investment portfolio may be an asset held for use in the trade or business of a foreign insurance company. By contrast, stock of a subsidiary generally is not held for the purpose of meeting an insurance company's business needs.

This proposed regulation provides that the general rule excluding stock from the asset-use test does not apply to stock held by a foreign insurance company unless such company owns directly, indirectly, or constructively 10 percent or more of the vote or value of the company's stock. The 10-percent threshold is intended to distinguish portfolio stock held to fund policyholder obligations and surplus requirements from investments in a subsidiary. Comments are requested as to whether this 10-percent threshold provides an appropriate standard for determining whether stock is a portfolio investment for these purposes.

Proposed Effective Date

This regulation is proposed to apply to taxable periods beginning on or after the date of publication of a Treasury decision adopting this rule as a final regulation 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 provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply. Pursuant to section 7805(f) of the Internal Revenue 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 Treasury Department 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 may be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for a public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Sheila Ramaswamy, Office of Associate Chief Counsel (International). 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 Amendment 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 is amended by revising § 1.864–4 as follows:

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

Par. 2. In § 1.864–4, paragraph (c)(2)(iii)(b) is revised to read as follows:

* * * * *

§ 1.864–4 U.S. source income effectively connected with U.S. business.

* * * * *

(c) * * *

(2) * * *

(iii) * * *

(b) Paragraph (c)(2)(iii) of this section shall not apply to stock of a corporation (whether domestic or foreign) held by a foreign insurance company unless the foreign insurance company owns 10 percent or more of the total voting power or value of all classes of stock of such corporation. For purposes of this section, section 318(a) shall be applied in determining ownership, except that in applying section 318(a)(2)(C), the phrase ''10 percent'' is used instead of the phrase ''50 percent.''

* * * * *

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

[FR Doc. 04–14392 Filed 6–24–04; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–131486–03]

RIN 1545–BC29

Adjustment To Net Unrealized Built-in Gain

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under section 1374 that provide for an adjustment to the amount that may be subject to tax under section 1374 in certain cases in which an S corporation acquires assets from a C corporation in an acquisition to which section 1374(d)(8) applies. These proposed regulations provide guidance to certain S corporations that acquire assets from a C corporation in a carryover basis transaction.

DATES: Written or electronic comments must be received by September 23, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–131486–03), 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–131486–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the IRS Internet site at *http://www.irs.gov/regs* or via the Federal eRulemaking Portal at *http://www.regulations.gov* (IRS—REG–131486–03). 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, Jennifer Sledge, (202) 622–7750; concerning submissions of comments, Treena Garrett, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Section 1374 of the Internal Revenue Code of 1986 (Code) generally imposes a corporate level tax on the income or gain of an S corporation that formerly was a C corporation to the extent the income or gain is attributable to the period during which the corporation was a C corporation. Congress amended section 1374 to provide this rule as part of the Tax Reform Act of 1986, which repealed the *General Utilities* doctrine. Under the *General Utilities* doctrine, a C corporation, in certain cases, could distribute appreciated assets to its shareholders, or sell appreciated assets and distribute the sale proceeds in connection with a complete liquidation to its shareholders, without recognizing gain. Section 1374 prevents a corporation from circumventing *General Utilities* repeal by converting to S corporation status before distributing its appreciated assets to its shareholders, or selling its appreciated assets and distributing the sale proceeds in connection with a complete liquidation to its shareholders.

Specifically, section 1374 imposes a tax on an S corporation's net recognized built-in gain attributable to assets that it held on the date it converted from a C corporation to an S corporation for the 10-year recognition period beginning on the first day the corporation is an S corporation. Under section 1374, the total amount subject to tax is limited to the S corporation's net unrealized built-in gain (NUBIG), which is the ''aggregate net built-in gain of the corporation at the time of conversion to S corporation status.'' See H.R. Conf. Rep. No. 99–841, at II–203 (1986). Section 1374 also imposes a tax on an S corporation's net recognized built-in gain attributable to assets that it acquired in a carryover basis transaction from a C corporation for the 10-year recognition period beginning on the day of the carryover basis transaction. The legislative history of section 1374 provides that each acquisition of assets from a C corporation is subject to a separate determination of the amount of net unrealized built-in gain and is subject to a separate 10-year recognition period. See H.R. Rep. No. 100–795, at 63 (1988).

Sections 337(d) and 1374(e) authorize the Secretary of the Treasury to prescribe regulations as necessary to carry out the purposes of *General Utilities* repeal generally and section 1374 specifically. The Treasury Department and the IRS have promulgated regulations consistent with these provisions. See, *e.g.*, §§ 1.337(d)–4 through 1.337(d)–7, 1.1374–1 through 1.1374–10.

Under § 1.1374–3, an S corporation's NUBIG generally is the amount of gain the S corporation would recognize on the conversion date if it sold all of its assets at fair market value to an unrelated party that assumed all of its liabilities on that date. Consistent with the legislative history of section 1374, section 1374(d)(8) and § 1.1374–8 require a separate determination of the amount subject to tax under section 1374 for the pool of assets the S corporation held on the date it converted to C status and each pool of assets acquired in a carryover basis transaction from a C corporation.

Under the current rules, therefore, if X, a C corporation, elects to be an S corporation when it owns all of the stock of Y, a C corporation, X's NUBIG will reflect the built-in gain or built-in loss in the Y stock. That built-in gain or built-in loss may be duplicative of the built-in gain or built-in loss in Y's assets. If Y later transfers its assets to X in a liquidation to which sections 332 and 337(a) apply, the built-in gain and built-in loss in Y's assets may be reflected twice: once in the NUBIG attributable to the assets X owned on the date of its conversion (including the stock of Y) and a second time in the NUBIG attributable to Y's former assets acquired by X in the liquidation of Y. A similar result would obtain if, on the date of its conversion to an S corporation, X owned less than 80 percent of the stock of Y and later acquired the assets of Y in a reorganization to which section 368(a) applies. These results are inconsistent with the fact that a liquidation to which sections 332 and 337(a) apply, and the acquisition of the assets of a corporation some or all of the stock of which is owned by the acquiring corporation in a reorganization under section 368(a), generally have the effect of eliminating the built-in gain or built-in loss in the redeemed or canceled stock of the liquidated or target corporation.

In the course of developing these proposed regulations, the Treasury Department and the IRS considered a number of approaches to address the issue raised by the situations described above. In particular, the Treasury Department and the IRS considered adopting an approach that would provide for a single determination of NUBIG for all of the assets of an S corporation and, thus, a single determination of the amount subject to tax under section 1374. While this approach may have produced results similar to those that would have been produced had the S corporation remained a C corporation and acquired the assets of another C corporation, it was rejected because such an approach appears to be inconsistent with the legislative history of section 1374, which seems to mandate a separate determination of tax for each pool of assets. See H.R. Rep. No. 100–795, at 63.

Instead, these regulations adopt an approach that adjusts (increases or decreases) the NUBIG of the pool of assets that included the stock of the liquidated or acquired C corporation to reflect the extent to which the built-in gain or built-in loss inherent in the redeemed or canceled C corporation stock at the time the pool of assets became subject to the tax under section 1374 has been eliminated from the corporate tax system in the liquidation or reorganization. These proposed regulations provide that, if section 1374(d)(8) applies to an S corporation's acquisition of assets, some or all of the stock of the C corporation from which such assets were acquired was taken into account in the computation of NUBIG for a pool of assets of the S corporation, and some or all of such stock is redeemed or canceled in such transaction, subject to certain limitations, the NUBIG of the pool of assets that included the C corporation stock redeemed or canceled in the transaction (other than stock with respect to which a loss under section 165 is claimed) is adjusted to eliminate any effect any built-in gain or built-in loss in the redeemed or canceled C corporation stock had on the initial computation of NUBIG for that pool of assets. For this purpose, stock that has an adjusted basis that is determined (in whole or in part) by reference to the adjusted basis of any other asset held by the S corporation as of the first day of the recognition period (*i.e.*, stock described in section 1374(d)(6)) is treated as taken into account in the computation of the NUBIG for the pool of assets of the S corporation.

Adjustments to NUBIG under these proposed regulations, however, are subject to two limitations. First, the NUBIG is only adjusted to reflect the amount of the built-in gain or built-in loss that was inherent in the redeemed or canceled stock at the time the pool of assets became subject to tax under section 1374 that has not resulted in recognized built-in gain or recognized built-in loss at any time during the recognition period, including on the date of the acquisition to which section 1374(d)(8) applies. For example, suppose that on the date X, a C corporation, converts to S corporation status, it owns the stock of Y, which has a basis of $0 and a value of $100. The gain inherent in the Y stock contributes $100 to X's NUBIG. During the recognition period and prior to the liquidation of Y, Y distributes $20 to X in a distribution to which section 301(c)(3) applies. That amount is recognized built-in gain under section 1374(d)(3). If Y later distributes its assets to X in a distribution to which sections 332 and 337(a) apply, pursuant to these regulations, X must adjust its original NUBIG to reflect the elimination of the Y stock. X will reduce that NUBIG by $80, the original built-in gain in such stock ($100) minus the recognized built-in gain with respect to such stock during the recognition period ($20).

Second, an adjustment cannot be made if it is duplicative of another adjustment to the NUBIG for a pool of assets. This rule is intended to prevent more than one adjustment to the NUBIG of a pool of assets for the same built-in gain or built-in loss stock.

Any adjustment to NUBIG under these proposed rules will only affect computations of the amount subject to tax under section 1374 for taxable years that end on or after the date of the liquidation or reorganization. It will not affect computations of the amount subject to tax under section 1374 for taxable years that end before the date of the liquidation or reorganization.

The Treasury Department and IRS request comments regarding whether the rule proposed in these regulations should be expanded to apply in other cases in which the stock basis that was taken into account in the computation of NUBIG is eliminated. This may occur, for example, where an S corporation owns stock of a C corporation on the date of its conversion to an S corporation and later distributes the stock of the C corporation in a distribution to which section 355 applies. In addition, the Treasury Department and IRS request comments concerning whether there are any situations other than those identified in these proposed regulations in which adjustments to NUBIG should be less than the built-in gain or the built-in loss in the redeemed or canceled stock as of the beginning of the recognition period.

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. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, these proposed regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Public Comment

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. All comments will be made available for public inspection and copying. A public hearing may be scheduled. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is Marie Byrne of the Office of Associate Chief Counsel (Corporate). Other personnel from Treasury and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 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 1.1374–3 is amended by:

1. Revising paragraph (b).
2. Adding paragraph (c).

The revision and addition read as follows:

§ 1.1374–3 Net unrealized built-in gain.

* * * * *

(b) *Adjustment to net unrealized built-in gain*—(1) *In general.* If section 1374(d)(8) applies to an S corporation's acquisition of assets, some or all of the stock of the corporation from which such assets were acquired was taken into account in the computation of the net unrealized built-in gain for a pool of assets of the S corporation, and some or all of such stock is redeemed or canceled in such transaction, then, subject to the limitations of paragraph (b)(2) of this section, such net unrealized built-gain is adjusted to eliminate any effect any built-in gain or built-in loss in the redeemed or canceled stock (other than stock with respect to which a loss under section 165 is claimed) had on the initial computation of net unrealized built-in gain for that pool of assets. For purposes of this paragraph, stock described in section 1374(d)(6) shall be treated as taken into account in the computation of the net unrealized built-in gain for a pool of assets of the S corporation.

(2) *Limitations on adjustment*—(i) *Recognized built-in gain or loss.* Net unrealized built-in gain for a pool of assets of the S corporation is only adjusted under paragraph (b)(1) of this section to reflect built-in gain or built-in loss in the redeemed or canceled stock that has not resulted in recognized built-in gain or recognized built-in loss during the recognition period.

(ii) *Anti-duplication rule.* Paragraph (b)(1) of this section shall not be applied to duplicate an adjustment to the net unrealized built-in gain for a pool of assets made pursuant to paragraph (b)(1) of this section.

(3) *Effect of adjustment.* Any adjustment to the net unrealized built-in gain made pursuant to this paragraph (b) only affects computations of the amount subject to tax under section 1374 for taxable years that end on or after the date of the acquisition to which section 1374(d)(8) applies.

(4) *Pool of assets.* For purposes of this section, a pool of assets means—

(i) The assets held by the corporation on the first day it became an S corporation, if the corporation was previously a C corporation; or

(ii) The assets the S corporation acquired from a C corporation in a section 1374(d)(8) transaction.

(c) *Examples.* The following examples illustrate the rules of this section:

Example 1. Computation of net unrealized built-in gain. (i)(A) X, a calendar year C corporation using the cash method, elects to become an S corporation on January 1, 1996. On December 31, 1995, X has assets and liabilities as follows:

Assets	FMV	Basis
Factory	$500,000	$900,000
Accounts Receivable	300,000	0
Goodwill	250,000	0
Total	1,050,000	900,000

Liabilities	Amount
Mortgage	$200,000
Accounts Payable	100,000
Total	300,000

(B) Further, X must include a total of $60,000 in taxable income in 1996, 1997, and 1998 under section 481(a).

(ii) If, on December 31, 1995, X sold all its assets to a third party that assumed all its liabilities, X's amount realized would be $1,050,000 ($750,000 cash received + $300,000 liabilities assumed = $1,050,000). Thus, X's net unrealized built-in gain is determined as follows:

Amount realized: $1,050,000
Deduction allowed: (100,000)
Basis of X's assets: (900,000)
Section 481 adjustments: 60,000
Net unrealized built-in gain: 110,000

Example 2. Adjustment to net unrealized built-in gain for built-in gain in eliminated C corporation stock. (i) X, a calendar year C corporation, elects to become an S corporation effective January 1, 2005. On that date, X's assets (the first pool of assets) have a net unrealized built-in gain of $15,000. Among the assets in the first pool of assets is all of the outstanding stock of Y, a C corporation, with a fair market value of $33,000 and an adjusted basis of $18,000. On March 1, 2009, X sells an asset that it owned on January 1, 2005, and as a result has $10,000 of recognized built-in gain. X has had no other recognized built-in gain or built-in loss. X's taxable income limitation for 2009 is $50,000. Effective June 1, 2009, X elects under section 1362 to treat Y as a qualified subchapter S subsidiary (QSub). The election is treated as a transfer of Y's assets to X in a liquidation to which sections 332 and 337(a) apply.

(ii) Under paragraph (b) of this section, the net unrealized built in-gain of the first pool of assets is adjusted to account for the elimination of the Y stock in the liquidation. The net unrealized built-in gain of the first pool of assets, therefore, is decreased by $15,000, the amount by which the fair market value of the Y stock exceeded its adjusted basis as of January 1, 2005. Accordingly, for taxable years ending after June 1, 2009, the net unrealized built-in gain of the first pool of assets is $0.

(iii) Under § 1.1374–2(a), X's net recognized built-in gain for any taxable year equals the least of X's pre-limitation amount, taxable income limitation, and net unrealized built-in gain limitation. In 2009, X's pre-limitation amount is $10,000, X's taxable income limitation is $50,000, and X's net unrealized built-in gain limitation is $0. Because the net unrealized built-in gain of the first pool of assets has been adjusted to $0, despite the $10,000 of recognized built-in gain in 2009, X has $0 net recognized built-in gain for the taxable year ending on December 31, 2009.

Example 3. Adjustment to net unrealized built-in gain for built-in loss in eliminated C corporation stock. (i) X, a calendar year C corporation, elects to become an S corporation effective January 1, 2005. On that date, X's assets (the first pool of assets) have a net unrealized built-in gain of negative $5,000. Among the assets in the first pool of assets is 10 percent of the outstanding stock of Y, a C corporation, with a fair market value of $18,000 and an adjusted basis of $33,000. On March 1, 2009, X sells an asset that it owned on January 1, 2005, resulting in $8,000 of recognized built-in gain. X has had no other recognized built-in gains or built-in losses. X's taxable income limitation for 2009 is $50,000. On June 1, 2009, Y transfers its assets to X in a reorganization under section 368(a)(1)(C).

(ii) Under paragraph (b) of this section, the net unrealized built in-gain of the first pool of assets is adjusted to account for the elimination of the Y stock in the reorganization. The net unrealized built-in gain of the first pool of assets, therefore, is increased by $15,000, the amount by which the adjusted basis of the Y stock exceeded its fair market value as of January 1, 2005. Accordingly, for taxable years ending after June 1, 2009, the net unrealized built-in gain of the first pool of assets is $10,000.

(iii) Under § 1.1374–2(a), X's net recognized built-in gain for any taxable year equals the least of X's pre-limitation amount, taxable income limitation, and net unrealized built-in gain limitation. In 2009, X's pre-limitation amount is $8,000 and X's taxable income limitation is $50,000. The net unrealized built-in gain of the first pool of assets has been adjusted to $10,000, so X's net unrealized built-in gain limitation is $10,000. X, therefore, has $8,000 net recognized built-in gain for the taxable year ending on December 31, 2009. X's net unrealized built-in gain limitation for 2010 is $2,000.

Example 4. Adjustment to net unrealized built-in gain in case of prior gain recognition. (i) X, a calendar year C corporation, elects to become an S corporation effective January 1, 2005. On that date, X's assets (the first pool of assets) have a net unrealized built-in gain of $30,000. Among the assets in the first pool of assets is all of the outstanding stock of Y, a C corporation, with a fair market value of $45,000 and an adjusted basis of $10,000. Y has no current or accumulated earnings and profits. On April 1, 2007, Y distributes $18,000 to X, $8,000 of which is treated as gain to X from the sale or exchange of property under section 301(c)(3). That $8,000 is recognized built-in gain to X under section 1374(d)(3), and results in $8,000 of net recognized built-in gain to X for 2007. X's net unrealized built-in gain limitation for 2008 is $22,000. On June 1, 2009, Y transfers its assets to X in a liquidation to which sections 332 and 337(a) apply.

(ii) Under paragraph (b) of this section, the net unrealized built in-gain of the first pool of assets is adjusted to account for the elimination of the Y stock in the liquidation. The net unrealized built-in gain of that pool of assets, however, can only be adjusted to reflect the amount of built-in gain that was inherent in the Y stock on January 1, 2005 that has not resulted in recognized built-in gain during the recognition period. In this case, therefore, the net unrealized built-in gain of the first pool of assets cannot be reduced by more than $27,000 ($35,000, the amount by which the fair market value of the Y stock exceeded its adjusted basis as of January 1, 2005, minus $8,000, the recognized built-in gain with respect to the stock during the recognition period). Accordingly, for taxable years ending after June 1, 2009, the net unrealized built-in gain of the first pool of assets is $3,000. The net unrealized built-in gain limitation for 2009 is $0.

Par. 3. Paragraph (a) of § 1.1374–10 is revised to read as follows:

§ 1.1374–10 Effective date and additional rules.

(a) *In general.* Sections 1.1374–1 through 1.1374–9, other than § 1.1374–3(b) and (c) *Examples 2* through *4,* apply for taxable years ending on or after December 27, 1994, but only in cases where the S corporation's return for the taxable year is filed pursuant to an S election or a section 1374(d)(8) transaction occurring on or after December 27, 1994. Section 1.1374–3(b) and (c) *Examples 2* through *4* apply for taxable years beginning after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

[FR Doc. 04–14391 Filed 6–24–04; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF JUSTICE

28 CFR Part 75

[Docket No. CRM 103; AG Order No. 2723–2004]

RIN 1105–AB05

Inspection of Records Relating to Depiction of Sexually Explicit Performances

AGENCY: Department of Justice.

ACTION: Proposed rule.

SUMMARY: This proposed rule amends the record-keeping and inspection requirements of 28 CFR part 75 to bring the regulations up to date with current law, to improve understanding of the regulatory system, and to make the inspection process effective for the purposes of the Child Protection and Obscenity Enforcement Act of 1988, as amended, relating to the sexual exploitation and other abuse of children.

DATES: Written comments must be received on or before August 24, 2004.

ADDRESSES: Written comments may be submitted to: Andrew Oosterbaan, Chief, Child Exploitation and Obscenity Section, Criminal Division, United States Department of Justice, Washington, DC 20530; Attn: ''Docket No. CRM 103.''

Comments may be submitted electronically to: *Admin.ceos@usdoj.gov* or to *www.regulations.gov* by using the electronic comment form provided on that site. Comments submitted electronically must include Docket No. CRM 103 in the subject box. You may also view an electronic version of this rule at the *www.regulations.gov* site.

Facsimile comments may be submitted to: (202) 514–1793. This is not a toll-free number. Comments