 4910–13–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–103842–07]

RIN 1545–BG33

Qualified Films Under Section 199

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed amendments to the regulations involving the deduction for income attributable to domestic production activities under section 199. The proposed amendments affect taxpayers who produce qualified films under section 199(c)(4)(A)(i)(II) and (c)(6) and taxpayers who are members of an expanded affiliated group under section 199(d)(4). This document also contains a notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by September 5, 2007. Outlines of topics to be discussed at the public hearing scheduled for October 2, 2007, must be received by September 11, 2007.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–103842–07), room 5203, Internal Revenue Service, PO 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–103842–07), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the Federal eRulemaking Portal at *www.regulations.gov* (IRS–REG–103842–07). The public hearing will be held in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning § 1.199–3(k) of the proposed regulations, David McDonnell, at (202) 622–3040; concerning § 1.199–7 of the proposed regulations, Ken Cohen (202) 622–7790; concerning submissions of comments, the hearing, or to be placed on the building access list to attend the hearing, Richard Hurst at *Richard.A.Hurst@irscounsel.treas.gov* or (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to §§ 1.199–3(k) and 1.199–7 of the Income Tax Regulations (26 CFR Part 1). Section 1.199–3(k) relates to the definition of qualified film produced by the taxpayer under section 199(c)(4)(A)(i)(II) and (c)(6) of the Internal Revenue Code (Code) and § 1.199–7 involves expanded affiliated groups under section 199(d)(4). Section 199 was added to the Code by section 102 of the American Jobs Creation Act of 2004 (Pub. L. 108–357, 118 Stat. 1418), and amended by section 403(a) of the Gulf Opportunity Zone Act of 2005 (Pub. L. 109–135, 119 Stat. 25), section 514 of the Tax Increase Prevention and

Reconciliation Act of 2005 (Public Law 109–222, 120 Stat. 345), and section 401 of the Tax Relief and Health Care Act of 2006 (Pub. L. 109–432, 120 Stat. 2922).

General Overview

Section 199(a)(1) allows a deduction equal to 9 percent (3 percent in the case of taxable years beginning in 2005 or 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of (A) The qualified production activities income (QPAI) of the taxpayer for the taxable year, or (B) taxable income (determined without regard to section 199) for the taxable year (or, in the case of an individual, adjusted gross income).

Section 199(c)(1) defines QPAI for any taxable year as an amount equal to the excess (if any) of (A) The taxpayer's domestic production gross receipts (DPGR) for such taxable year, over (B) the sum of (i) The cost of goods sold (CGS) that are allocable to such receipts; and (ii) other expenses, losses, or deductions (other than the deduction under section 199) that are properly allocable to such receipts.

Section 199(c)(4)(A)(i) provides that the term DPGR means the taxpayer's gross receipts that are derived from any lease, rental, license, sale, exchange, or other disposition of (I) Qualifying production property (QPP) that was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States; (II) any qualified film produced by the taxpayer; or (III) electricity, natural gas, or potable water produced by the taxpayer in the United States.

Section 199(c)(6) defines a qualified film to mean any property described in section 168(f)(3) if not less than 50 percent of the total compensation relating to production of the property is compensation for services performed in the United States by actors, production personnel, directors, and producers. The term does not include property with respect to which records are required to be maintained under 18 U.S.C. 2257 (generally, films, videotapes, or other matter that depict actual sexually explicit conduct and are produced in whole or in part with materials that have been mailed or shipped in interstate or foreign commerce, or are shipped or transported or are intended for shipment or transportation in interstate or foreign commerce).

Section 199(d)(4)(A) provides that all members of an expanded affiliated group (EAG) are treated as a single corporation for purposes of section 199. Under section 199(d)(4)(B), an EAG is an affiliated group as defined in section 1504(a), determined by substituting "more than 50 percent" for "at least 80 percent" each place it appears and without regard to section 1504(b)(2) and (4).

Section 199(d)(8) authorizes the Secretary to prescribe such regulations as are necessary to carry out the purposes of section 199, including regulations that prevent more than one taxpayer from being allowed a deduction under section 199 with respect to any activity described in section 199(c)(4)(A)(i).

Explanation of Provisions

Qualified Film Produced by the Taxpayer

On June 1, 2006, final regulations (TD 9263) under section 199 were published in the **Federal Register** (71 FR 31268). Subsequent to the publication of the final regulations, the IRS and Treasury Department became aware that the definition of a qualified film produced by a taxpayer as outlined in the final regulations may not be consistent with the statute. Under section 199(c)(4)(A)(i)(II), a taxpayer's gross receipts qualify as DPGR if the receipts are derived from any lease, rental, license, sale, exchange, or other disposition of any qualified film (as defined in section 199(c)(6)) produced by the taxpayer. A film must be both a "qualified film" under section 199(c)(6) and "produced by the taxpayer" under section 199(c)(4)(A)(i)(II) in order for the gross receipts to qualify as DPGR. Section 1.199–3(k)(5) of the final regulations addresses these two requirements by adding "by the taxpayer" to the not-less-than-50-percent-of-the-total-compensation requirement under § 1.199–3(k)(1). However, under the test provided in § 1.199–3(k)(5) of the final regulations, a film that was produced entirely within the United States could fail to qualify for the section 199 deduction if less than 50 percent of the total compensation relating to production was paid "by the taxpayer."

The proposed regulations more closely follow the statutory language in section 199(c)(6) by revising the fraction in § 1.199–3(k)(5) for determining the not-less-than-50-percent-of-the-total-compensation requirement under § 1.199–3(k)(1). Under the fraction set forth in the proposed regulations, the numerator of the revised fraction is the compensation for services performed in the United States and the denominator is the total compensation for services regardless of where the production activities are performed. The revised fraction essentially compares (in the numerator) the sum of the compensation for services paid by the taxpayer for services performed in the United States and the compensation for services paid by others for services performed in the United States to (in the denominator) the sum of the total compensation for services paid by the taxpayer for services and the total compensation for services paid by others for services regardless of location. The proposed regulations also clarify in § 1.199–8(a) that, for purposes of §§ 1.199–1 through 1.199–9, use of terms such as "payment," "paid," "incurred," or "paid or incurred" is not intended to provide any specific rule based upon the use of one term versus another. In general, the use of the term "payment," "paid," "incurred," or "paid or incurred" is intended to convey the appropriate standard under the taxpayer's method of accounting.

Under § 1.199–3(k)(6) of the proposed regulations, a film that is a qualified film under § 1.199–3(k)(1) will be treated as "produced by the taxpayer" for purposes of section 199(c)(4)(A)(i)(II) if the production activity performed by the taxpayer is substantial in nature within the meaning of § 1.199–3(g)(2). The special rules of § 1.199–3(g)(4) regarding a contract with an unrelated person and aggregation apply in determining whether the taxpayer's production activity is substantial in nature. Section 1.199–3(g)(2) and (4) are applied by substituting the term "qualified film" for QPP and disregarding the requirement that the production activity must be within the United States. Thus, a qualified film will be treated as produced by the taxpayer if the production of the qualified film by the taxpayer is substantial in nature taking into account all of the facts and circumstances, including the relative value added by, and relative cost of, the taxpayer's production activity, the nature of the qualified film, and the nature of the production activity that the taxpayer performs.

The rules provided in § 1.199–3(k)(5) of the proposed regulations closely follow the statutory language in section 199(c)(6) by referencing all compensation for services related to the production as opposed to a more limited "by the taxpayer" compensation test. Commentators have expressed concern over the difficulty of obtaining information related to the compensation paid by others. In response to this concern, the IRS and Treasury Department have provided a safe harbor in § 1.199–3(k)(7) of the proposed regulations provides a safe harbor that will treat a film as a qualified film if not less than 50 percent of the total compensation for services paid by the taxpayer is compensation for services performed in the United States. The safe harbor further provides that a qualified film will be treated as produced by the taxpayer if the taxpayer satisfies the safe harbor in § 1.199–3(g)(3) with respect to the qualified film, which requires that the direct labor and overhead costs incurred by the taxpayer to produce the qualified film within the United States account for 20 percent or more of the total costs of the film.

Similar to § 1.199–3(k)(6) of the proposed regulations, the special rules of § 1.199–3(g)(4) regarding a contract with an unrelated person and aggregation apply in determining whether the taxpayer satisfies § 1.199–3(g)(3). Section 1.199–3(g)(3) and (4) are applied by substituting the term ''qualified film'' for QPP but not disregarding the requirement that the direct labor and overhead of the taxpayer to produce the qualified film must be within the United States. Thus, a taxpayer will be treated as having produced a qualified film if, in connection with the qualified film, the direct labor and overhead of the taxpayer to produce the qualified film within the United States account for 20 percent or more of the taxpayer's CGS of the qualified film, or in a transaction without CGS (for example, a lease, rental, or license) account for 20 percent or more of the taxpayer's ''unadjusted depreciable basis'' (as defined in § 1.199–3(g)(3)(ii)) in the qualified film.

Expanded Affiliated Groups

After issuance of the final regulations, several commentators noted that § 1.199–7(e), *Example 10*, of the final regulations misapplies § 1.1502–13 of the consolidated return regulations. In *Example 10*, a member of a consolidated group sells QPP to another member of the consolidated group. Before the QPP is sold to an unrelated party, the purchasing corporation is disaffiliated from the consolidated group. *Example 10* provides that neither the selling corporation nor the purchasing corporation has DPGR. After further consideration, the IRS and Treasury Department have determined that *Example 10* does not properly apply § 1.1502–13 of the consolidated return regulations and that both the selling corporation and the purchasing corporation have DPGR in the facts described. Accordingly, the proposed regulations remove *Example 10* of the final regulations and replace it with a new *Example 10*, properly applying § 1.1502–13 of the consolidated return regulations.

In addition, the IRS and Treasury Department discovered a problem concerning the section 199 closing of the books method under § 1.199–7(f)(1)(ii) of the final regulations. A corporation that becomes or ceases to be a member of an EAG during its taxable year must allocate its taxable income or loss, QPAI, and W–2 wages between the portion of the taxable year that it is a member of the EAG and the portion of the taxable year that it is not a member of the EAG. In general, this allocation is made by using the pro rata allocation method described in § 1.199–7(f)(1)(i) of the final regulations. Section 1.199–7(f)(1)(ii) provides that in lieu of the pro rata allocation method, a corporation may elect to apply the section 199 closing of the books method under which a corporation treats its taxable year as two separate taxable years, the first of which ends at the close of the day on which the corporation's status as a member of the EAG changes and the second of which begins at the beginning of the day after the corporation's status as a member of the EAG changes.

In certain situations, the section 199 closing of the books method can create a larger section 199 deduction than is warranted. The facts of the *Example* in § 1.199–7(g)(3) of the final regulations demonstrate such a situation. In the *Example,* Corporations X and Y, calendar year corporations, are members of the same EAG for the entire 2007 taxable year. Corporation Z, also a calendar year corporation, is a member of the EAG of which X and Y are members for the first half of 2007 and not a member of any EAG for the second half of 2007. During the 2007 taxable year, Z does not join in the filing of a consolidated return. Z makes a section 199 closing of the books election. As a result, Z has $80 of taxable income and $100 of QPAI that is allocated to the first half of 2007 and a $150 taxable loss and ($200) of QPAI that is allocated to the second half of 2007. In addition to the facts presented in the *Example,* assume that X and Y each have $60 of taxable income and QPAI in 2007, Z has $170 of taxable income and QPAI in 2008, and that X, Y, and Z each have W–2 wages in excess of the section 199(b) wage limitation for all relevant periods. After applying the section 199 closing of the books method, the EAG has $200 of taxable income and $220 of QPAI in 2007. Accordingly, the EAG will have a section 199 deduction of $12 (6 percent of the lesser of the EAG's $200 of taxable income and $220 of QPAI). Z, as a stand-alone corporation for the second half of 2007, will have both negative taxable income and negative QPAI and therefore will have no section 199 deduction. In 2008, notwithstanding that Z made a section 199 closing of the books election pursuant to which Z is deemed to have a $150 taxable loss for the second half of 2007, for purposes of computing its taxable income in 2008, Z only has a $70 NOL carryover from 2007. Accordingly, Z will have taxable income of $100 in 2008 and will have a section 199 deduction of $6 (6 percent of the lesser of its $100 of taxable income and $170 of QPAI). Because X and Y had a total of $120 of taxable income and Z had total taxable income in 2007 and 2008 of $100, the maximum aggregate section 199 deduction should have been $13.20 (6 percent of the aggregate taxable income of X, Y, and Z of $220), instead of the aggregate $18 deduction derived in the above example because of the use of the section 199 closing of the books method. The section 199 closing of the books method effectively eliminated $80 of Z's losses from being used to offset taxable income for purposes of the section 199 deduction in either 2007 or 2008.

The proposed regulations remove the section 199 closing of the books method and revise the *Example* in § 1.199–7(g)(3) to apply the pro rata allocation method. However, the IRS and Treasury Department invite comments concerning the necessity for a section 199 closing of the books method and suggestions under which a section 199 closing of the books election would be allowable, provided that the election does not create an unwarranted section 199 deduction nor does it impose an undue burden on either taxpayers or the government.

Proposed Effective Date

Sections 1.199–3(k), 1.199–7(e), *Example 10*, and 1.199–7(f)(1) are proposed to be applicable to taxable years beginning on or after the date the final regulations are published in the **Federal Register**. Until the date the final regulations are published in the **Federal Register**, taxpayers may rely on § 1.199–3(k) and § 1.199–7(e), *Example 10*, of the proposed regulations for taxable years beginning after December 31, 2004. However, for taxable years beginning before June 1, 2006, a taxpayer may rely on § 1.199–3(k) of the proposed regulations only if the taxpayer does not apply Notice 2005–14 (2005–1 C.B. 498) (see § 601.601(d)(2)) or REG–105847–05 (2005–2 CB 987) (see § 601.601(d)(2)(ii)(*b*)) to the taxable year.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. Comments are requested on all aspects of the proposed regulations. In addition, the IRS and Treasury Department specifically 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 2, 2007, at 10 a.m. in the auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 30 minutes before the hearing starts. 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. 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 5, 2007 and submit 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 11, 2007. 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 authors of these regulations are Lauren Ross Taylor and David M. McDonnell, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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 * * *

Section 1.199–3 also issued under 26 U.S.C. 199(d). * * *

Section 1.199–7 also issued under 26 U.S.C. 199(d). * * *

Section 1.199–8 also issued under 26 U.S.C. 199(d). * * *

Par. 2. Section 1.199–3 is amended by:

1. Revising paragraphs (k)(1), (k)(4), and (k)(5).

2. Redesignating paragraph (k)(6) as (k)(9).

3. Redesignating paragraph (k)(7) as (k)(10).

4. Adding new paragraphs (k)(6), (k)(7), and (k)(8).

5. Revising *Example 6* of newly designated paragraph (k)(10).

The revisions and additions read as follows:

§ 1.199–3 Domestic production gross receipts.

* * * * *

(k) * * *

(1) *In general.* The term *qualified film* means any motion picture film or video tape under section 168(f)(3), or live or delayed television programming (film), if not less than 50 percent of the total compensation relating to the production of such film is compensation for services performed in the United States by actors, production personnel, directors, and producers. For purposes of this paragraph (k), the term *actors* includes players, newscasters, or any other persons who are compensated for their performance or appearance in a film. For purposes of this paragraph (k), the term *production personnel* includes writers, choreographers and composers who are compensated for providing services during the production of a film, as well as casting agents, camera operators, set designers, lighting technicians, make-up artists, and other persons who are compensated for providing services that are directly related to the production of the film. Except as provided in paragraph (k)(2) of this section, the definition of a qualified film does not include tangible personal property embodying the qualified film, such as DVDs or videocassettes.

* * * * *

(4) *Compensation for services.* For purposes of this paragraph (k), the term *compensation for services* means all payments for services performed by actors, production personnel, directors, and producers relating to the production of the film, including participations and residuals. Payments for services include all elements of compensation as provided for in § 1.263A–1(e)(2)(i)(B) and (3)(ii)(D). Compensation for services is not limited to W–2 wages and includes compensation paid to independent contractors. In the case of a taxpayer that uses the income forecast method of section 167(g) and capitalizes participations and residuals into the adjusted basis of the qualified film, the taxpayer must use the same estimate of participations and residuals in determining compensation for services. In the case of a taxpayer that excludes participations and residuals from the adjusted basis of the qualified film under section 167(g)(7)(D)(i), the taxpayer must use the amount expected to be paid as participations and residuals based on the total forecasted income used in determining income forecast depreciation in determining compensation for services.

(5) *Determination of 50 percent.* The not-less-than-50-percent-of-the-total-compensation requirement under paragraph (k)(1) of this section is calculated using a fraction. The numerator of the fraction is the compensation for services performed in the United States and the denominator is the total compensation for services regardless of where the production activities are performed. A taxpayer may use any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, including all historic information available, to determine the compensation for services performed in the United States and the total compensation for services regardless of where the production activities are performed. Among the factors to be considered in determining whether a taxpayer's method of allocating compensation is reasonable is whether

the taxpayer uses that method consistently from one taxable year to another.

(6) *Produced by the taxpayer.* A qualified film will be treated as produced by the taxpayer for purposes of section 199(c)(4)(A)(i)(II) if the production activity performed by the taxpayer is substantial in nature within the meaning of paragraph (g)(2) of this section. The special rules of paragraph (g)(4) of this section regarding a contract with an unrelated person and aggregation apply in determining whether the taxpayer's production activity is substantial in nature. Paragraphs (g)(2) and (4) of this section are applied by substituting the term *qualified film* for QPP and disregarding the requirement that the production activity must be within the United States. The production activity of the taxpayer must consist of more than the minor or immaterial combination or assembly of two or more components of a film. For purposes of paragraph (g)(2) of this section, the relative value added by affixing trademarks or trade names as defined in § 1.197–2(b)(10)(i) will be treated as zero.

(7) *Qualified film produced by the taxpayer—safe harbor.* A film will be treated as a qualified film under paragraph (k)(1) of this section and produced by the taxpayer under paragraph (k)(6) of this section (qualified film produced by the taxpayer) if the taxpayer meets the requirements of paragraphs (k)(7)(i) and (ii) of this section. A taxpayer that chooses to use this safe harbor must apply all the provisions of this paragraph (k)(7).

(i) *Safe harbor.* A film will be treated as a qualified film produced by the taxpayer if not less than 50 percent of the total compensation for services paid by the taxpayer is compensation for services performed in the United States and the taxpayer satisfies the safe harbor in paragraph (g)(3) of this section. The special rules of paragraph (g)(4) of this section regarding a contract with an unrelated person and aggregation apply in determining whether the taxpayer satisfies paragraph (g)(3) of this section. Paragraphs (g)(3) and (4) of this section are applied by substituting the term *qualified film* for QPP but not disregarding the requirement that the direct labor and overhead of the taxpayer to produce the qualified film must be within the United States. Paragraph (g)(4)(ii)(A) of this section includes any election under section 181.

(ii) *Determination of 50 percent.* The not-less-than-50-percent-of-the-total-compensation requirement under paragraph (k)(7)(i) of this section is calculated using a fraction. The numerator of the fraction is the compensation for services paid by the taxpayer for services performed in the United States and the denominator is the total compensation for services paid by the taxpayer regardless of where the production activities are performed. For purposes of this paragraph (k)(7)(ii), the term *paid by the taxpayer* includes amounts that are treated as paid by the taxpayer under paragraph (g)(4) of this section. A taxpayer may use any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, including all historic information available, to determine the compensation for services paid by the taxpayer for services performed in the United States and the total compensation for services paid by the taxpayer regardless of where the production activities are performed. Among the factors to be considered in determining whether a taxpayer's method of allocating compensation is reasonable is whether the taxpayer uses that method consistently from one taxable year to another.

(8) *Production pursuant to a contract.* With the exception of the rules applicable to an expanded affiliated group (EAG) under § 1.199–7 and EAG partnerships under § 1.199–3T(i)(8), only one taxpayer may claim the deduction under § 1.199–1(a) with respect to any activity related to the production of a qualified film performed in connection with the same qualified film. If one taxpayer performs a production activity pursuant to a contract with another party, then only the taxpayer that has the benefits and burdens of ownership of the qualified film under Federal income tax principles during the period in which the production activity occurs is treated as engaging in the production activity.

* * * * *

(10) * * *

Example 6. X creates a television program in the United States that includes scenes from films licensed by X from unrelated persons Y and Z. Assume that Y and Z produced the films licensed by X. The not-less-than-50-percent-of-the-total-compensation requirement under paragraph (k)(1) of this section is determined by reference to all compensation for services paid in the production of the television program, including the films licensed by X from Y and Z, and is calculated using a fraction as described in paragraph (k)(5) of this section. The numerator of the fraction is the compensation for services performed in the United States and the denominator is the total compensation for services regardless of where the production activities are performed. However, for purposes of calculating the denominator, in determining the total compensation paid by Y and Z, X need only include the total compensation paid by Y and Z to actors, production personnel, directors, and producers for the production of the scenes used by X in creating its television program.

Par. 3. Section 1.199–7 is amended by:

1. Revising *Example 10* of paragraph (e).

2. Revising paragraphs (f)(1) and (g)(3).

The revisions read as follows:

§ 1.199–7 Expanded affiliated groups.

* * * * *

(e) * * *

Example 10. (i) *Facts.* Corporation P owns all of the stock of Corporations S and B. P, S, and B file a consolidated Federal income tax return on a calendar year basis. P, S, and B each use the section 861 method for allocating and apportioning their deductions. In 2010, S MPGE QPP in the United States at a cost of $1,000. On November 30, 2010, S sells the QPP to B for $2,500. On February 28, 2011, P sells 60% of the stock of B to X, an unrelated person. On June 30, 2011, B sells the QPP to U, another unrelated person, for $3,000.

(ii) *Consolidated group's 2010 QPAI.* Because S and B are members of a consolidated group in 2010, pursuant to § 1.199–7(d)(1) and § 1.1502–13, neither S's $1,500 of gain on the sale of QPP to B nor S's $2,500 gross receipts from the sale are taken into account in 2010. Accordingly, neither S nor B has QPAI in 2010.

(iii) *Consolidated group's 2011 QPAI.* B becomes a nonmember of the consolidated group at the end of the day on February 28, 2011, the date on which P sells 60% of the B stock to X. Under § 1.199–7(d)(1) and § 1.1502–13(d), S takes the intercompany transaction into account immediately before B becomes a non-member of the consolidated group. Pursuant to § 1.1502–13(d)(1)(ii)(A)(*1*), because the QPP is owned by B, a nonmember of the consolidated group immediately after S's gain is taken into account, B is treated as selling the QPP to a nonmember for $2,500, B's adjusted basis in the property, immediately before B becomes a nonmember of the consolidated group. Accordingly, immediately before B becomes a nonmember of the consolidated group, S takes into account $1,500 of QPAI (S's $2,500 DPGR received from B–S's $1,000 cost of MPGE the QPP).

(iv) *B's 2011 QPAI.* Pursuant to § 1.1502–13(d)(2)(i)(B), the attributes of B's corresponding item, that is, its sale of the QPP to U, are determined as if the S division (but not the B division) were transferred by the P, S, and B consolidated group (treated as a single corporation) to an unrelated person. Thus, S's activities in MPGE the QPP before the intercompany sale of the QPP to B continue to affect the attributes of B's sale of the QPP. As such, B is treated as having MPGE the QPP. Accordingly, upon its sale of the QPP, B has $500 of QPAI (B's $3,000 DPGR received from U–B's $2,500 cost of MPGE the QPP).

* * * * *

(f) *Allocation of income and loss by a corporation that is a member of the expanded affiliated group for only a portion of the year*—(1) *In general.* A corporation that becomes or ceases to be a member of an EAG during its taxable year must allocate its taxable income or loss, QPAI, and W–2 wages between the portion of the taxable year that it is a member of the EAG and the portion of the taxable year that it is not a member of the EAG. This allocation of items is made by using the pro rata allocation method described in this paragraph (f)(1). Under the pro rata allocation method, an equal portion of a corporation's taxable income or loss, QPAI, and W–2 wages for the taxable year is assigned to each day of the corporation's taxable year. Those items assigned to those days that the corporation was a member of the EAG are then aggregated.

* * * * *

(g) * * *

(3) *Example.* The following example illustrates the application of paragraphs (f) and (g) of this section:

Example. (i) *Facts.* Corporations X and Y, calendar year corporations, are members of the same EAG for the entire 2010 taxable year. Corporation Z, also a calendar year corporation, is a member of the EAG of which X and Y are members for the first half of 2010 and not a member of any EAG for the second half of 2010. During the 2010 taxable year, neither X, Y, nor Z join in the filing of a consolidated Federal income tax return. Assume that X, Y, and Z each have W–2 wages in excess of the section 199(b) wage limitation for all relevant periods. In 2010, X has taxable income of $2,000 and QPAI of $600, Y has a taxable loss of $400 and QPAI of ($200), and Z has taxable income of $1,400 and QPAI of $2,400.

(ii) *Analysis.* Pursuant to the pro rata allocation method, $700 of Z's 2010 taxable income and $1,200 of Z's 2010 QPAI are allocated to the first half of the 2010 taxable year (the period in which Z is a member of the EAG) and $700 of Z's 2010 taxable income and $1,200 of Z's 2010 QPAI are allocated to the second half of the 2010 taxable year (the period in which Z is not a member of any EAG). Accordingly, in 2010, the EAG has taxable income of $2,300 (X's $2,000 + Y's ($400) + Z's $700) and QPAI of $1,600 (X's $600 + Y's ($200) + Z's $1,200). The EAG's section 199 deduction for 2010 is therefore $144 (9% of the lesser of the EAG's $2,300 of taxable income or $1,600 of QPAI). Pursuant to § 1.199–7(c)(1), this $144 deduction is allocated to X, Y, and Z in proportion to their respective QPAI. Accordingly, X is allocated $48 of the EAG's section 199 deduction, Y is allocated $0 of the EAG's section 199 deduction, and Z is allocated $96 of the deduction. For the second half of 2010, Z has taxable income of $700 and QPAI of $1,200. Therefore, for the second half of 2010, Z has a section 199 deduction of $63 (9% of the lesser of its $700 taxable income or $1,200 QPAI for the second half of 2010). Accordingly, X's 2010 section 199 deduction is $48, Y's 2010 section 199 deduction is $0, and Z's 2010 section 199 deduction is $159, the sum of the $96 section 199 deduction of the EAG allocated to Z for the first half of 2010 and Z's $63 section 199 deduction for the second half of 2010.

Par. 4. Section 1.199–8 is amended by:

1. Adding two sentences at the end of paragraph (a).
2. Adding new paragraphs (i)(8) and (i)(9).

The revisions and additions read as follows:

§ 1.199–8 Other rules.

(a) * * * For purposes of §§ 1.199–1 through 1.199–9, use of terms such as *payment, paid, incurred,* or *paid or incurred* is not intended to provide any specific rule based upon the use of one term versus another. In general, the use of the term *payment, paid, incurred,* or *paid or incurred* is intended to convey the appropriate standard under the taxpayer's method of accounting.

* * * * *

(i) * * *

(8) *Qualified film produced by the taxpayer.* Section 1.199–3(k) is proposed to be applicable to taxable years beginning on or after the date the final regulations are published in the **Federal Register**. Until the date the final regulations are published in the **Federal Register**, taxpayers may rely on § 1.199–3(k) of these proposed regulations for taxable years beginning after December 31, 2004. However, for taxable years beginning before June 1, 2006, a taxpayer may rely on § 1.199–3(k) of the proposed regulations only if the taxpayer does not apply Notice 2005–14 (2005–1 CB 498) (see § 601.601(d)(2)(ii)(*b*) of this chapter) or REG–105847–05 (2005–2 CB 987) (see § 601.601(d)(2)(ii)(*b*) of this chapter) to the taxable year.

(9) *Expanded affiliated groups.* Section 1.199–7(e), *Example 10,* and § 1.199–7(f)(1) are proposed to be applicable to taxable years beginning on or after the date the final regulations are published in the **Federal Register**. Until the date the final regulations are published in the **Federal Register,** taxpayers may rely on § 1.199–7(e), *Example 10,* of these proposed regulations for taxable years beginning after December 31, 2004.

Kevin M. Brown,

Deputy Commissioner for Services and Enforcement.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–157711–02]

RIN 1545–BB61

Unified Rule for Loss on Subsidiary Stock; Correction

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to notice of proposed rulemaking.

SUMMARY: This document contains corrections to a notice of proposed rulemaking that were published in the **Federal Register** on Tuesday, January 23, 2007 (72 FR 2964). These regulations apply to corporations filing consolidated returns. The regulations implement aspects of the repeal of the *General Utilities* doctrine by redetermining members' bases in subsidiary stock and requiring certain reductions in subsidiary stock basis on a transfer of the stock. The regulations promote the clear reflection of income by redetermining members' bases in subsidiary's stock and reducing the subsidiary's attributes to prevent the duplication of loss, and they also, provide guidance limiting the application of section 362(e)(2) with respect to transactions between members of a consolidated group.

FOR FURTHER INFORMATION CONTACT: Theresa Abell (202) 622–7700 or Phoebe Bennett (202) 622–7770 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

The notice of proposed rulemaking (REG–157711–02) that is the subject of these corrections are under sections 358, 362(e)(2) and 1502 of the Internal Revenue Code.

Need for Correction

As published, the notice of proposed rulemaking (REG–157711–02) contains errors that may prove to be misleading and are in need of clarification.

Correction of Publication

Accordingly, the publication of the notice of proposed rulemaking (REG–157711–02), that is the subject of FR Doc. 07–187, is corrected as follows:

1. On page 2964, column 2, in the preamble, under the paragraph heading ''Paperwork Reduction Act'', eighth paragraph of the column, line 3, the language ''13(e)(4)(v) and 1.1502–36(d)(7). The'' is corrected to read ''13(e)(4)(v) and 1.1502–36(d)(6). The''.