Internal Revenue
bulletin

Bulletin No. 2008-41
October 14, 2008

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Ct. D. 2087, page 845.

Refund of taxes unlawfully assessed; administrative claim. The Supreme Court holds that the plain language of 26 U.S.C. sections 7422(a) and 6511 requires a taxpayer seeking a refund for a tax assessed in violation of the export clause, just as for any other unlawfully assessed tax, to file a timely administrative refund claim before bringing suit against the government. **United States *v.* Clintwood Elkhorn Mining Co. *et. al*.**

REG–209006–89, page 867.

Proposed regulations under sections 367(a)(5), 367(b), and 1248(f) of the Code concern certain cross-border asset reorganizations and nonrecognition distributions of the stock of certain foreign corporations by domestic corporations. The regulations incorporate Notices 2008–10 and 87–64.

Notice 2008–78, page 851.

Section 382. This notice provides guidance regarding capital contributions under section 382(l)(1) of the Code and requests comments on the subject.

Notice 2008–81, page 852.

This notice provides guidance relating to a temporary program being provided by the Treasury Department to enable money market funds to maintain stable $1.00 per share net asset values. The notice provides that the Treasury Department and the Service will not assert that the program violates the restrictions against federal guarantees of tax-exempt bonds with respect to any tax-exempt bond assets held by tax-exempt money market funds participating in the program, and will not impair the ability of a money market fund participating in the program to designate exempt interest dividends or of the shareholders of such a fund to claim the benefits of tax exemption with respect to such exempt interest dividends.

Notice 2008–82, page 853.

This notice provides guidance on section 114 of the Heroes Earnings Assistance and Relief Act of 2008, which amended section 125 of the Code to provide a special rule allowing distributions of unused amounts in a health Flexible Spending Arrangement (FSA) to reservists called up to active duty.

Notice 2008–84, page 855.

Section 382. This notice provides guidance regarding section 382 of the Code in the case of certain acquisitions made by the United States.

Rev. Proc. 2008–58, page 856.

This procedure provides federal income tax guidance to taxpayers for certain settlement offers involving auction rate securities.

EXEMPT ORGANIZATIONS

Announcement 2008–90, page 896.

The IRS has revoked its determination that Heavens Hand Foundation of McCordsville, IN; Airport Working Group of Orange County of Newport Beach, CA; and Portland Fathering Center of Portland, OR, qualify as organizations described in sections 501(c)(3) and 170(c)(2) of the Code.

(Continued on the next page)

Announcement of Declaratory Judgment Proceedings Under Section 7428 begins on page 896.
Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

ADMINISTRATIVE

Rev. Proc. 2008–57, page 855.
This procedure publishes the amounts of unused housing credit carryovers allocated to qualified states under section 42(h)(3)(D) of the Code for calendar year 2008.

Rev. Proc. 2008–59, page 857.
This procedure provides optional rules for deeming substantiated the amount of certain business expenses of traveling away from home reimbursed to an employee or deductible by an employee or self-employed individual. Rev. Proc. 2007–63 superseded.

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are compiled semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 42.—Low-Income Housing Credit

26 CFR 1.42–14: Allocation rules for post-1989 state housing credit ceiling amounts.

Guidance is provided to state housing credit agencies of qualified states that request an allocation of unused housing credit carryover under section 42(h)(3)(D) of the Internal Revenue Code. See Rev. Proc. 2008-57, page 855.

Section 61.—Gross Income Defined

A revenue procedure provides federal income tax guidance to taxpayers for certain settlement offers involving auction rate securities. See Rev. Proc. 2008-58, page 856.

Section 62.—Adjusted Gross Income Defined

A revenue procedure provides optional rules for deeming substantiated the amount of certain business expenses of traveling away from home reimbursed to an employee or deductible by an employee or self-employed individual. See Rev. Proc. 2008-59, page 857.

Section 103.—Interest on State and Local Bonds

A notice relates to a program being provided by the United States Department of the Treasury in response to the credit market instability to make available certain funds from its Exchange Stabilization Fund on a temporary basis upon prescribed terms and conditions to money market funds that are regulated under the Security and Exchange Commission's Rule 2a-7, 17 C.F.R. 270.2a-7, under the Investment Company Act of 1940 ("Rule 2a-7") to enable money market funds to maintain stable $1.00 per share net asset values. The program is available to both money market funds holding assets subject to Federal income taxation and to money market funds holding assets that include State and local governmental debt obligations the interest on which is excludable from gross income ("tax-exempt bonds") under § 103 of the Internal Revenue Code, as amended. See Notice 2008-81, page 852.

Section 149.—Bonds Must be Registered to be Tax Exempt: Other Requirements

A notice relates to a program being provided by the United States Department of the Treasury in response to the credit market instability to make available certain funds from its Exchange Stabilization Fund on a temporary basis upon prescribed terms and conditions to money market funds that are regulated under the Security and Exchange Commission's Rule 2a-7, 17 C.F.R. 270.2a-7, under the Investment Company Act of 1940 ("Rule 2a-7") to enable money market funds to maintain stable $1.00 per share net asset values. The program is available to both money market funds holding assets subject to Federal income taxation and to money market funds holding assets that include State and local governmental debt obligations the interest on which is excludable from gross income ("tax-exempt bonds") under § 103 of the Internal Revenue Code, as amended. See Notice 2008-81, page 852.

Section 162.—Trade or Business Expenses

A revenue procedure provides optional rules for deeming substantiated the amount of certain business expenses of traveling away from home reimbursed to an employee or deductible by an employee or self-employed individual. See Rev. Proc. 2008-59, page 857.

Section 267.—Losses, Expenses, and Interest With Respect to Transactions Between Related Taxpayers

A revenue procedure provides optional rules for deeming substantiated the amount of certain business expenses of traveling away from home reimbursed to an employee or deductible by an employee or self-employed individual. See Rev. Proc. 2008-59, page 857.

Section 274.—Disallowance of Certain Entertainment, etc., Expenses

A revenue procedure provides optional rules for deeming substantiated the amount of certain business expenses of traveling away from home reimbursed to an employee or deductible by an employee or self-employed individual. See Rev. Proc. 2008-59, page 857.

Section 1001.—Determination of Amount of and Recognition of Gain or Loss

A revenue procedure provides federal income tax guidance to taxpayers for certain settlement offers involving auction rate securities. See Rev. Proc. 2008-58, page 856.

Section 7422.—Civil Actions for Refund

Ct. D. 2087

SUPREME COURT OF THE UNITED STATES

No. 07–308

UNITED STATES *v.* CLINTWOOD ELKHORN MINING CO. ET AL.

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

Argued March 24, 2008-Decided April 15, 2008

Syllabus

The Internal Revenue Code requires a taxpayer seeking a refund of taxes unlawfully assessed to file an administrative claim with the Internal Revenue Service (IRS) before filing suit against the Government, see 26 U. S. C. §7422(a). Such claim must be filed within three years of the filing of a tax return or two years of the tax's payment, whichever is later, see §6511(a). In contrast, the Tucker Act allows claims to be brought against the Government within six years of the challenged conduct. Respondent coal companies paid taxes on coal exports under a portion of the Code later invalidated under the Export Clause of the Constitution. They filed timely administrative claims and recovered refunds of their 1997–1999 taxes, but sought are fund of their 1994–1996 taxes in the Court of Federal Claims without complying with the Code's refund procedures. Nevertheless, the court allowed

them to proceed directly under the Export Clause and the Tucker Act. Affirming in relevant part, the Federal Circuit ruled that the companies could pursue their Export Clause claim despite their failure to file timely administrative refund claims.

Held: The plain language of 26 U. S. C. §§7422(a) and 6511 requires a taxpayer seeking a refund for a tax assessed in violation of the Export Clause, just as for any other unlawfully assessed tax, to file a timely administrative refund claim before bringing suit against the Government. Pp. 4–12.

(a) Because the companies did not file a refund claim with the IRS for the 1994–1996 taxes, they may, under §7422(a), bring "[n]o suit" in "any court" to recover "any internal revenue tax" or "any sum" alleged to have been wrongfully collected "in any manner." Moreover, §6511's time limits for filing administrative refund claims-set forth in an "unusually emphatic form," *United States* v. *Brockamp*, 519 U. S. 347, 350—apply to "*any* tax imposed by [Title 26]," §6511(a) (emphasis added). Contrary to the companies' claim that these statutes are ambiguous, the provisions clearly state that taxpayers must comply with the Code's refund scheme before bringing suit, including the filing of a timely administrative claim. Indeed, this question was all but decided in *United States* v. *A. S. Kreider Co.*, 313 U. S. 443, where the Court held that the limitations period in the Revenue Act then in effect, not the Tucker Act's longer period, applied to tax refund actions. As was the case there, the current Code's refund scheme would have "no meaning whatever," *id.,* at 448, if taxpayers failing to comply with it were nonetheless allowed to bring suit subject only to the Tucker Act's longer time bar. Pp. 4–6.

(b) The companies nonetheless assert that their claims are exempt from the Code provisions' broad sweep because the claims derive from the Export Clause. The principles that a "constitutional claim can become time-barred just as any other claim can," *Block* v. *North Dakota ex rel. Board of Univ. and School Lands*, 461 U. S. 273, 292, and that Congress has the authority to require administrative exhaustion before allowing a suit against the Government, even for a constitutional violation, see, *e.g., Ruckelshaus* v. *Monsanto Co.*, 467 U. S. 986, 1018, are fully applicable to unconstitutional taxation claims. The companies' attempt to distinguish Export Clause claims on the ground that the Clause is not simply a limitation on taxing authority but a prohibition carving particular economic activity out of Congress's power is without substance and totally manipulable. There is no basis for treating taxes collected in violation of that Clause differently from taxes challenged on other grounds. Because the companies acknowledge that their claims are subject to the Tucker Act's time bar, the question is not whether their refund claim can be limited, but rather which limitation applies. Their argument that, despite explicit and expansive statutory language, the Code's refund scheme does not apply to their case as a matter of statutory interpretation is unavailing. They claim that Congress could not have intended it to apply a "constitutionally dubious" refund scheme to taxes assessed in violation of the Export Clause, but the statutory language emphatically covers the facts of this case. In any event, there is no constitutional problem. Congress's detailed scheme is designed "to advise the appropriate officials of the demands or claims intended to be asserted, so as to insure an orderly administration of the revenue," *United States* v. *Felt & Tarrant Mfg. Co.*, 283 U. S. 269, 272, to provide that refund claims are made promptly, and to allow the IRS to avoid unnecessary litigation by correcting conceded errors. Even when a tax's constitutionality is challenged, taxing authorities have an "exceedingly strong interest in financial stability," *McKesson Corp.* v. *Division of Alcoholic Beverages and Tobacco, Fla. Dept. of Business Regulation*, 496 U. S. 18, 37, that they may pursue through provisions of the sort at issue. There is no reason why invoking the Export Clause would deprive Congress of the power to protect this interest. The companies' claim that the Code procedures are excessively burdensome is belied by their own invocation of those procedures for taxes paid within the Code's limitations period, which resulted in full refunds with interest. Pp. 6–10.

(c) The companies' fallback argument—that even if the refund scheme applies to Export Clause cases generally, it does not apply when taxes are unconstitutional on their face—is rejected. *Enochs* v. *Williams Packing & Nav. Co.*, 370 U. S. 1, distinguished. Pp. 10–12.

473 F. 3d 1373, reversed.

ROBERTS, C. J., delivered the opinion for a unanimous Court.

SUPREME COURT OF THE UNITED STATES

No. 07–308

UNITED STATES, PETITIONER
v. CLINTWOOD ELKHORN MINING COMPANY ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

April 15, 2008

CHIEF JUSTICE ROBERTS delivered the opinion of the Court.

The Internal Revenue Code provides that taxpayers seeking a refund of taxes unlawfully assessed must comply with tax refund procedures set forth in the Code. Under those procedures, a taxpayer must file an administrative claim with the Internal Revenue Service before filing suit against the Government. Such a claim must be filed within three years of the filing of a return or two years of payment of the tax, whichever is later. The Tucker Act, in contrast, is more forgiving, allowing claims to be brought against the United States within six years of the challenged conduct. The question in this case is whether a taxpayer suing for a refund of taxes collected in violation of the Export Clause of the Constitution may proceed under the Tucker Act, when his suit does not meet the time limits for refund actions in the Internal Revenue Code. The answer is no.

I

A taxpayer seeking a refund of taxes erroneously or unlawfully assessed or collected may bring an action against the Government either in United States district court or in the United States Court of Federal Claims. 28 U. S. C. §1346(a)(1); *EC Term of Years Trust* v. *United States*, 550 U. S. _____, _____, and n. 2 (2007) (slip op., at 2, and n. 2). The Internal

Revenue Code specifies that before doing so, the taxpayer must comply with the tax refund scheme established in the Code. *United States* v. *Dalm*, 494 U. S. 596, 609–610 (1990). That scheme provides that a claim for a refund must be filed with the Internal Revenue Service before suit can be brought, and establishes strict timeframes for filing such a claim.

In particular, 26 U. S. C. §7422(a) specifies:

> "No suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the [IRS]."

The Code further establishes a time limit for filing such a refund claim with the IRS: To receive a "refund of an overpayment of any tax imposed by this title in respect of which tax the taxpayer is required to file a return," a refund claim must be filed no later than "3 years from the time the return was filed or 2 years from the time the tax was paid, whichever of such periods expires the later." §6511(a). And §6511(b)(1) mandates that "[n]o credit or refund shall be allowed or made" if a claim is not filed within the time limits set forth in §6511(a). "Read together, the import of these sections is clear: unless a claim for refund of a tax has been filed within the time limits imposed by §6511(a), a suit for refund . . . may not be maintained in any court." *Dalm*, *supra*, at 602.

In 1978, Congress levied a tax "on coal from mines located in the United States sold by the producer," 26 U. S. C. §4121(a)(1), and specifically applied this tax to coal exports, see §4221(a) (1994 ed.) (excepting from the general ban on taxing exports those taxes imposed under, *inter alia*, §4121). In 1998, a group of companies challenged the tax in the District Court for the Eastern District of Virginia, contending that it violated the Export Clause of the Constitution. That Clause provides that "No Tax or Duty shall be laid on Articles exported from any State." Art. I, §9, cl. 5. The District Court agreed and held the tax unconstitutional. *Ranger Fuel Corp.* v. *United States*, 33 F. Supp. 2d 466, 469 (1998). The Government did not appeal, and the IRS acquiesced in the District Court's holding. See IRS Notice 2000–28, 2000–1 Cum. Bull. 1116, 1116–1117 (IRS Notice).

The respondents here, three coal companies, had all paid taxes on coal exports under §4121(a) "[s]ince as early as 1978." App. to Pet. for Cert. 36a. After §4121(a) was held unconstitutional as applied to coal exports, the companies filed timely administrative claims in accordance with the refund scheme outlined above, seeking a refund of coal taxes they had paid in 1997, 1998, and 1999. The IRS refunded those taxes, with interest.

The companies also filed suit in the Court of Federal Claims seeking a refund of $1,065,936 in taxes paid between 1994 and 1996. They did not file any claim for those taxes with the IRS; any such claim would of course have been denied, given the limits set forth in §6511. See IRS Notice, at 1117 ("Claims [for a refund of taxes paid under §4121] must be filed within the period prescribed by§6511"). Notwithstanding the failure of the companies to file timely administrative refund claims, the Court of Federal Claims allowed the companies to pursue their suit directly under the Export Clause. Jurisdiction rested on the Tucker Act, 28 U. S. C. §1491(a)(1), and the companies limited their claim to taxes paid within that statute's 6-year limitations period, §2501 (2000 ed. and Supp. V).

In allowing the companies to proceed outside the confines of the Internal Revenue Code refund procedures, the court relied on the decision of the Court of Appeals for the Federal Circuit in *Cyprus Amax Coal Co.* v. *United States*, 205 F. 3d 1369 (2000). *Andalex Resources, Inc.* v. *United States*, 54 Fed. Cl. 563, 564 (2002). The Court of Federal Claims did not, however, allow the companies to recover interest on the taxes paid under 28 U. S. C. §2411. That provision requires the Government to pay interest "for any overpayment in respect of any internal-revenue tax," but the court held that the statute applied only to refund claims brought under the Code, not to claims brought directly under the Export Clause. 54 Fed. Cl., at 566.

The Court of Appeals affirmed in part and reversed in part. It first refused to revisit its holding in *Cyprus Amax*, and therefore upheld the ruling that the companies could pursue their claim under the Export Clause, despite having failed to file timely administrative refund claims. 473 F. 3d 1373, 1374–1375 (CA Fed. 2007). The Court of Appeals reversed the Court of Federal Claims interest holding, however, finding that the Government was required to pay the companies interest on the 1994–1996 amounts under §2411. *Id.*, at 1376.

We granted certiorari, 552 U. S. ___ (2007), and now reverse.

II

A

The outcome here is clear given the language of the pertinent statutory provisions. Title 26 U. S. C. §7422(a) states that "*[n]o suit* . . . shall be maintained in *any court* for the recovery of *any internal revenue tax* alleged to have been erroneously or illegally assessed or collected, or of *any penalty* claimed to have been collected without authority, or of *any sum* alleged to have been excessive or *in any manner* wrongfully collected, until a claim for refund . . . has been duly filed with" the IRS. (Emphasis added.) Here the companies did not file a refund claim with the IRS for the 1994–1996 taxes, and therefore may bring "[n]o suit" in "any court" to recover "any internal revenue tax" or "any sum" alleged to have been wrongfully collected "in any manner." Five "any's" in one sentence and it begins to seem that Congress meant the statute to have expansive reach.

Moreover, the time limits for filing administrative refund claims in §6511—set forth in an "unusually emphatic form," *United States* v. *Brockamp*, 519 U. S. 347, 350 (1997)-apply to "*any* tax imposed by this title," 26 U. S. C. §6511(a) (emphasis added). The statute further provides that "[n]o credit or refund shall be allowed or made after the expiration of the period of limitation prescribed in subsection (a) . . . unless a claim for credit or refund is filed by the taxpayer within such period."§6511(b)(1). Again, this language on its face plainly covers the companies' claim for a "refund" of "tax[es] imposed by" Title 26, specifically 26 U. S. C. §4121. The companies argue that these statutory provisions are ambiguous, Brief for Respondents 43–45, but we cannot

imagine what language could more clearly state that taxpayers seeking refunds of unlawfully assessed taxes must comply with the Code's refund scheme before bringing suit, including the requirement to file a timely administrative claim.

Indeed, we all but decided the question presented over six decades ago in *United States* v. *A. S. Kreider Co.*, 313 U. S. 443 (1941). Section 1113(a) of the Revenue Act of 1926, like the refund claim provision in §7422(a) of the current Code, prescribed that "[n]o suit or proceeding shall be maintained in any court for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected until a claim for refund or credit has been duly filed with the Commissioner of Internal Revenue,"and established a time limit for bringing suit once the claim-filing requirement had been met. 44 Stat. 116. Like the companies here, A. S. Kreider had failed to file a tax-refund action within that limitations period. See 313 U. S., at 446. And, like the companies here, A. S. Kreider argued that it was instead subject only to the longer 6-year statute of limitations under the Tucker Act. *Id.*, at 447.

We rejected the claim, holding that the Tucker Act limitations period "was intended merely to place an outside limit on the period within which all suits must be initiated" under that Act, and that "Congress left it open to provide less liberally for particular actions which, because of special considerations, required different treatment." *Ibid.* We held that the limitations period in §1113(a) was "precisely that type of provision," finding that Congress created a shorter statute of limitations for tax claims because "suits against the United States for the recovery of taxes impeded effective administration of the revenue laws." *Ibid.* If such suits were allowed to be brought subject only to the 6-year limitations period in the Tucker Act, we explained, §1113(a) would have "no meaning whatever." *Id.*, at 448. So too here. The refund scheme in the current Code would have "no meaning whatever" if taxpayers failing to comply with it were nonetheless allowed to bring suit subject only to the Tucker Act's longer time bar.

B

The companies gamely argue for a different result here because the coal tax at issue was assessed in violation of the Export Clause of the Constitution. They spend much of their brief arguing that the Export Clause itself creates a cause of action against the Government, which can be brought directly under the Tucker Act. See Brief for Respondents 8–25. We need not decide this question here, because it does not matter. If the companies' claims are subject to the Code provisions, those claims are barred whatever the source of the cause of action. We therefore turn to the companies' assertion that their claims are somehow exempt from the broad sweep of the Code provisions.

The companies do not argue for such an exemption simply because their claims are based on a constitutional violation. As they acknowledge, *id.*, at 34, a "constitutional claim can become time-barred just as any other claim can," *Block* v. *North Dakota ex rel. Board of Univ. and School Lands*, 461 U. S. 273, 292 (1983). Further, Congress has the authority to require administrative exhaustion before allowing a suit against the Government, even for a constitutional violation. See, *e.g., Ruckelshaus* v. *Monsanto Co.*, 467 U. S. 986, 1018 (1984); *Christian* v. *New York State Dept. of Labor*, 414 U. S. 614, 622 (1974); *Aircraft & Diesel Equipment Corp.* v. *Hirsch*, 331 U. S. 752, 766–767 (1947).

These principles are fully applicable to claims of unconstitutional taxation, a point highlighted by what we have said in other cases about the Anti-Injunction Act. That statute commands that (absent certain exceptions) "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court." 26 U. S. C. §7421(a). The "decisions of this Court make it unmistakably clear that the constitutional nature of a taxpayer's claim . . . is of no consequence" to whether the prohibition against tax injunctions applies. *Alexander* v. *"Americans United" Inc.*, 416 U. S. 752, 759 (1974). This is so even though the Anti-Injunction Act's prohibitions impose upon the wronged taxpayer requirements at least as onerous as those mandated by the refund scheme—the taxpayer must succumb to an unconstitutional tax, and seek recourse only after it has been unlawfully exacted. We see no reason why compliance with straightforward administrative requirements and reasonable time limits to seek a refund once a tax has been paid should lead to a different result.

The companies assert that Export Clause claims in particular must be treated differently from constitutional claims in general. This is so, they argue, because the Clause is not simply a limitation on the taxing authority but a prohibition that "carves one particular economic activity completely out of Congress's power." Brief for Respondents 11. That distinction is without substance and totally manipulable: If the pertinent authority is regarded as the power to tax exports, the Clause is indeed a complete prohibition on congressional power. But if the pertinent authority is instead viewed as the "Power To lay and collect Taxes," U. S. Const., Art. I, §8, cl. 1, then the Clause is properly regarded as a limitation on that power. We do not question the importance of the Export Clause to the success of the enterprise in Philadelphia in 1787, see Brief for Respondents 11–13, but we see no basis for treating taxes collected in violation of its terms differently from taxes challenged on other grounds.

Indeed, the companies more or less give up the game when they acknowledge that their claims are subject to the Tucker Act's statute of limitations. See *id.*, at 34. The question is thus not whether the companies' refund claim under the Export Clause can be limited, but rather which limitation applies. The companies are therefore left to argue that, despite the explicit and expansive statutory language described above, the refund scheme in Title 26 does not apply to their case as a matter of statutory interpretation. We find this ambitious argument unavailing.

The companies seek to support it by characterizing the refund scheme set out in the Code as "pro-government and revenue-protective," and therefore "constitutionally dubious" as applied to Export Clause cases. *Id.*, at 28–29. Given this potential constitutional infirmity, the companies argue, Congress could not have intended the refund scheme to apply to taxes assessed in violation of the Export Clause. See *Ashwander* v. *TVA*, 297 U. S. 288, 341 (1936) (Brandeis, J., concurring). We disagree. To begin with, any argument

that Congress did not mean to require those in the companies' position to comply with the tax refund scheme runs into a powerful impediment, for "[t]he 'strong presumption' that the plain language of the statute expresses congressional intent is rebutted only in 'rare and exceptional circumstances.'" *Ardestani* v. *INS*, 502 U. S. 129, 135 (1991) (quoting *Rubin* v. *United States*, 449 U. S. 424, 430 (1981)). As we have already explained, the language of the relevant statutes emphatically covers the facts of this case.

In any event, we see no constitutional problem at all. Congress has indeed established a detailed refund scheme that subjects complaining taxpayers to various requirements before they can bring suit. This scheme is designed "to advise the appropriate officials of the demands or claims intended to be asserted, so as to insure an orderly administration of the revenue," *United States* v. *Felt & Tarrant Mfg. Co.*, 283 U. S. 269, 272 (1931), to provide that refund claims are made promptly, and to allow the IRS to avoid unnecessary litigation by correcting conceded errors. Even when the constitutionality of a tax is challenged, taxing authorities do in fact have an "exceedingly strong interest in financial stability," *McKesson Corp.* v. *Division of Alcoholic Beverages and Tobacco, Fla. Dept. of Business Regulation*, 496 U. S. 18, 37 (1990), an interest they may pursue through provisions of the sort at issue here.

We do not see why invocation of the Export Clause would deprive Congress of the power to protect this "exceedingly strong interest." Congress may not impose a tax in violation of the Export Clause (or any other constitutional provision, for that matter). But it is certainly within Congress's authority to assure that allegations of taxes unlawfully assessed—whether the asserted illegality is based upon the Export Clause or any other provision of law—are processed in an orderly and timely manner, and that costly litigation is avoided when possible. The companies' claim that the Code procedures are themselves excessively burdensome is belied by the companies' own invocation of those procedures for taxes paid within the Code's limitations period, which resulted in full refunds with interest.

C

As a fallback argument, the companies maintain that even if the refund scheme applies to Export Clause cases generally, it does not "apply to taxes that are, on their face, unconstitutional." Brief for Respondents 39. They rely for this proposition on *Enochs* v. *Williams Packing & Nav. Co.*, 370 U. S. 1 (1962), a case dealing with the Anti-Injunction Act, 26 U. S. C. §7421(a). Despite that Act's broad and mandatory language, we explained that "if it is clear that under no circumstances could the Government ultimately prevail, . . . the attempted collection may be enjoined if equity jurisdiction otherwise exists. In such a situation the exaction is merely in 'the guise of a tax.'" 370 U. S., at 7 (quoting *Miller* v. *Standard Nut Margarine Co. of Fla.*, 284 U. S. 498, 509 (1932)). See also *Bob Jones Univ.* v. *Simon*, 416 U. S. 725, 745–746 (1974) (reaffirming the "under no circumstances" rule of *Williams Packing*).

On the force of *Williams Packing*, the companies argue that the refund scheme should similarly be read as inapplicable to situations in which there are "no circumstances" under which the tax imposed could be held valid under the Export Clause. The trouble with this is that §7422, the primary statute governing the refund process, is written much more broadly than §7421(a), the statute at issue in *Williams Packing*. Section §7422(a) states that "[n]o suit . . . shall be maintained in any court for the recovery of any *internal revenue tax* alleged to have been erroneously or illegally assessed or collected . . . until a claim for refund or credit has been duly filed with the" IRS. (Emphasis added.) This language generally tracks that of the Anti-Injunction Act, which also applies to suits "restraining the assessment or collection of any *tax*." §7421(a) (emphasis added). But §7422(a) goes on to apply its prohibition against suit absent a proper refund claim to "*any sum* alleged to have been excessive or in any manner wrongfully collected." (Emphasis added.) Even if we agreed that a facially unconstitutional tax for purposes of the tax refund scheme is "merely in 'the guise of a tax,'" *Williams Packing*, *supra*, at 7 (quoting *Standard Nut Margarine*, *supra*, at 509), and therefore not a "tax alleged to have been erroneously or illegally assessed or collected," §7422(a), it would nevertheless clearly fall into the broader category of "any sum . . . in any manner wrongfully collected," *ibid.*

Moreover, even if we were to accept the companies' argument that the "under no circumstances" limitation on the Anti-Injunction Act applies to the refund scheme, they still would not prevail. We made clear in *Williams Packing* that "the question of whether the Government has a chance of ultimately prevailing is to be determined on the basis of the information available to it at the time of suit. Only if it is then apparent that, under the most liberal view of the law and the facts, the United States cannot establish its claim, may the suit for an injunction be maintained." 370 U. S., at 7. A tax injunction suit, of course, is brought at the time the Government attempts to assess a tax on the taxpayer. Thus, if we applied the *Williams Packing* "under no circumstances" rule to the refund scheme, we would judge the Government's chances of success as of the time the tax was assessed.

In this case, the companies seek refunds for taxes paid between 1994 and 1996. At that time, the scope of the Export Clause was sufficiently debatable that we granted certiorari in 1996, see *United States* v. *International Business Machines Corp.*, 517 U. S. 843, and again in 1998, see *United States* v. *United States Shoe Corp.*, 523 U. S. 360, to clear it up. What is more, the District Court that struck down the application of §4121(a) to coal exports partially relied on these cases in arriving at its decision, *Ranger Fuel Corp.*, 33 F. Supp. 2d, at 469, and the IRS cited, *inter alia*, *International Business Machines*, *supra*, in its acquiescence notice, see IRS Notice, at 1116. Indeed, we would think that if the unconstitutionality of the coal export tax were so obvious that the Government had no chance of prevailing, someone paying the tax—such as these companies—would have successfully challenged it earlier than 20 years after its enactment.

We therefore hold that the plain language of 26 U. S. C. §§7422(a) and 6511 requires a taxpayer seeking a refund for a tax assessed in violation of the Export Clause, just as for any other unlawfully assessed tax, to file a timely administrative refund claim before bringing suit against the Government. Because we find that the Court of Appeals erred in allowing the

companies to bring suit seeking a refund for the 1994–1996 taxes, we do not reach the question whether the Court of Appeals also erred in awarding the companies interest on those amounts under 28 U. S. C. §2411. The judgment of the Court of Appeals is reversed.

It is so ordered.

Part III. Administrative, Procedural, and Miscellaneous

Capital Contributions Under Section 382(l)(1)

Notice 2008–78

This notice provides guidance regarding capital contributions under section 382(l)(1) of the Internal Revenue Code and requests comments on the subject.

I. Purpose.

The Internal Revenue Service (Service) and Treasury Department (Treasury) intend to issue regulations under section 382(l)(1) as described below. Pending the issuance of further guidance, taxpayers may rely on the rules set forth in this notice to the extent provided herein.

II. Background.

Section 382(a) of the Internal Revenue Code (Code), as amended, provides that the taxable income of a loss corporation for a year following an ownership change that may be offset by pre-change losses cannot exceed the section 382 limitation for such year. Similarly, section 383 limits the use of certain credits and net capital losses based on the principles applicable under section 382.

The section 382 limitation for a post-change year is generally equal to the fair market value of the stock of the loss corporation immediately before the ownership change multiplied by the applicable long-term tax-exempt rate. Section 382(l)(1)(A) provides that for purposes of section 382 any capital contribution received by a loss corporation as part of a plan a principal purpose of which is to avoid or increase any limitation under section 382 is not taken into account. Under section 382(l)(1)(B), any capital contribution made during the two-year period ending on the change date (as defined in section 382(j)) is, except as provided in regulations, treated as part of a plan described in section 382(l)(1)(A). Therefore, the value of any such capital contribution is excluded from the computation of the section 382 limitation.

Section 382(m) provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of sections 382 and 383.

III. Guidance Under Section 382(l)(1) Regarding Capital Contributions.

The Service and Treasury intend to issue regulations regarding the application of section 382(l)(1). These regulations are expected to set forth the rules described in this section of this notice.

DEFINITIONS.

Except as otherwise provided, any definitions and terms used herein have the same meaning as they do in section 382 and the regulations thereunder.

In addition, any reference herein to terms and definitions in § 1.355–7 have the same meaning as they do in § 1.355–7, taking into account all other terms and definitions in § 1.355–7, but substituting, in each instance, "contribution" for "distribution," "loss corporation" for "Distributing and/or Controlled," and "ownership change" for "acquisition." For example, the phrase "agreement, understanding, arrangement, or substantial negotiations" as used herein has the same meaning as it does in § 1.355–7, taking into account other terms in § 1.355–7 (such as the definition of "controlling shareholder" in § 1.355–7(h)(3)). In addition, for purposes of substituting "ownership change" for "acquisition," any reference in § 1.355–7 to "the acquisition" shall be treated as a reference to "any acquisition."

A "related party" is a party related to the loss corporation (within the meaning of section 267(b), and determined immediately after a capital contribution) or one or more persons that, pursuant to a formal or informal understanding, would be treated as becoming a related party under the principles of § 1.355–7(h)(4) (*i.e.*, a "coordinating group"). The phrase "capital contribution" includes a series of related capital contributions.

RULES.

A. Section 382(l)(1)(B).

Notwithstanding section 382(l)(1)(B), a capital contribution shall not be presumed to be part of a plan a principal purpose of which is to avoid or increase a section 382 limitation solely as a result of having been made during the two-year period ending on the change date.

B. Section 382(l)(1)(A).

(1) *In general.* A capital contribution received by an old loss corporation shall be taken into account (and will not reduce the value of the old loss corporation for purposes of section 382(e)(1)) unless the contribution is part of a plan a principal purpose of which is to avoid or increase a section 382 limitation (hereinafter, a plan). Whether a capital contribution is part of a plan is determined based on all the facts and circumstances, unless the contribution is described in one of the safe harbors in Section III.B.2 below or section 382(l)(1) does not apply to the contribution pursuant to § 1.382–9(k). The fact that a contribution is not described in a safe harbor does not constitute evidence that the contribution is part of a plan.

(2) *Safe harbors.* A capital contribution will not be considered part of a plan if —

(a) The contribution is made by a person who is neither a controlling shareholder (determined immediately before the contribution) nor a related party, no more than 20% of the total value of the loss corporation's outstanding stock is issued in connection with the contribution, there was no agreement, understanding, arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change, and the ownership change occurs more than six months after the contribution.

(b) The contribution is made by a related party but no more than 10% of the total value of the loss corporation's stock is issued in connection with the contribution, or the contribution is made by a person other than a related party, and in either case there was no agreement, understanding, arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change, and the ownership change occurs more than one year after the contribution.

(c) The contribution is made in exchange for stock issued in connection with the performance of services, or stock acquired by a retirement plan, under the

terms and conditions of § 1.355–7(d)(8) or (9), respectively.

(d) The contribution is received on the formation of a loss corporation (not accompanied by the incorporation of assets with a net unrealized built in loss) or it is received before the first year from which there is a carryforward of a net operating loss, capital loss, excess credit, or excess foreign taxes (or in which a net unrealized built-in loss arose).

C. Coordination of Sections 382(l)(1) and 382(l)(4).

If the value of the old loss corporation is subject to reduction under both sections 382(l)(1) and 382(l)(4), appropriate adjustments must be made to ensure that a reduction in value is not duplicated.

IV. Reliance on Notice.

The Service and Treasury intend to issue regulations under section 382(l)(1) that set forth the rules described in Section III of this notice. Taxpayers may rely on the rules described in Section III for purposes of determining whether a capital contribution is part of a plan with respect to an ownership change that occurs in any taxable year ending on or after September 26, 2008, and these rules will continue to apply unless and until there is additional guidance.

V. Request for Comments.

The Service and Treasury request comments regarding (i) the appropriate scope and application of section 382(l)(1) generally, (ii) the appropriate factors that may tend to show that a capital contribution is or is not made as part of a plan, including standards for contributions made by related parties, (iii) the desirability of applying similar standards in § 1.355–7 as safe harbors for purposes of section 382(l)(1), and whether additional safe harbors are needed, and (iv) the appropriate treatment under section 382(l)(1) of options and conversion rights in general, and whether coordinating rules should be issued under § 1.382–4(d).

VI. Instructions.

Comments should be submitted on or before December 22, 2008, and should include a reference to Notice 2008–78. Send submissions to CC:PA:LPD:PR (Notice 2008–78), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8:00 a.m. and 4:00 p.m. to CC:PA:LPD:PR (Notice 2008–78), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224, or sent electronically via the following email address: *Notice.Comments@irscounsel.treas.gov*. Please include the notice number 2008–78 in the subject line of any electronic communication. All materials submitted will be available for public inspection and copying.

The principal author of this notice is Michael J. Wilder of the Office of Associate Chief Counsel (Corporate). For further information regarding this notice, contact Michael J. Wilder at (202) 622–7700 (not a toll-free call).

Tax-Exempt Money Market Funds-Temporary Treasury Program to Support Money Market Funds-No Violation of Restrictions Against Federal Guarantees of Tax-Exempt Bonds Under Section 149(b)

Notice 2008–81

SECTION 1. Purpose

This notice relates to a program being provided by the United States Department of the Treasury (the "Treasury Department") in response to the credit market instability to make available certain funds from its Exchange Stabilization Fund on a temporary basis upon prescribed terms and conditions (as described further below, the "Program"), to money market funds that are regulated under the Security and Exchange Commission's Rule 2a–7, 17 C.F.R. 270.2a–7, under the Investment Company Act of 1940 ("Rule 2a–7") to enable money market funds to maintain stable $1.00 per share net asset values. The Program is available to both money market funds holding assets subject to Federal income taxation and to money market funds holding assets that include State and local governmental debt obligations the interest on which is excludable from gross income ("tax-exempt bonds") under § 103 of the Internal Revenue Code, as amended (the "Code"). (Except as noted, section references herein are to the Code.) Money market funds that hold a sufficient portion of their total assets in tax-exempt bonds to be eligible to pay exempt interest dividends under § 852(b)(5) are referred to herein as "tax-exempt money market funds." This notice provides guidance to the effect that the Program will not result in any violation of the restrictions against federal guarantees of tax-exempt bonds with respect to the tax-exempt bond assets of tax-exempt money market funds which would impair the tax-exempt status of dividends received by their shareholders.

SECTION 2. Background

2.1. *The Program*. In general, under the Program, the Treasury Department plans to make available its Exchange Stabilization Fund on a temporary basis to assist participating money market funds in maintaining $1.00 per share net asset values and in paying their shareholders $1.00 per share upon liquidation of shares. The Program will be limited to assets in money market funds as of the close of business on September 19, 2008, and to investors of record as of that date. Participating money market funds are required to make premium payments to participate in the Program. Payments to a money market fund under the Program are tied to the per share net asset value of the money market fund itself. Payments to a money market fund under the Program are not tied to the terms or performance of any particular assets held by the money market fund, such as tax-exempt bond assets held by a tax-exempt money market fund. The general description of certain aspects of the Program herein is subject fully to the specific terms, conditions, maximum size limitations, and other limitations to be set forth in the operative legal documents for the Program.

2.2. *The Restrictions Against Federal Guarantees of Tax-exempt Bonds*. Section 149(b) provides generally that, subject to certain specific exceptions, the interest on State or local governmental bonds is not excludable from gross income under

§ 103(a) if the bonds are federally guaranteed. Section 149(b)(2) provides generally that a bond is federally guaranteed if: (A) the payment of principal or interest with respect to such bond is guaranteed (in whole or in part) by the United States (or any agency or instrumentality thereof)); (B) such bond is issued as part of an issue and five (5) percent or more of the proceeds of such issue is to be (i) used in making loans the payment of principal or interest with respect to which are to be guaranteed (in whole or in part) by the United States (or any agency or instrumentality thereof), or (ii) invested (directly or indirectly) in federally insured deposits or accounts; or (C) the payment of principal or interest on such bond is otherwise indirectly guaranteed (in whole or in part) by the United States (or any agency or instrumentality thereof).

SECTION 3. Scope and Application

3.1 *No Violation of Restrictions Against Federal Guarantees of Tax-exempt Bonds*. The Treasury Department and the Internal Revenue Service ("IRS") will not assert that the Program causes any violation of the restrictions against Federal guarantees of tax-exempt bonds under § 149(b) with respect to any tax-exempt bond assets held by tax-exempt money market funds participating in the Program. In addition, the Treasury Department and the IRS will not assert that the Program impairs the ability either of a money market fund participating in the Program to designate exempt interest dividends under § 852(b)(5) or of the shareholders of such a fund to claim the benefits of tax exemption with respect to such exempt interest dividends under § 852(b)(5)(B).

3.2 *No Inferences on Law*. This notice provides administrative relief in furtherance of public policy to promote stability in the market for money market funds. Except with respect to the administrative relief expressly provided in this notice, no inference should be drawn from this notice regarding any other Federal tax issues affecting tax-exempt bonds, money market funds, or any other security. In addition, this notice is not intended to address any other Federal tax issue implicated in the described transactions under the Program.

SECTION 4. Effective Date

This notice is effective on September 22, 2008.

Cafeteria Plans

Notice 2008–82

PURPOSE AND BACKGROUND

Section 114 of the Heroes Earnings Assistance and Relief Tax Act of 2008 (the HEART Act), enacted June 17, 2008, Pub. L. No. 110–245, amended section 125 of the Internal Revenue Code to provide a special rule allowing distributions of unused amounts in a health Flexible Spending Arrangement (health FSA) to reservists ordered or called to active duty. Section 114 of the HEART Act applies to distributions made on or after June 18, 2008.

Generally, new subsection 125(h) provides that a plan or other arrangement does not fail to be a cafeteria plan or health FSA merely because the arrangement provides, in certain circumstances, for "qualified reservist distributions" (QRDs) to an employee of all or a portion of the balance of the employee's unused amounts in the health FSA. This notice provides guidance on QRDs from health FSAs. It also includes a transition rule allowing plans to be retroactively amended for QRDs made before January 1, 2010.

QUALIFIED RESERVIST DISTRIBUTION

In general, a QRD is a distribution to an individual of all or a portion of the balance in the employee's health FSA if: (1) the individual is a member of a reserve component ordered or called to active duty for a period of 180 days or more or for an indefinite period and (2) the request for distribution is made during the period beginning with the order or call to active duty and ending on the last day of the plan year (or grace period, if applicable, under Prop. Treas. Reg. § 1.125–1(e)) that includes the date of the order or call to active duty. QRDs are an exception to the rule that a health FSA may not make distributions other than reimbursements of substantiated medical expenses. See Prop. Treas. Reg. § 1.125–6.

QRD OPTIONAL WITH EMPLOYER

A cafeteria plan is not required to provide for a QRD. The decision of whether to allow a QRD from a health FSA is optional with the employer.

PLAN MUST BE AMENDED

A QRD may not be made before the cafeteria plan is amended to provide for a QRD from a health FSA. Pursuant to the requirements of Prop. Treas. Reg. § 1.125–1(c), a plan may be amended at any time on a prospective basis. The QRD amendment must apply uniformly to all participants in the cafeteria plan.

TRANSITION RULE FOR QRDS MADE BEFORE JANUARY 1, 2010

Notwithstanding the general rule that amendments to cafeteria plans and health FSAs may only be effective prospectively from the date of the plan amendment and that a QRD may not be made before the cafeteria plan is first amended to provide for QRDs, a plan may be amended retroactively to permit QRDs requested on or before December 31, 2009, provided that the QRD satisfies the other requirements in this notice. The retroactive amendment must be made by December 31, 2009, and be effective retroactively to the date of the first QRD paid under the plan, but not prior to June 18, 2008. This transition rule does not extend the period during which an employee may request a QRD. Thus, regardless of when the plan is amended, the transition rule does not allow an employee to request a QRD with respect to a plan year after the last day of the plan year (or grace period, if applicable) during which the order or call to active duty occurred.

EMPLOYEES WHO MAY RECEIVE QRDs

An employee who is, by reason of being a member of a reserve component (as

defined in 37 U.S.C. § 101[1]), ordered or called to active duty for a period of 180 days or more or for an indefinite period may request a QRD. An individual ordered or called to active duty before June 18, 2008 is eligible for a QRD if the individual's period of active duty continues after June 18, 2008 and meets the duration requirements in this notice. A QRD may not be made based on an order or call to active duty of any individual other than the employee, including the spouse of the employee.

After an employee requests a QRD and before the employer may distribute an amount, the employer must first receive a copy of the order or call to active duty. An employer may rely on the order or call to determine the period that the employee has been ordered or called to active duty. If the order or call specifies that the period of active duty is for 180 days or more or is indefinite, the employee is eligible for a QRD, and the employee's eligibility is not affected if the actual period of active duty is less than 180 days or is otherwise changed.

If the period specified in the order or call is less than 180 days, a QRD is not allowed. However, subsequent calls or orders that increase the total period of active duty to 180 days or more will qualify an employee for a QRD. Thus, for example, if an employee is ordered or called to active duty for 120 days, and his or her order or call is subsequently extended for an additional 60 days, that individual qualifies for a QRD.

AMOUNT AVAILABLE AS A QRD

If a cafeteria plan provides for QRDs, the cafeteria plan amendment should indicate how the plan will determine an employee's health FSA balance for purposes of making QRDs. See uniform coverage rules in Prop. Treas. Reg. § 1.125–5(d). The cafeteria plan may provide that the amount available as a QRD will be:

(1) the entire amount elected for the health FSA for the plan year minus health FSA reimbursements received as of the date of the QRD request;

(2) the amount contributed to the health FSA as of the date of the QRD request minus health FSA reimbursements received as of the date of the QRD request; or

(3) some other amount (not exceeding the entire amount elected for the health FSA for the plan year minus reimbursements).

If the cafeteria plan amendment does not indicate how the plan will determine the amount available as a QRD, then the amount available shall be the amount contributed to the health FSA as of the date of the QRD request minus health FSA reimbursements received as of the date of the QRD request.

A QRD may only be made with respect to an employee's health FSA balance in existence on or after June 18, 2008. A QRD may not be made with respect to amounts (1) forfeited on or before June 18, 2008, (2) attributable to a prior plan year (including a plan year ending on or before June 18, 2008), or (3) attributable to non-health FSAs.

CAFETERIA PLAN QRD PROCEDURES

The cafeteria plan may specify a process for employees to request a QRD. The cafeteria plan may specify how many QRDs may be made with respect to an employee during the same plan year. A plan must permit an employee to submit health FSA claims for medical expenses incurred before the date a QRD is requested and must pay or reimburse substantiated claims for those medical expenses. With respect to medical expenses incurred after the date a QRD is requested, the plan may either:

(1) permit employees to continue to submit health FSA claims incurred before the end of the health FSA plan year (and grace period, if applicable); or

(2) terminate an employee's right to submit claims.

WHEN TO REQUEST A QRD AND MAKE A DISTRIBUTION

An employee must request a QRD on or after the date of the order or call to active duty, and before the last day of plan year (or grace period, if applicable) during which the order or call to active duty occurred. An employer must pay the QRD to the employee within a reasonable time, but not more than sixty days after the request for a QRD has been made. A QRD may not be made with respect to a plan year ending before the order or call to active duty. In addition, a QRD may only be made on or after the effective date of amendment of the plan to provide for QRDs. But see above for a transition rule for QRDs made before January 1, 2010.

CAFETERIA PLAN NONDISCRIMINATION RULES

QRDs must be uniformly available to all plan participants. The QRD amounts are disregarded for purposes of the cafeteria plan nondiscrimination rules.

TAXATION OF A QRD

A QRD is included in the gross income and wages of the employee, and is subject to employment taxes. The employer must report the QRD as wages on the employee's Form W–2 for the year in which the QRD is paid to the employee. The amount reported as wages is reduced by any amount in the health FSA representing after-tax contributions (such as COBRA continuation premiums).

EFFECTIVE DATE

New section 125(h) is effective for a QRD made on or after June 18, 2008.

EFFECT ON OTHER DOCUMENTS

Future guidance will amend the § 125 Income Tax Regulations to provide an exception for QRDs as described in new § 125(h).

[1] Under paragraph 24 of section 101 of title 37 of the United States Code, the term "reserve component" means—
(A) the Army National Guard of the United States;
(B) the Army Reserve;
(C) the Navy Reserve;
(D) the Marine Corps Reserve;
(E) the Air National Guard of the United States;
(F) the Air Force Reserve;
(G) the Coast Guard Reserve; or
(H) the Reserve Corps of the Public Health Service.

COMMENTS REQUESTED

The IRS and the Treasury Department request comments on the amendment made by section 114 of the HEART Act, including the guidance set forth in this notice and on any other issues concerning QRDs.

Comments should be submitted on or before January 12, 2009, and should include a reference to Notice 2008–82. Send submissions to CC:PA:LPD:PR (Notice 2008–82), 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 (Notice 2008–82), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20044, or sent electronically, via the following e-mail address: *Notice.comments@irscounsel.treas.gov*. Please include "Notice 2008–82" in the subject line of any electronic communication. All material submitted will be available for public inspection and copying.

DRAFTING INFORMATION

The principal author of this notice is Mireille Khoury of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other individuals participated in its development. For further information regarding this notice, contact Ms. Khoury at (202) 622–6080 (not a toll-free call).

Application of Section 382 in the Case of Certain Acquisitions Made by the United States

Notice 2008–84

SECTION 1. OVERVIEW

This notice announces that the Internal Revenue Service (IRS) and the Treasury Department (Treasury) will issue regulations under section 382(m) of the Internal Revenue Code (Code) that address the application of section 382 in the case of certain acquisitions not described in Notice 2008–76, 2008–39 I.R.B. 768, in which the United States (or any agency or instrumentality thereof) (United States) becomes a direct or indirect owner of a more-than-50-percent interest in a loss corporation. For this purpose, a "more-than-50-percent interest" is stock of the loss corporation possessing more than 50 percent of the total value of shares of all classes of stock (excluding stock described in section 1504(a)(4)) or more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or an option to acquire such stock.

SECTION 2. REGULATIONS TO BE ISSUED UNDER SECTION 382(m)

The IRS and Treasury will issue regulations under section 382(m) providing that notwithstanding any other provision of the Code or the regulations thereunder, for purposes of section 382 and the regulations thereunder, with respect to a loss corporation, the term "testing date" (as defined in § 1.382–2(a)(4)) shall not include any date as of the close of which the United States directly or indirectly owns a more-than-50-percent interest in the loss corporation. Thus, the loss corporation will be required to determine whether there is a testing date and, if so, whether there has been an ownership change for purposes of section 382, on any date as of the close of which the United States does not directly or indirectly own a more-than-50-percent interest in the loss corporation.

SECTION 3. EFFECTIVE DATE

The regulations to be issued under section 382(m) that are described in section 2 of this notice will apply for any taxable year ending on or after September 26, 2008, and will apply unless and until there is additional guidance.

---

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, § 42; 1.42–14.)

Rev. Proc. 2008–57

SECTION 1. PURPOSE

This revenue procedure publishes the amounts of unused housing credit carryovers allocated to qualified states under § 42(h)(3)(D) of the Internal Revenue Code for calendar year 2008.

SECTION 2. BACKGROUND

Rev. Proc. 92–31, 1992–1 C.B. 775, provides guidance to state housing credit agencies of qualified states on the procedure for requesting an allocation of unused housing credit carryovers under § 42(h)(3)(D). Section 4.06 of Rev. Proc. 92–31 provides that the Internal Revenue Service will publish in the Internal Revenue Bulletin the amount of unused housing credit carryovers allocated to qualified states for a calendar year from a national pool of unused credit authority (the National Pool). This revenue procedure publishes these amounts for calendar year 2008.

SECTION 3. PROCEDURE

The unused housing credit carryover amount allocated from the National Pool by the Secretary to each qualified state for calendar year 2008 is as follows:

Qualified State	Amount Allocated
Alabama	$ 100,398
Connecticut	75,980
Florida	395,947
Georgia	207,066
Idaho	32,528
Indiana	137,656
Kansas	60,223
Massachusetts	139,923
Michigan	218,501
Minnesota	112,758
Mississippi	63,321
Missouri	127,528
Nebraska	38,498
New Jersey	188,434
New Mexico	42,736
New York	418,650
North Dakota	13,878
Ohio	248,766
Pennsylvania	269,720
South Carolina	95,622
South Dakota	17,273
Tennessee	133,565
Texas	518,587
Utah	57,388
Vermont	13,478
Virginia	167,308
Washington	140,328
Wisconsin	121,523

EFFECTIVE DATE

This revenue procedure is effective for allocations of housing credit dollar amounts attributable to the National Pool component of a qualified state's housing credit ceiling for calendar year 2008.

DRAFTING INFORMATION

The principal author of this revenue procedure is Christopher J. Wilson of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Mr. Wilson at (202) 622–3040 (not a toll-free call).

---

26 CFR 601.601: Rules and regulations.
(Also Part I, §§ 61, 1001.)

Rev. Proc. 2008–58

SECTION 1. PURPOSE

This revenue procedure provides guidance regarding the treatment of taxpayers receiving certain offers relating to auction rate securities.

SECTION 2. BACKGROUND

.01 In general, an auction rate security is a security in which the payment rate is reset periodically (typically every seven to 28 days), pursuant to an auction rate-setting process or a similar remarketing agent rate-setting process that is designed to produce the minimum payment rate necessary to enable all interested sellers to sell the security to willing buyers at a price equal to the par amount of the security, plus accrued but unpaid periodic payments. A "failed" auction or remarketing occurs if the auction or remarketing fails to produce buyers for all interested sellers at a payment rate that is at or below the maximum payment rate specified by the terms of the auction rate security. Upon a failed auction or remarketing, the periodic payment rate is reset at a prescribed maximum rate until the next auction or remarketing. In addition, in the case of some issues of auction rate securities, the periodic payment rate may escalate further to prescribed increasing maximum rates based on the continued occurrence of failed auctions or remarketings for increasing periods of time. *See, e.g.*, Notice 2008–55, 2008–27 I.R.B. 11.

.02 On February 12, 2008, auctions with respect to auction rate securities began to fail. Thereafter, as a result of auction failures, many taxpayers were unable to sell auction rate securities for the par amount of the securities.

.03 Taxpayers may assert legal claims against another person (hereinafter, "Corporation *X*") for its conduct as it relates to auction rate securities. For example, a taxpayer might allege that Corporation *X* improperly failed to disclose (1) at the time of the taxpayer's purchase, the potential that the auction rate security could become illiquid, or (2) subsequent to the taxpayer's purchase, information relating to the market for auction rate securities which might have suggested it would soon become illiquid.

.04 Corporation *X* may make an offer (the "Settlement Offer") to affected taxpayers. Pursuant to the terms of the Settlement Offer, the taxpayer will have the right during a specified period (the "Window Period") to cause Corporation *X* to buy the taxpayer's auction rate securities for the par amount of the securities, upon the taxpayer's giving notice to Corporation *X*. If the taxpayer receives the Settlement Offer,

subject to the possible existence (and exercise) of the mitigation provision described in section 2.06 of this revenue procedure, so long as auctions continue to fail (and the taxpayer does not direct Corporation *X* to purchase the security), the taxpayer will continue to receive the maximum payment rate specified by the terms of the auction rate security.

.05 In the event the auction rate-setting process begins to succeed during the Window Period, so long as the taxpayer does not direct Corporation *X* to purchase the security (and the taxpayer does not sell in the auction), the taxpayer's return will fluctuate with that process, such that as the reset rates go up or down, this variation directly affects the taxpayer's economic return. If the taxpayer continues to hold the security after the Window Period, the taxpayer's entitlements are determined exclusively under the provisions of the auction rate security (*e.g.*, if rates go up or down, or the security becomes worthless, the taxpayer experiences the full economic impact). During the Window Period (and thereafter, if Corporation *X* does not purchase the security during the Window Period), the taxpayer is entitled to (1) exercise all voting rights associated with the security, and (2) sell the security to a third party. By its terms, the auction rate security is not redeemable on a fixed date (or, if it is, the redemption date is at least two years later than the end of the Window Period).

.06 The Settlement Offer may also contain a provision which has the effect of allowing Corporation *X* to mitigate its potential economic losses during the Window Period. If the taxpayer accepts a Settlement Offer with such a provision, Corporation *X* will be authorized to effect sales or dispositions of the security to the market during the Window Period (so long as the taxpayer receives the par amount of the security upon the sale or disposition). Thus, for example, if, during the Window Period, Corporation *X* finds a person willing to purchase an auction rate security with a par amount of $100x for $99x, Corporation X can purchase the security from the taxpayer for $100x, sell the security for $99x, and limit its economic loss to $1x (rather than risk a larger, or smaller, loss). If Corporation *X* buys the security under this provision, it will not hold the security for investment purposes.

.07 The Settlement Offer may also permit the taxpayer to elect to "borrow" (in form) the par amount of the auction rate security from Corporation *X* before the Window Period begins (or during the Window Period). In this case, the taxpayer's obligation to return the cash amount advanced by Corporation *X* in the form of a "loan" is secured (in form) by the auction rate security. Taxpayers who accept the Settlement Offer are not required to make this election or otherwise participate in this feature of the Settlement Offer.

SECTION 3. SCOPE

This revenue procedure applies to taxpayers who, before June 30, 2009, receive Settlement Offers generally described in section 2 of this revenue procedure that (1) include Window Periods that do not extend beyond December 31, 2012, and (2) require that the taxpayer deliver an auction rate security that the taxpayer purchased on or before February 13, 2008.

SECTION 4. APPLICATION

For taxpayers within the scope of this revenue procedure, the Internal Revenue Service will not challenge the following positions:

.01 The position that the taxpayer continues to own the auction rate security upon receiving or accepting (or "opting into") the Settlement Offer (but not after tendering the security).

.02 The position that the taxpayer does not realize any income as a result of receiving or accepting (or "opting into") the Settlement Offer and does not reduce the basis of the auction rate security from its original purchase price.

.03 The position that the taxpayer's amount realized from the sale of the auction rate security during the Window Period to the person offering the settlement (Corporation *X* in this revenue procedure) is the full amount of the cash proceeds received from that person.

SECTION 5. NO INFERENCE

This revenue procedure provides administrative guidance in light of the significant number of taxpayers affected by auction failures and the potential litigation resulting therefrom. Except with respect to the administrative guidance expressly provided in this revenue procedure, no inferences should be drawn from this revenue procedure in any other context regarding the ownership of any other security (or the effect of a loan secured by such security), the application of the replacement or restoration of capital doctrine, or any other federal tax issues.

SECTION 6. CONTACT INFORMATION

For further information regarding this revenue procedure, contact William E. Blanchard of the Office of Associate Chief Counsel (Financial Institutions and Products) at (202) 622–3950 or Andrew J. Keyso of the Office of Associate Chief Counsel (Income Tax and Accounting) at (202) 622–4800.

---

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, §§ 62, 162, 267, 274; 1.62–2, 1.162–17, 1.267(a)–1, 1.274–5.)

Rev. Proc. 2008–59

SECTION 1. PURPOSE

This revenue procedure updates Rev. Proc. 2007–63, 2007–42 I.R.B. 809, and provides rules under which the amount of ordinary and necessary business expenses of an employee for lodging, meal, and incidental expenses, or for meal and incidental expenses, incurred while traveling away from home are deemed substantiated under § 1.274–5 of the Income Tax Regulations when a payor (the employer, its agent, or a third party) provides a *per diem* allowance under a reimbursement or other expense allowance arrangement to pay for the expenses. In addition, this revenue procedure provides an optional method for employees and self-employed individuals who are not reimbursed to use in computing the amounts paid or incurred for business meal and incidental expenses, or for incidental expenses only if no meal expenses are paid or incurred, while traveling away from home. Use of a method described in this revenue procedure is not mandatory, and a taxpayer may use actual

allowable expenses if the taxpayer maintains adequate records or other sufficient evidence for proper substantiation. This revenue procedure does not provide rules under which the amount of an employee's lodging expenses will be deemed substantiated to a payor when a payor provides an allowance to pay for those expenses but not meal and incidental expenses.

SECTION 2. BACKGROUND AND CHANGES

.01 Section 162(a) of the Internal Revenue Code allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Under that provision, an employee or self-employed individual may deduct expenses paid or incurred while traveling away from home in pursuit of a trade or business. However, under § 262, no portion of the travel expenses that is attributable to personal, living, or family expenses is deductible.

.02 Section 274(n) generally limits the amount allowable as a deduction under § 162 for any expense for food, beverages, or entertainment to 50 percent of the amount of the expense that otherwise would be allowable as a deduction. In the case of any expenses for food or beverages consumed while away from home (within the meaning of § 162(a)(2)) by an individual during, or incident to, the period of duty subject to the hours of service limitations of the Department of Transportation, § 274(n)(3) provides that, for taxable years beginning in 2008, the deductible percentage for these expenses is 80 percent.

.03 Section 274(d) provides, in part, that no deduction is allowed under § 162 for any travel expense (including meals and lodging while away from home) unless the taxpayer complies with certain substantiation requirements. Section 274(d) further provides that regulations may prescribe that some or all of the substantiation requirements do not apply to an expense that does not exceed an amount prescribed by the regulations.

.04 Section 1.274–5(g), in part, grants the Commissioner the authority to prescribe rules relating to reimbursement arrangements or *per diem* allowances for ordinary and necessary expenses paid or incurred while traveling away from home. Pursuant to this grant of authority, the Commissioner may prescribe rules under which these arrangements or allowances, if in accordance with reasonable business practice, are regarded (1) as equivalent to substantiation, by adequate records or other sufficient evidence, of the amount of travel expenses for purposes of § 1.274–5(c), and (2) as satisfying the requirements of an adequate accounting to the employer of the amount of travel expenses for purposes of § 1.274–5(f).

.05 For purposes of determining adjusted gross income, § 62(a)(2)(A) allows an employee a deduction for expenses allowed by Part VI (§ 161 and following), subchapter B, chapter 1 of the Code, paid or incurred by the employee in connection with the performance of services as an employee under a reimbursement or other expense allowance arrangement with a payor.

.06 Section 62(c) provides that an arrangement is not treated as a reimbursement or other expense allowance arrangement for purposes of § 62(a)(2)(A) if it—

(1) does not require the employee to substantiate the expenses covered by the arrangement to the payor, or

(2) provides the employee with the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Section 62(c) further provides that the substantiation requirements described therein do not apply to any expense to the extent that, under the grant of regulatory authority prescribed in § 274(d), the Commissioner has provided that substantiation is not required for the expense.

.07 Under § 1.62–2(c), a reimbursement or other expense allowance arrangement satisfies the requirements of § 62(c) if it meets the requirements of business connection, substantiation, and returning amounts in excess of expenses as specified in the regulations. If an arrangement meets these requirements, all amounts paid under the arrangement are treated as paid under an accountable plan and are excluded from income and wages. If an arrangement does not meet these requirements, all amounts paid under the arrangement are treated as paid under a nonaccountable plan and are included in the employee's gross income, must be reported as wages or compensation on the employee's Form W–2, and are subject to the withholding and payment of employment taxes. Section 1.62–2(e)(2) specifically provides that substantiation of certain business expenses in accordance with rules prescribed under the authority of § 1.274–5(g) is treated as substantiation of the amount of the expenses for purposes of § 1.62–2. Under § 1.62–2(f)(2), the Commissioner may prescribe rules under which an arrangement providing *per diem* allowances is treated as satisfying the requirement of returning amounts in excess of expenses, even though the arrangement does not require the employee to return the portion of the allowance that relates to days of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated pursuant to rules prescribed under § 274(d), provided the allowance is reasonably calculated not to exceed the amount of the employee's expenses or anticipated expenses and the employee is required to return within a reasonable period of time any portion of the allowance that relates to days of travel not substantiated.

.08 Section 1.62–2(h)(2)(i)(B) provides that, if a payor pays a *per diem* allowance that meets the requirements of § 1.62–2(c)(1), the portion, if any, of the allowance that relates to days of travel substantiated in accordance with § 1.62–2(e), that exceeds the amount of the employee's expenses deemed substantiated for the travel pursuant to rules prescribed under § 274(d) and § 1.274–5(g), and that the employee is not required to return, is subject to withholding and payment of employment taxes. See §§ 31.3121(a)–3, 31.3231(e)–1(a)(5), 31.3306(b)–2, and 31.3401(a)–4 of the Employment Tax Regulations. Because the employee is not required to return this excess portion, the reasonable period of time provisions of § 1.62–2(g) (relating to the return of excess amounts) do not apply to this portion.

.09 Under § 1.62–2(h)(2)(i)(B)(4), the Commissioner has the discretion to prescribe special rules regarding the timing of withholding and payment of employment taxes on *per diem* allowances.

.10 Section 1.274–5(j)(1) grants the Commissioner the authority to establish a method under which a taxpayer may elect to treat a specific amount as paid or incurred for meals while traveling away from home in lieu of substantiating the actual cost of meals.

.11 Section 1.274–5(j)(3) grants the Commissioner the authority to establish a method under which a taxpayer may

elect to treat a specific amount as paid or incurred for incidental expenses while traveling away from home in lieu of substantiating the actual cost of incidental expenses.

.12 Sections 3.02(1)(a), 4.04(6), and 5.06 of this revenue procedure provide transition rules for the last 3 months of calendar year 2008.

.13 Section 5.02 of this revenue procedure contains revisions to the *per diem* rates for high-cost localities and for other localities for purposes of section 5.

.14 Section 5.03 of this revenue procedure contains the list of high-cost localities, and section 5.04 of this revenue procedure describes changes to the list of high-cost localities for purposes of section 5.

.15 Sections 7.10 and 8.06 of this revenue procedure refer to Rev. Rul. 2006–56, 2006–2 C.B. 874, which describes circumstances when a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of § 62(c) and the regulations thereunder.

SECTION 3. DEFINITIONS

.01 *Per diem allowance*. The term "*per diem* allowance" means a payment under a reimbursement or other expense allowance arrangement that is—

(1) paid with respect to ordinary and necessary business expenses incurred, or that the payor reasonably anticipates will be incurred, by an employee for lodging, meal, and incidental expenses, or for meal and incidental expenses, for travel away from home in connection with the performance of services as an employee of the employer,

(2) reasonably calculated not to exceed the amount of the expenses or the anticipated expenses, and

(3) paid at or below the applicable federal *per diem* rate, a flat rate or stated schedule, or in accordance with any other Service-specified rate or schedule.

.02 *Federal per diem rate and federal M&IE rate*.

(1) *In general*. The federal *per diem* rate is equal to the sum of the applicable federal lodging expense rate and the applicable federal meal and incidental expense (M&IE) rate for the day and locality of travel.

(a) *CONUS rates*. The rates for localities in the continental United States ("CONUS") are set forth in Appendix A to 41 C.F.R. ch. 301. However, in applying section 4.01, 4.02, or 4.03 of this revenue procedure, taxpayers may continue to use the CONUS rates in effect for the first 9 months of 2008 for expenses of all CONUS travel away from home that are paid or incurred during calendar year 2008 in lieu of the updated GSA rates. A taxpayer must consistently use either these rates or the updated rates for the period October 1, 2008, through December 31, 2008.

(b) *OCONUS rates*. The rates for localities outside the continental United States ("OCONUS") are established by the Secretary of Defense (rates for non-foreign localities, including Alaska, Hawaii, Puerto Rico, the Northern Mariana Islands, and the possessions of the United States) and by the Secretary of State (rates for foreign localities), and are published in the *Per Diem* Supplement to the Standardized Regulations (Government Civilians, Foreign Areas) (updated on a monthly basis).

(c) *Internet access to the rates*. The CONUS and OCONUS rates may be found on the Internet at *www.gsa.gov*.

(2) *Locality of travel*. The term "locality of travel" means the locality where an employee traveling away from home in connection with the performance of services as an employee of the employer stops for sleep or rest.

(3) *Incidental expenses*. The term "incidental expenses" has the same meaning as in the Federal Travel Regulations, 41 C.F.R. 300–3.1 (2007). Thus, based on the current definition of "incidental expenses" in the Federal Travel Regulations, "incidental expenses" means fees and tips given to porters, baggage carriers, bellhops, hotel maids, stewards or stewardesses and others on ships, and hotel servants in foreign countries; transportation between places of lodging or business and places where meals are taken, if suitable meals can be obtained at the temporary duty site; and the mailing cost associated with filing travel vouchers and payment of employer-sponsored charge card billings.

.03 *Flat rate or stated schedule*.

(1) *In general*. Except as provided in section 3.03(2) of this revenue procedure, an allowance is paid at a flat rate or stated schedule if it is provided on a uniform and objective basis with respect to the expenses described in section 3.01 of this revenue procedure. The allowance may be paid with respect to the number of days away from home in connection with the performance of services as an employee or on any other basis that is consistently applied and in accordance with reasonable business practice. Thus, for example, an hourly payment to cover meal and incidental expenses paid to a pilot or flight attendant who is traveling away from home in connection with the performance of services as an employee is an allowance paid at a flat rate or stated schedule. Likewise, a payment based on the number of miles traveled (such as cents per mile) to cover meal and incidental expenses paid to an over-the-road truck driver who is traveling away from home in connection with the performance of services as an employee is an allowance paid at a flat rate or stated schedule.

(2) *Limitation*. An allowance that is computed on a basis similar to that used in computing the employee's wages or other compensation (such as the number of hours worked, miles traveled, or pieces produced) does not meet the business connection requirement of § 1.62–2(d), is not a *per diem* allowance, and is not paid at a flat rate or stated schedule, unless, as of December 12, 1989, (a) the allowance was identified by the payor either by making a separate payment or by specifically identifying the amount of the allowance, or (b) an allowance computed on that basis was commonly used in the industry in which the employee is employed. See § 1.62–2(d)(3)(ii).

SECTION 4. *PER DIEM* SUBSTANTIATION METHOD

.01 *Per diem allowance*. If a payor pays a *per diem* allowance in lieu of reimbursing actual lodging, meal, and incidental expenses incurred or to be incurred by an employee for travel away from home, the amount of the expenses that is deemed substantiated for each calendar day is equal to the lesser of the *per diem* allowance for that day or the amount computed at the federal *per diem* rate (see section 3.02 of this revenue procedure) for the locality of travel for that day (or partial day, see section 6.04 of this revenue procedure).

.02 *Meal and incidental expenses only per diem allowance*. If a payor pays a *per diem* allowance only for meal and incidental expenses in lieu of reimbursing actual meal and incidental expenses incurred or to be incurred by an employee for travel away from home, the amount of the expenses that is deemed substantiated for each calendar day is equal to the lesser of the *per diem* allowance for that day or the amount computed at the federal M&IE rate for the locality of travel for that day (or partial day). A *per diem* allowance is treated as paid only for meal and incidental expenses if (1) the payor pays the employee for actual expenses for lodging based on receipts submitted to the payor, (2) the payor provides the lodging in kind, (3) the payor pays the actual expenses for lodging directly to the provider of the lodging, (4) the payor does not have a reasonable belief that lodging expenses were or will be incurred by the employee, or (5) the allowance is computed on a basis similar to that used in computing the employee's wages or other compensation (such as the number of hours worked, miles traveled, or pieces produced).

.03 *Optional method for meal and incidental expenses only deduction*. In lieu of using actual expenses in computing the amount allowable as a deduction for ordinary and necessary meal and incidental expenses paid or incurred for travel away from home, employees and self-employed individuals who pay or incur meal expenses may use an amount computed at the federal M&IE rate for the locality of travel for each calendar day (or partial day) the employee or self-employed individual is away from home. This amount will be deemed substantiated for purposes of paragraphs (b)(2) and (c) of § 1.274–5, provided the employee or self-employed individual substantiates the elements of time, place, and business purpose of the travel for that day (or partial day) in accordance with those regulations. See section 6.05(1) of this revenue procedure for rules related to the application of the limitation under § 274(n) to amounts determined under this section 4.03. See section 4.05 of this revenue procedure for a method for substantiating incidental expenses that may be used by employees or self-employed individuals who do not pay or incur meal expenses.

.04 *Special rules for transportation industry*.

(1) *In general*. This section 4.04 applies to (a) a payor that pays a *per diem* allowance only for meal and incidental expenses for travel away from home as described in section 4.02 of this revenue procedure to an employee in the transportation industry, or (b) an employee or self-employed individual in the transportation industry who computes the amount allowable as a deduction for meal and incidental expenses for travel away from home in accordance with section 4.03 of this revenue procedure.

(2) *Transportation industry defined*. For purposes of this section 4.04, an employee or self-employed individual is in the transportation industry only if the employee's or individual's work (a) is of the type that directly involves moving people or goods by airplane, barge, bus, ship, train, or truck, and (b) regularly requires travel away from home which, during any single trip away from home, usually involves travel to localities with differing federal M&IE rates. For purposes of the preceding sentence, a payor must determine that an employee or a group of employees is in the transportation industry by using a method that is consistently applied and in accordance with reasonable business practice.

(3) *Rates*. A taxpayer described in section 4.04(1) of this revenue procedure may treat $52 as the federal M&IE rate for any CONUS locality of travel, and $58 as the federal M&IE rate for any OCONUS locality of travel. A payor that uses either (or both) of these special rates with respect to an employee must use the special rate(s) for all amounts subject to section 4.02 of this revenue procedure paid to that employee for travel away from home within CONUS and/or OCONUS, as the case may be, during the calendar year. Similarly, an employee or self-employed individual that uses either (or both) of these special rates must use the special rate(s) for all amounts computed pursuant to section 4.03 of this revenue procedure for travel away from home within CONUS and/or OCONUS, as the case may be, during the calendar year. See section 4.04(6) of this revenue procedure for transition rules.

(4) *Periodic rule*. A payor described in section 4.04(1) of this revenue procedure may compute the amount of the employee's expenses that is deemed substantiated under section 4.02 of this revenue procedure periodically (not less frequently than monthly), rather than daily, by comparing the total *per diem* allowance paid for the period to the sum of the amounts computed either at the federal M&IE rate(s) for the localities of travel, or at the special rate described in section 4.04(3), for the days (or partial days) the employee is away from home during the period.

(5) *Examples*.

(a) *Example 1*. Taxpayer, an employee in the transportation industry, travels away from home on business within CONUS on 17 days (including partial days) during a calendar month and receives a *per diem* allowance only for meal and incidental expenses from a payor that uses the special rule under section 4.04(3) of this revenue procedure. The amount deemed substantiated under section 4.02 of this revenue procedure is equal to the lesser of the total *per diem* allowance paid for the month or $884 (17 days at $52 per day).

(b) *Example 2*. Taxpayer, a truck driver employee in the transportation industry, is paid a "cents-per-mile" allowance that qualifies as an allowance paid under a flat rate or stated schedule as defined in section 3.03 of this revenue procedure. Taxpayer travels away from home on business for 10 days. Based on the number of miles driven by Taxpayer, Taxpayer's employer pays an allowance of $500 for the 10 days of business travel. Taxpayer actually drives for 8 days, and does not drive for the other 2 days Taxpayer is away from home. Taxpayer is paid under the periodic rule used for transportation industry employers and employees in accordance with section 4.04(4) of this revenue procedure. The amount deemed substantiated is the full $500 because that amount does not exceed $520 (ten days away from home at $52 per day).

(6) *Transition rules*. Under the calendar-year convention provided in section 4.04(3), a taxpayer who used the federal M&IE rates during the first 9 months of calendar year 2008 to substantiate the amount of an individual's travel expenses under sections 4.02 or 4.03 of Rev. Proc. 2007–63 may not use, for that individual, the special transportation industry rates provided in this section 4.04 until January 1, 2009. Similarly, a taxpayer who used the special transportation industry rates during the first 9 months of calendar year 2008 to substantiate the amount of an individual's travel expenses may not use, for that individual, the federal M&IE rates until January 1, 2009.

.05 *Optional method for incidental expenses only deduction*. In lieu of using actual expenses in computing the amount allowable as a deduction for ordinary and necessary incidental expenses paid or incurred for travel away from home, employees and self-employed individuals who do

not pay or incur meal expenses for a calendar day (or partial day) of travel away from home may use, for each calendar day (or partial day) the employee or self-employed individual is away from home, an amount computed at the rate of $3 per day for any CONUS or OCONUS locality of travel. This amount will be deemed substantiated for purposes of paragraphs (b)(2) and (c) of § 1.274–5, provided the employee or self-employed individual substantiates the elements of time, place, and business purpose of the travel for that day (or partial day) in accordance with those regulations. See section 4.03 of this revenue procedure for a method that may be used by employees or self-employed individuals who pay or incur meal expenses. The method authorized by this section 4.05 may not be used by payors that use section 4.01, 4.02, or 5.01 of this revenue procedure, or by employees or self-employed individuals who use the method described in section 4.03 of this revenue procedure. See section 6.05(5) of this revenue procedure for rules related to the application of the limitation under § 274(n) to amounts determined under this section 4.05.

SECTION 5. HIGH-LOW SUBSTANTIATION METHOD

.01 *In general*. If a payor pays a *per diem* allowance in lieu of reimbursing actual lodging, meal, and incidental expenses incurred or to be incurred by an employee for travel away from home and the payor uses the high-low substantiation method described in this section 5 for travel within CONUS, the amount of the expenses that is deemed substantiated for each calendar day is equal to the lesser of the *per diem* allowance for that day or the amount computed at the rate set forth in section 5.02 of this revenue procedure for the locality of travel for that day (or partial day, see section 6.04 of this revenue procedure). Except as provided in section 5.06 of this revenue procedure, this high-low substantiation method may be used in lieu of the *per diem* substantiation method provided in section 4.01 of this revenue procedure, but may not be used in lieu of the meal and incidental expenses only *per diem* substantiation method provided in section 4.02 of this revenue procedure.

.02 *Specific high-low rates*. Except as provided in section 5.06 of this revenue procedure, the *per diem* rate set forth in this section 5.02 is $256 for travel to any "high-cost locality" specified in section 5.03 of this revenue procedure, or $158 for travel to any other locality within CONUS. The high or low rate, as appropriate, applies as if it were the federal *per diem* rate for the locality of travel. For purposes of applying the high-low substantiation method and the § 274(n) limitation on meal expenses (see section 6.05(3) of this revenue procedure), the amount of the high and low rates that is treated as paid for meals is $58 for a high-cost locality and $45 for any other locality within CONUS.

.03 *High-cost localities*. The following localities have a federal *per diem* rate of $207 or more, and are high-cost localities for all of the calendar year or the portion of the calendar year specified in parentheses under the key city name:

Key City	*County or other defined location*
Arizona	
Phoenix/Scottsdale (January 1-April 30)	Maricopa
Sedona (March 1-April 30)	City Limits of Sedona
California	
Napa	Napa
San Diego (January 1-August 31)	San Diego
San Francisco	San Francisco
Santa Barbara	Santa Barbara
Santa Monica	City limits of Santa Monica
South Lake Tahoe (December 1-March 31)	El Dorado
Colorado	
Aspen (December 1-April 30)	Pitkin
Crested Butte/Gunnison (December 1-March 31)	Gunnison
Silverthorne/Breckenridge (December 1-April 30)	Summit
Steamboat Springs (December 1-March 31)	Routt
Telluride (October 1-March 31)	San Miguel

Key City	*County or other defined location*
Colorado (continued)	
Vail (December 1-July 31)	Eagle
District of Columbia	
Washington D.C. (also the cities of Alexandria, Falls Church, and Fairfax, and the counties of Arlington and Fairfax, in Virginia; and the counties of Montgomery and Prince George's in Maryland) (See also Maryland and Virginia)	
Florida	
Fort Lauderdale (October 1-April 30)	Broward
Fort Walton Beach/De Funiak Springs (June 1-July 31)	Okaloosa and Walton
Key West	Monroe
Miami (October 1-February 28)	Miami-Dade
Naples (February 1-March 31)	Collier
Palm Beach (December 1-April 30)	Boca Raton, Delray Beach, Jupiter, Palm Beach Gardens, Palm Beach, Palm Beach Shores, Singer Island and West Palm Beach
Illinois	
Chicago	Cook and Lake
Maryland	
Baltimore City	Baltimore City
Cambridge/St. Michaels (May 1-August 31)	Dorchester and Talbot
Ocean City (June 1-September 30)	Worcester
Washington, DC Metro Area	Montgomery and Prince George=s
Massachusetts	
Boston/Cambridge	Suffolk, City of Cambridge
Martha's Vineyard (June 1-August 31)	Dukes
Nantucket (June 1-September 30)	Nantucket
New York	
Floral Park/Garden City/Glen Cove/Great Neck/Roslyn	Nassau
Manhattan (includes the boroughs of Manhattan, Brooklyn, the Bronx, Queens and Staten Island)	Bronx, Kings, New York, Queens, Richmond
Saratoga Springs/Schenectady (July 1-August 31)	Saratoga and Schenectady
Tarrytown/White Plains/New Rochelle/Yonkers	Westchester
Pennsylvania	
Philadelphia	Philadelphia
Rhode Island	
Jamestown/Middletown/Newport (June 1-September 30)	Newport

Key City	*County or other defined location*
Utah	
Park City (January 1-March 31)	Summit
Virginia	
Washington, DC Metro Area	Cities of Alexandria, Fairfax, and Falls Church; counties of Arlington and Fairfax
Washington	
Seattle	King
Wyoming	
Jackson/Pinedale (July 1-August 31)	Teton and Sublette

.04 *Changes in high-cost localities*. The list of high-cost localities in section 5.03 of this revenue procedure differs from the list of high-cost localities in section 5.03 of Rev. Proc. 2007–63 (changes listed by key cities).

(1) The following localities have been added to the list of high-cost localities: Jackson/Pinedale, Wyoming.

(2) The portion of the year for which the following are high-cost localities has been changed: Phoenix/Scottsdale, Arizona; San Diego, California; Silverthorne/Breckenridge, Colorado; Steamboat Springs, Colorado; Vail, Colorado; Palm Beach, Florida; Cambridge/St. Michaels, Maryland; Ocean City, Maryland; Martha's Vineyard, Massachusetts; Nantucket, Massachusetts; Jamestown/Middletown/Newport, Rhode Island.

(3) The following localities have been removed from the list of high-cost localities: Palm Springs, California; Yosemite National Park, California; Stuart, Florida; Incline Village/Crystal Bay/Reno/Sparks, Nevada; Conway, New Hampshire; Providence, Rhode Island; Loudon County, Virginia; Virginia Beach, Virginia; Lake Geneva, Wisconsin.

.05 *Specific limitation*.

(1) Except as provided in section 5.05(2) of this revenue procedure, a payor that uses the high-low substantiation method with respect to an employee must use that method for all amounts paid to that employee for travel away from home within CONUS during the calendar year. See section 5.06 of this revenue procedure for transition rules.

(2) With respect to an employee described in section 5.05(1) of this revenue procedure, the payor may reimburse actual expenses or use the meal and incidental expenses only *per diem* substantiation method described in section 4.02 of this revenue procedure for any travel away from home, and may use the *per diem* substantiation method described in section 4.01 of this revenue procedure for any OCONUS travel away from home.

.06 *Transition rules*. A payor who used the substantiation method of section 4.01 of Rev. Proc. 2007–63 for an employee during the first 9 months of calendar year 2008 may not use the high-low substantiation method in section 5 of this revenue procedure for that employee until January 1, 2009. A payor who used the high-low substantiation method of section 5 of Rev. Proc. 2007–63 for an employee during the first 9 months of calendar year 2008 must continue to use the high-low substantiation method for the remainder of calendar year 2008 for that employee. A payor described in the previous sentence may use the rates and high-cost localities published in section 5 of Rev. Proc. 2007–63, in lieu of the updated rates and high-cost localities provided in section 5 of this revenue procedure, for travel on or after October 1, 2008, and before January 1, 2009, if those rates and localities are used consistently during this period for all employees reimbursed under this method.

SECTION 6. LIMITATIONS AND SPECIAL RULES

.01 *In general*. The federal *per diem* rate and the federal M&IE rate described in section 3.02 of this revenue procedure for the locality of travel will be applied in the same manner as applied under the Federal Travel Regulations, 41 C.F.R. Part 301–11 (2007), except as provided in sections 6.02 through 6.04 of this revenue procedure.

.02 *Federal per diem rate*. A receipt for lodging expenses is not required in determining the amount of expenses deemed substantiated under section 4.01 or 5.01 of this revenue procedure. See section 7.01 of this revenue procedure for the requirement that the employee substantiate the time, place, and business purpose of the expense.

.03 *Federal per diem or M&IE rate*. A payor is not required to reduce the federal *per diem* rate or the federal M&IE rate for the locality of travel for meals provided in kind, provided the payor has a reasonable belief that meal and incidental expenses were or will be incurred by the employee during each day of travel.

.04 *Proration of the federal per diem or M&IE rate*. Pursuant to the Federal Travel Regulations, in determining the federal *per diem* rate or the federal M&IE rate for the locality of travel, the full applicable federal M&IE rate is available for a full day of travel from 12:01 a.m. to 12:00 midnight. The method described in section 6.04(1) of this revenue procedure must be used for purposes of determining the amount deemed substantiated under section 4.03 or 4.05 of this revenue procedure for partial days of travel away from home. For purposes of determining the amount deemed substantiated under section 4.01, 4.02, 4.04, or 5 of this revenue procedure for partial days of travel away from home, either of the following methods may be used to prorate the federal M&IE rate to determine the federal *per diem* rate or the federal M&IE rate for the partial days of travel:

(1) The rate may be prorated using the method prescribed by the Federal Travel Regulations. Currently the Federal Travel Regulations allow three-fourths of the applicable federal M&IE rate for each partial day during which the employee or self-employed individual is traveling away from home in connection with the performance of services as an employee or self-employed individual. The same ratio may be applied to prorate the allowance for incidental expenses described in section 4.05 of this revenue procedure; or

(2) The rate may be prorated using any method that is consistently applied and in accordance with reasonable business practice. For example, if an employee travels away from home from 9 a.m. one day to 5 p.m. the next day, a method of proration that results in an amount equal to two times the federal M&IE rate will be treated as being in accordance with reasonable business practice (even though only one and a half times the federal M&IE rate would be allowed under the Federal Travel Regulations).

.05 *Application of the appropriate § 274(n) limitation on meal expenses*. Except as provided in section 6.05(5), all or part of the amount of an expense deemed substantiated under this revenue procedure is subject to the appropriate limitation under § 274(n) (see section 2.02 of this revenue procedure) on the deductibility of food and beverage expenses.

(1) If an amount for meal and incidental expenses is computed pursuant to section 4.03 of this revenue procedure, the taxpayer must treat that amount as an expense for food and beverages.

(2) If a *per diem* allowance is paid only for meal and incidental expenses, the payor must treat an amount equal to the lesser of the allowance or the federal M&IE rate for the locality of travel for each day (or partial day, see section 6.04 of this revenue procedure) as an expense for food and beverages.

(3) If a *per diem* allowance is paid for lodging, meal, and incidental expenses for each calendar day (or partial day) the employee is away from home at a rate equal to or in excess of the federal *per diem* rate for the locality of travel, the payor must treat an amount equal to the federal M&IE rate for the locality of travel for each calendar day (or partial day) as an expense for food or beverages.

(4) If a *per diem* allowance is paid for lodging, meal, and incidental expenses for each calendar day (or partial day) the employee is away from home at a rate less than the federal *per diem* rate for the locality of travel, the payor must:

(a) treat an amount equal to the federal M&IE rate for the locality of travel for each calendar day (or partial day) or, if less, the amount of the allowance, as an expense for food or beverages; or

(b) treat an amount equal to 40 percent of the allowance as an expense for food or beverages.

(5) If an amount for incidental expenses is computed under section 4.05 of this revenue procedure, none of the amount so computed is subject to limitation under § 274(n) on the deductibility of food and beverage expenses.

.06 *No double reimbursement or deduction*. If a payor pays a *per diem* allowance in lieu of reimbursing actual lodging, meal, and incidental expenses, or meal and incidental expenses, in accordance with section 4 or 5 of this revenue procedure, and such amounts are treated as paid under an accountable plan, any additional payment with respect to those expenses is treated as paid under a nonaccountable plan, is included in the employee's gross income, is reported as wages or other compensation on the employee's Form W–2, and is subject to withholding and payment of employment taxes. Similarly, if an employee or self-employed individual computes the amount allowable as a deduction for meal and incidental expenses for travel away from home in accordance with section 4.03 or 4.04 of this revenue procedure, no other deduction is allowed to the employee or self-employed individual with respect to those expenses. For example, assume an employee receives a *per diem* allowance from a payor for lodging, meal, and incidental expenses, or for meal and incidental expenses, incurred while traveling away from home and such amounts are treated as paid under an accountable plan. During that trip, the employee pays for dinner for the employee and two business associates. The payor reimburses as a business entertainment meal expense the meal expense for the employee and the two business associates. Because the payor also pays a *per diem* allowance to cover the cost of the employee's meals, the amount paid by the payor for the employee's portion of the business entertainment meal expense is treated as paid under a nonaccountable plan, is reported as wages or other compensation on the employee's Form W–2, and is subject to withholding and payment of employment taxes.

.07 *Related parties*. Sections 4.01 and 5 of this revenue procedure do not apply if a payor and an employee are related within the meaning of § 267(b), but for this purpose the percentage of ownership interest referred to in § 267(b)(2) is 10 percent.

SECTION 7. APPLICATION

.01 If the amount of travel expenses is deemed substantiated under the rules provided in section 4 or 5 of this revenue procedure, and the employee substantiates to the payor the elements of time, place, and business purpose of the travel for that day (or partial day) in accordance with paragraphs (b)(2) and (c) (other than subparagraph (2)(iii)(A) thereof) of § 1.274–5, the employee is deemed to satisfy the adequate accounting requirements of § 1.274–5(f) as well as the requirement to substantiate by adequate records or other sufficient evidence for purposes of § 1.274–5(c). See also § 1.62–2(e)(1) for the rule that in order to satisfy the substantiation requirement of an accountable plan, an arrangement must require business expenses to be substantiated to the payor within a reasonable period of time.

.02 An arrangement providing *per diem* allowances will be treated as satisfying the requirement of § 1.62–2(f)(2) of returning amounts in excess of expenses if the employee is required to return within a reasonable period of time (as defined in § 1.62–2(g)) any portion of the allowance that relates to days of travel not substantiated, even though the arrangement does not require the employee to return the portion of the allowance that relates to days of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated. For example, assume a payor provides an employee an advance *per diem* allowance for meal and incidental expenses of $250, based on an anticipated 5 days of business travel at $50 per day to a locality for which the federal M&IE rate is $39, and the employee substantiates 3 full days of business travel. The requirement to return excess amounts is treated as satisfied if the employee is

required to return within a reasonable period of time (as defined in § 1.62–2(g)) the portion of the allowance that is attributable to the 2 unsubstantiated days of travel ($100), even though the employee is not required to return the portion of the allowance ($33) that exceeds the amount of the employee's expenses deemed substantiated under section 4.02 of this revenue procedure ($117) for the 3 substantiated days of travel. However, the $33 excess portion of the allowance is treated as paid under a nonaccountable plan as discussed in section 7.04 of this revenue procedure.

.03 An employee is not required to include in gross income the portion of a *per diem* allowance received from a payor that is less than or equal to the amount deemed substantiated under the rules provided in section 4 or 5 of this revenue procedure if the employee substantiates the business travel expenses covered by the *per diem* allowance in accordance with section 7.01 of this revenue procedure. See § 1.274–5T(f)(2)(i). Assuming that the remaining requirements for an accountable plan provided in § 1.62–2 are satisfied, that portion of the allowance is treated as paid under an accountable plan, is not reported as wages or other compensation on the employee's Form W–2, and is exempt from the withholding and payment of employment taxes. See § 1.62–2(c)(2) and (c)(4).

.04 An employee is required to include in gross income only the portion of the *per diem* allowance received from a payor that exceeds the amount deemed substantiated under the rules provided in section 4 or 5 of this revenue procedure if the employee substantiates the business travel expenses covered by the *per diem* allowance in accordance with section 7.01 of this revenue procedure. See § 1.274–5T(f)(2)(ii). In addition, the excess portion of the allowance is treated as paid under a nonaccountable plan, is reported as wages or other compensation on the employee's Form W–2, and is subject to withholding and payment of employment taxes. See § 1.62–2(c)(3)(ii), (c)(5), and (h)(2)(i)(B).

.05 If the amount of the expenses that is deemed substantiated under the rules provided in section 4.01, 4.02, or 5 of this revenue procedure is less than the amount of the employee's business expenses for travel away from home, the employee may claim an itemized deduction for the amount by which the business travel expenses exceed the amount that is deemed substantiated, provided the employee substantiates all the business travel expenses (not just the excess over the federal *per diem* rate), includes on Form 2106, "*Employee Business Expenses*," the deemed substantiated portion of the *per diem* allowance received from the payor, and includes in gross income the portion (if any) of the *per diem* allowance received from the payor that exceeds the amount deemed substantiated. See § 1.274–5T(f)(2)(iii). However, for purposes of claiming this itemized deduction with respect to meal and incidental expenses, substantiation of the amount of the expenses is not required if the employee is claiming a deduction that is equal to or less than the amount computed under section 4.03 of this revenue procedure minus the amount deemed substantiated under sections 4.02 and 7.01 of this revenue procedure. The itemized deduction is subject to the appropriate limitation (see section 2.02 of this revenue procedure) on meal and entertainment expenses provided in § 274(n) and the 2-percent floor on miscellaneous itemized deductions provided in § 67.

.06 An employee who pays or incurs amounts for meal expenses and does not receive a *per diem* allowance for meal and incidental expenses may deduct an amount computed pursuant to section 4.03 of this revenue procedure only as an itemized deduction. This itemized deduction is subject to the appropriate limitation on meal and entertainment expenses provided in § 274(n) and the 2-percent floor on miscellaneous itemized deductions provided in § 67. See section 7.07 of this revenue procedure for the treatment of an employee who does not pay or incur amounts for meal expenses and does not receive a *per diem* allowance for incidental expenses.

.07 An employee who does not pay or incur amounts for meal expenses and does not receive a *per diem* allowance for incidental expenses may deduct an amount computed pursuant to section 4.05 of this revenue procedure only as an itemized deduction. This itemized deduction is subject to the 2-percent floor on miscellaneous itemized deductions provided in § 67. See section 7.06 of this revenue procedure for the treatment of an employee who pays or incurs amounts for meal expenses and does not receive a *per diem* allowance for meal and incidental expenses.

.08 A self-employed individual who pays or incurs meal expenses for a calendar day (or partial day) of travel away from home may deduct an amount computed pursuant to section 4.03 of this revenue procedure in determining adjusted gross income under § 62(a)(1). This deduction is subject to the appropriate limitation on meal and entertainment expenses provided in § 274(n).

.09 A self-employed individual who does not pay or incur meal expenses for a calendar day (or partial day) of travel away from home may deduct an amount computed pursuant to section 4.05 of this revenue procedure in determining adjusted gross income under § 62(a)(1).

.10 If a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of § 62(c) and the regulations thereunder, all payments under the arrangement will be treated as made under a nonaccountable plan. See § 1.62–2(k) and Rev. Rul. 2006–56. Thus, these payments are included in the employee's gross income, are reported as wages or other compensation on the employee's Form W–2, and are subject to withholding and payment of employment taxes. See § 1.62–2(c)(3), (c)(5), and (h)(2), and section 8.06 of this revenue procedure.

SECTION 8. WITHHOLDING AND PAYMENT OF EMPLOYMENT TAXES

.01 The portion of a *per diem* allowance, if any, that relates to the days of business travel substantiated and that exceeds the amount deemed substantiated for those days under section 4.01, 4.02, or 5 of this revenue procedure is treated as paid under a nonaccountable plan and is subject to withholding and payment of employment taxes. See § 1.62–2(h)(2)(i)(B).

.02 In the case of a *per diem* allowance paid as a reimbursement, the excess described in section 8.01 of this revenue procedure is subject to withholding and payment of employment taxes in the payroll period in which the payor reimburses the expenses for the days of travel substantiated. See § 1.62–2(h)(2)(i)(B)(2).

.03 In the case of a *per diem* allowance paid as an advance, the excess described in section 8.01 of this revenue procedure is subject to withholding and payment of employment taxes no later than the first

payroll period following the payroll period in which the days of travel with respect to which the advance was paid are substantiated. See § 1.62–2(h)(2)(i)(B)(3). If some or all of the days of travel with respect to which the advance was paid are not substantiated within a reasonable period of time and the employee does not return the portion of the allowance that relates to those days within a reasonable period of time, the portion of the allowance that relates to those days is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period. See § 1.62–2(h)(2)(i)(A).

.04 In the case of a *per diem* allowance only for meal and incidental expenses for travel away from home paid to an employee in the transportation industry by a payor that uses the rule in section 4.04(4) of this revenue procedure, the excess of the *per diem* allowance paid for the period over the amount deemed substantiated for the period under section 4.02 of this revenue procedure (after applying section 4.04(4) of this revenue procedure), is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the excess is computed. See § 1.62–2(h)(2)(i)(B)(4).

.05 For example, assume that an employer pays an employee a *per diem* allowance under an arrangement that otherwise meets the requirements of an accountable plan to cover business expenses for meals and lodging for travel away from home at a rate of 120 percent of the federal *per diem* rate for the localities to which the employee travels. The employer does not require the employee to return the 20 percent by which the reimbursement for those expenses exceeds the federal *per diem* rate. The employee substantiates 6 days of travel away from home: 2 days in a locality in which the federal *per diem* rate is $160 and 4 days in a locality in which the federal *per diem* rate is $120. The employer reimburses the employee $960 for the 6 days of travel away from home (2 x (120% x $160) + 4 x (120% x $120)), and does not require the employee to return the excess payment of $160 (2 days x $32 ($192-$160) + 4 days x $24 ($144-$120)). For the payroll period in which the employer reimburses the expenses, the employer must withhold and pay employment taxes on $160. See section 8.02 of this revenue procedure.

.06 If a *per diem* allowance arrangement has no mechanism or process to determine when an allowance exceeds the amount that may be deemed substantiated and the arrangement routinely pays allowances in excess of the amount that may be deemed substantiated without requiring actual substantiation of all the expenses or repayment of the excess amount, the failure of the arrangement to treat the excess allowances as wages for employment tax purposes causes all payments made under the arrangement to be treated as made under a nonaccountable plan. See Rev. Rul. 2006–56.

SECTION 9. EFFECTIVE DATE

This revenue procedure is effective for *per diem* allowances for lodging, meal and incidental expenses, or for meal and incidental expenses only, that are paid to an employee on or after October 1, 2008, with respect to travel away from home on or after October 1, 2008. For purposes of computing the amount allowable as a deduction for travel away from home, this revenue procedure is effective for meal and incidental expenses or for incidental expenses only paid or incurred on or after October 1, 2008.

SECTION 10. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2007–63 is superseded.

DRAFTING INFORMATION

The principal author of this revenue procedure is Stewart H. Brant of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Brant at (202) 622–4930 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking

Transfers by Domestic Corporations That are Subject to Section 367(a)(5); Distributions by Domestic Corporations That are Subject to Section 1248(f)

REG–209006–89

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under sections 367(a), 367(a)(5), 367(b), 1248(a), 1248(e), 1248(f), and 6038B of the Internal Revenue Code (Code). The proposed regulations under sections 367(a)(5) and 367(b) apply when a domestic corporation transfers certain property to a foreign corporation in an exchange described in section 361(a) or (b). The proposed regulations under section 1248(e) suspend the application of section 1248(e) when capital gains are taxed at a rate equal to or greater than the rate at which ordinary income is taxed. The proposed regulations under section 1248(f) apply when a domestic corporation distributes stock of certain foreign corporations in a distribution to which section 337, 355, or 361 applies. The proposed regulations under section 1248(f) include regulations described in Notice 87–64, 1987–2 C.B. 375. The proposed regulations under section 6038B establish reporting requirements for certain transfers of property by a domestic corporation to a foreign corporation in certain exchanges described in section 361(a) or (b). Finally, the proposed regulations under section 367(a) include the regulations described in Notice 2008–10, 2008–3 I.R.B. 277.

The proposed regulations included in this document affect domestic corporations that transfer property to foreign corporations in certain transactions, or that distribute the stock of certain foreign corporations, and certain shareholders of such domestic corporations. The proposed regulations are necessary, in part, to provide guidance on changes to the law made by the Technical and Miscellaneous Revenue Act of 1988 (Public Law 100–647, 102 Stat. 3342).

DATES: Written or electronic comments and requests for a public hearing must be received by November 18, 2008.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–209006–89), 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–209006–89), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224, or sent electronically, via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–209006–89).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Daniel McCall, (202) 622–3860; concerning submissions of comments, requests for a public hearing, and/or to be placed on the building access list to attend a hearing, Richard Hurst (*Richard.A.Hurst@irscounsel.treas.gov*), or (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collections of information should be received by October 20, 2008.

Comments are requested concerning:

Whether the proposed collections of information are necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

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

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

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

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

The collections of information in these proposed regulations are in §§1.367(a)–7(c)(4) and (5); 1.1248(f)–2(b)(1) and (c)(1); and 1.6038B–1(c)(6). The collections of information are mandatory. The likely respondents are domestic corporations.

Estimated total annual reporting burden: 3260.

Estimated average annual burden hours per respondent: 10.69.

Estimated number of respondents: 305.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books and records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains proposed amendments to 26 CFR part 1 under sections 367(a), 367(a)(5), 367(b), 1248(a), 1248(e), 1248(f), and 6038B of the Code.

Section 367(a)(1) generally provides that if a United States person transfers property to foreign corporation in connection with an exchange described in section

332, 351, 354, 356, or 361, then the foreign corporation shall not be considered a corporation for purposes of determining the extent to which the United States person recognizes gain on the transfer. Sections 367(a)(2) and 367(a)(3), respectively, provide exceptions to the general rule of section 367(a)(1) for transfers of stock or securities of a foreign corporation that is a party to the exchange or a party to the reorganization, and for certain property used in an active foreign trade or business. However, section 367(a)(5) provides that, except to the extent provided in regulations, the exceptions to the general rule of section 367(a)(1) provided by section 367(a)(2) and (a)(3) do not apply to a transfer of property by a domestic corporation to a foreign corporation in an exchange described in section 361(a) or (b).

Section 367(b)(1) provides that in the case of any exchange described in section 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in section 367(a)(1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes. A fundamental policy of section 367(b) is to preserve the potential application of section 1248 following the acquisition of the stock or assets of a foreign corporation by another foreign corporation. H.R. Rep. No. 94–658, at 242 (1975).

Section 367(c)(1) provides that for purposes of section 367, any distribution described in section 355 (or so much of section 356 as relates to section 355) shall be treated as an exchange whether or not it is an exchange.

Section 1248(a) provides that a United States person shall include in gross income as a dividend any gain recognized on the sale or exchange of stock of a foreign corporation that was a controlled foreign corporation (CFC) (as defined in section 957(a)) at any time during the five-year period ending on the date of the sale or exchange but only if the United States person owned (or is considered to have owned, within the meaning of section 958) 10 percent or more of the total combined voting power of the foreign corporation at any time during that five-year period (a section 1248 shareholder). The amount of the gain recognized by the United States person on the sale or exchange that is recharacterized as a dividend is limited to the earnings and profits of the foreign corporation, and of certain foreign subsidiaries of such corporation, attributable to the stock sold or exchanged that were accumulated in taxable years of the foreign corporation beginning after December 31, 1962, and during the period or periods the stock was held by the United States person while the foreign corporation was a CFC.

Section 1248(e) provides that, except as provided in regulations, if a United States person sells or exchanges stock of a domestic corporation that was formed or availed of principally for the holding, directly or indirectly, of stock of one or more foreign corporations, such sale or exchange shall be treated for purposes of section 1248 as a sale or exchange of the stock of the foreign corporations held by the domestic corporation.

Section 1248(f)(1) provides that, except as provided in regulations, a domestic corporation that distributes stock of a foreign corporation in a distribution to which section 311(a), 337, 355(c)(1), or 361(c)(1) applies, shall include in gross income as a dividend an amount equal to the excess of the fair market value of such stock over its adjusted basis, but only to the extent of the earnings and profits of the foreign corporation attributable (under regulations prescribed by the Secretary) to such stock which were accumulated in taxable years of such foreign corporation beginning after December 31, 1962, and during the period or periods the stock was held by the domestic corporation while the foreign corporation was a CFC.

Explanation of Provisions

A. *Section 367(a)(5)*

1. *Overview*

As noted in the Background part of this preamble, section 367(a)(2) and (3) provide exceptions to the general rule of section 367(a)(1). Section 367(a)(2) provides that, except to the extent provided in regulations, section 367(a)(1) shall not apply to the transfer of stock or securities of a foreign corporation that is a party to the exchange or a party to the reorganization. Section 367(a)(3) provides that, except to the extent provided in regulations, section 367(a)(1) shall not apply to the transfer of property used in an active foreign trade or business. Sections 1.367(a)–2T and §1.367(a)–3, along with other related provisions, implement the exceptions in section 367(a)(2) and (a)(3). In addition, section 367(a)(6) grants the Secretary authority to promulgate regulations providing additional exceptions to the general rule of section 367(a)(1).

Section 367(a)(5) provides that the exceptions to the general rule of section 367(a)(1) provided under section 367(a)(2) and (3) shall not apply in the case of a transfer of property by a domestic corporation (U.S. transferor) to a foreign corporation (foreign acquiring corporation) in an exchange described in section 361(a) or (b) (section 361 exchange). The general rule under section 367(a)(5), therefore, is that a transfer of property by a U.S. transferor to a foreign acquiring corporation in a section 361 exchange is subject to the general rule of section 367(a)(1). In that case, the U.S. transferor recognizes gain with respect to the transfer of appreciated property in the section 361 exchange. See section 367(a)(1) and the regulations under that section.

Section 367(a)(5), however, further provides that subject to such basis adjustments and such other conditions as shall be provided in regulations the general rule of section 367(a)(5) shall not apply (and therefore the exceptions to the general rule of section 367(a)(1) may be available) if the U.S. transferor is controlled (within the meaning of section 368(c)), by five or fewer domestic corporations. For purposes of the control requirement, members of the same affiliated group (within the meaning of section 1504) are treated as a single corporation. The legislative history to section 367(a)(5) explains that regulations are expected to provide relief from the general rule only if the "U.S. corporate shareholders in the transferor agree to take a basis in the stock they receive in a foreign corporation that is a party to the reorganization equal to the lesser of (a) the U.S. corporate shareholders' basis in such stock received pursuant to section 358, or (b) their proportionate share of the basis in the assets of the transferor corporation transferred to the foreign corporation." S. Rep. No. 100–445, at 62 (1988).

The legislative history explains that "the requirement that five or fewer domestic corporations own at least 80 percent of the U.S. transferor's stock assures that the bulk of the built-in gain [in the transferred property] remains subject to U.S. taxing jurisdiction." The legislative history further states that "it is expected that regulations [issued under section 367(a)(5)] will require the U.S. corporate transferor to recognize immediately any built-in gain that does not remain subject to U.S. taxing jurisdiction by virtue of a substituted stock basis." For example, the U.S. transferor would recognize gain "where 20 percent or less of the U.S. corporate transferor is owned by foreign shareholders who receive substituted basis stock in the transferee corporation, which stock would not be subject to U.S. taxing jurisdiction on disposition." The U.S. transferor would also recognize gain to the extent each controlling domestic corporate shareholder does not receive an amount of stock of the issuing corporation in the reorganization sufficient to preserve its share of the built-in gain in the property transferred by the U.S. transferor in the section 361 exchange.

2. *Explanation of proposed regulations*

The proposed regulations confirm the general rule of section 367(a)(5), but provide an elective exception to the general rule pursuant to which the exceptions provided by section 367(a) and the regulations under that section may be available.

a) *General rule of section 367(a)(5)*

Consistent with section 367(a)(5), the proposed regulations confirm that the exceptions to the general rule of section 367(a)(1) provided in section 367(a) generally are not available to a transfer of property by a U.S. transferor to a foreign acquiring corporation in a section 361 exchange. As noted, under the general rule of section 367(a)(5), section 367(a)(1) would require the U.S. transferor to recognize gain on the transfer of appreciated property to the foreign acquiring corporation in the section 361 exchange. This general rule applies even if the conditions and requirements for the application of such exceptions would otherwise be met. The proposed regulations clarify that the general rule of section 367(a)(5) applies to a transfer of property pursuant to an exchange described in section 351 (section 351 exchange) that qualifies as both a section 351 exchange and a section 361 exchange. See Notice 2008–10, 2008–3 I.R.B. 277.

b) *Elective exception to the general rule*

The proposed regulations provide an elective exception to the general rule of section 367(a)(5) if certain conditions and requirements are satisfied (discussed in parts A.2.b.i through v of this preamble). If the exception applies, then the exceptions to the general rule of section 367(a)(1) provided in section 367(a) and the regulations under that section are available to the transfer of property by the U.S. transferor to the foreign acquiring corporation in the section 361 exchange, subject to any conditions and requirements for the application of such exceptions. In addition, even if the exception provided by the proposed regulations applies, the U.S. transferor may still recognize gain on the section 361 exchange in certain circumstances (discussed in part A.2.b.ii of this preamble), including any gain otherwise required to be recognized under section 367(a). See, for example, section 367(a)(3)(B) and (C).

The conditions and requirements of the elective exception carry out the policy of section 367(a)(5) by ensuring that the exceptions to the general rule of section 367(a)(1) are available only to the extent the net built-in gain in certain property transferred by the U.S. transferor in the section 361 exchange remains subject to corporate-level taxation in the hands of the controlling domestic corporate shareholders of the U.S. transferor through their ownership of stock received in the transaction. References to "stock received" in this preamble include stock deemed received in the transaction.

The proposed regulations apply to all property transferred by the U.S. transferor in the section 361 exchange, other than property to which section 367(d) applies (section 367(d) property). But see part D.2 of this preamble regarding proposed regulations under section 367(a) that require section 367(d) property to be treated as property to which section 367(a) applies (section 367(a) property) in transactions that may be eligible for the exception to the coordination rule of §1.367(a)–3(d)(2)(vi)(A) provided by §1.367(a)–3(d)(2)(vi)(B)(*1*). For purposes of these proposed regulations, section 367(a) property includes any property transferred by the U.S. transferor in the section 361 exchange (other than section 367(d) property), whether the property is appreciated (built-in gain property) or depreciated (built-in loss property) at the time of the section 361 exchange. The proposed regulations preserve (or require the recognition of) the net built-in gain in the section 367(a) property transferred in the section 361 exchange (generally defined as "inside gain" by the proposed regulations). In this regard, a transfer of section 367(a) property pursuant to a section 361 exchange to which the elective exception applies is treated differently than a transfer of built-in gain property and built-in loss property by a U.S. person to a foreign corporation in a section 351 exchange that is not also a section 361 exchange. In the latter transaction, only the built-in gain property would be subject to section 367(a)(1), and the U.S. transferor would be required to recognize gain with respect to such property without offsetting the gain with losses related to the built-in loss property.

The proposed regulations contain an anti-stuffing rule pursuant to which any property that would otherwise constitute section 367(a) property shall not be considered section 367(a) property for purposes of any determination under the proposed regulations for which the amount of section 367(a) property is relevant, if the U.S. transferor acquires such property in connection with the section 361 exchange with a principle purpose of affecting any such determination (for example, inside gain and inside basis). This rule may apply, for example, if the U.S. transferor acquires built-in loss property or cash proceeds from indebtedness incurred in connection with the transaction.

The conditions and requirements for the application of the exception provided by the proposed regulations ensure that, in the aggregate, the inside gain is recognized currently by the U.S. transferor or preserved for future taxation in the stock received in the transaction by the controlling domestic corporate shareholders of the U.S. transferor. If the entire inside gain is preserved in the stock received by

the controlling domestic corporate shareholders, the basis adjustment required by the exception (discussed in part A.2.b.iii of this preamble) effectively results in the section 361 exchange being treated similarly to a transfer of the section 367(a) property in a section 351 exchange insofar as, in the aggregate, the controlling domestic corporate shareholders' adjusted basis in the stock received in the transaction generally would reflect the aggregate bases of the section 367(a) property and the net built-in gain in such property on the date of the section 361 exchange.

The inside gain equals the amount by which the aggregate gross fair market value of the section 367(a) property transferred by the U.S. transferor in the section 361 exchange exceeds the sum of the aggregate bases of such property and a proportionate amount of any liabilities of the U.S. transferor assumed in the section 361 exchange or satisfied in the reorganization pursuant to section 361(c)(3), but only to the extent the payment of any such liability would give rise to a deduction (deductible liabilities). For this purpose, gross fair market value means fair market value determined without regard to mortgages, liens, pledges, or other liabilities. However, the fair market value of any property subject to nonrecourse indebtedness shall not be less than the amount of such indebtedness. In addition, the aggregate bases of the section 367(a) property is determined after taking into account any gain otherwise required to be recognized by the U.S. transferor under section 367(a). See, for example, section 367(a)(3)(B) and (C). The proposed regulations provide rules for determining the proportionate amount of any deductible liabilities taken into account in determining the inside gain. The IRS and Treasury Department believe that taking deductible liabilities into account in determining inside gain comports with the policy of section 367(a)(5) to protect the corporate tax base following the repeal of the "General Utilities" doctrine, insofar as the U.S. transferor would have received the benefit of any deductible liabilities if it had disposed of its assets in a taxable transaction in which the deductible liabilities were assumed by the acquirer.

In determining the inside gain, the IRS and Treasury Department declined to consider attributes (for example, net operating losses and foreign tax credits) of the U.S. transferor other than the tax bases of the section 367(a) property and deductible liabilities allocable to section 367(a) property. These attributes are not considered for this purpose because of concerns regarding the complexity for determining how any limitations on the use of such attributes should be taken into account and the potential for duplicating the benefit of such attributes. Comments are requested regarding whether and how other attributes of the U.S. transferor should be taken into account for determining inside gain.

If the section 361 exchange is part of a divisive reorganization described in section 368(a)(1)(D) in which the U.S. transferor distributes the stock of the foreign acquiring corporation in a distribution to which section 355 applies (section 355 distribution) and, as part of a plan or series of related transactions, such stock is subsequently distributed in one or more section 355 distributions, in addition to the conditions discussed in parts A.2.b.i through v of this preamble, two additional conditions must be satisfied. First, each section 355 distribution must be to a member of the affiliated group (within the meaning of section 1504) that includes the U.S. transferor at the time of the 361 exchange. Second, each affiliated group member that receives stock of the foreign acquiring corporation in the final section 355 distribution must adjust the basis of the stock received (as determined under section 358 and the regulations under that section) as required by the proposed regulations (discussed in part A.2.b.iii of this preamble). These two additional conditions ensure that the amount of inside gain attributable to the U.S. transferor's controlling domestic corporate shareholders remains subject to corporate-level taxation following the final section 355 distribution and permit section 355 distributions of the stock of the foreign acquiring corporation within an affiliated group.

i) *Control requirement*

At the time of the section 361 exchange, the U.S. transferor must be controlled (within the meaning of section 368(c)) by five or fewer, but at least one, domestic corporations (the control group). For this purpose, members of the same affiliated group (within the meaning of section 1504) are treated as one corporation. If the U.S. transferor is controlled (within the meaning of section 368(c)) by more than five domestic corporations, but some combination of five or fewer domestic corporations control the U.S. transferor within the meaning of section 368(c), the U.S. transferor must designate the five or fewer domestic corporations that comprise the control group on Form 926, "*Return by a U.S. Transferor of Property to a Foreign Corporation*."

Although a regulated investment company (as defined in section 851(a)) (RIC), a real estate investment trust (as defined in section 856(a)) (REIT), and a subchapter S corporation (as defined in section 1361(a)) is each generally treated as a domestic corporation for purposes of the Code, such entities are not generally subject to corporate-level taxation. Therefore, the proposed regulations provide that these entities cannot be members of the control group.

The proposed regulations confirm that because the stock ownership threshold for the control requirement is determined by reference to section 368(c), only direct ownership of the stock of the U.S. transferor is taken into account. The IRS and Treasury Department declined to exercise the authority under section 367(a)(6) to permit indirect ownership (through a partnership or other entity) to be taken into account for this purpose, in part, because of the complexity and administrative difficulties that would arise from the basis adjustments (discussed in part A.2.b.iii of this preamble) that would be needed to account for the intervening partnership or other entity. For example, in the case of indirect ownership through a partnership, basis adjustments would need to account for differences between a partner's basis in its partnership interest and the partnership's basis in the stock of the U.S. transferor. Comments are requested regarding the manner in which indirect ownership could be taken into account for this purpose without undue complexity.

ii) *Gain recognition by U.S. transferor*

Even if the exception provided by the proposed regulations applies, in two instances the U.S. transferor must recognize gain on the transfer of section 367(a) property in the section 361 exchange. This is the case even if an exception to the general

rule of section 367(a)(1) would otherwise apply to such transfer.

First, the U.S. transferor must recognize gain equal to the aggregate amount of inside gain allocable to non-control group members. The inside gain is allocated among control group members and non-control group members based on each shareholder's ownership interest (by value) in the U.S. transferor at the time of the section 361 exchange. The U.S. transferor must recognize gain with respect to non-control group members even if the entire inside gain could be preserved in the stock received by the control group members as a group.

Second, the U.S. transferor must recognize gain to the extent any control group member cannot preserve its share of inside gain in the stock received that is allocable to the section 367(a) property transferred in the section 361 exchange. The amount of a control group member's share of inside gain that cannot be preserved in the stock received is the amount by which the control group member's share of inside gain exceeds the fair market value of the stock received by the control group member that is allocable to section 367(a) property. Gain is required to be recognized in such a case because the fair market value of the stock equals the maximum amount of the control group member's share of inside gain that can be preserved in such stock (if the basis of such stock were zero). Under this rule, stock received that is allocable to property other than section 367(a) property is not available to preserve any portion of the control group member's share of inside gain. The U.S. transferor may be required to recognize gain under this rule when, for example, non-qualifying property (property other than stock or securities permitted to be received under section 361(a)) is received or when the foreign acquiring corporation assumes certain liabilities of the U.S. transferor in the section 361 exchange.

The proposed regulations provide rules for determining the portion of the stock received by a control group member that is attributable to section 367(a) property that are consistent with general tax principles, including Rev. Rul. 68–55, 1968–1 C.B. 140, and the authorities cited therein. Under these rules, stock received by a control group member is allocated between the aggregate section 367(a) property and all other property transferred in the section 361 exchange based on relative gross fair market value.

The U.S. transferor must recognize gain with respect to any control group member that cannot preserve its entire share of inside gain in the stock received in the transaction even if the control group members' aggregate share of inside gain can be preserved in the stock received by the control group members as a group. For example, assume that the U.S. transferor is wholly owned by two domestic corporations (US1 and US2) and that each control group member's share of inside gain is $40x. If in the transaction US1 received stock with a value of $30x and $20x of non-qualifying property, the U.S. transferor would recognize $10x gain with respect to US1, even if US2 received sufficient stock to preserve $50x gain (the sum of US2's $40x share of inside gain and the portion of US1's share of inside gain ($10x) that cannot be preserved in the stock received by US1).

iii) *Adjustments to basis of stock received by control group members*

Under the proposed regulations, each control group member's basis in the stock received in the transaction as determined under section 358 and the regulations under that section (section 358 basis) that is allocable to the section 367(a) property transferred by the U.S. transferor in the section 361 exchange is reduced to the extent necessary to preserve the control group member's share of inside gain. As a general matter, if the U.S. transferor must recognize gain with respect to a control group member because the control group member's entire share of inside gain cannot be preserved in the stock received by the control group member in the transaction (see part A.2.b.ii of this preamble), the control group member's section 358 basis in the stock received that is attributable to section 367(a) property is reduced to zero.

Only the basis of stock received by the control group member that is attributable to section 367(a) property transferred in the section 361 exchange is reduced (for example, the basis of stock attributable to section 367(d) property is not reduced). The reduction to a control group member's section 358 basis in the stock received that is attributable to section 367(a) property equals the amount, if any, by which the control group member's share of inside gain (reduced by the amount of any gain recognized by the U.S. transferor with respect to the control group member (discussed in part A.2.b.ii of this preamble)) exceeds the built-in gain (or loss) in such stock, defined as outside gain (or loss) in the proposed regulations. The outside gain (or loss) is the amount by which the fair market value of such stock is greater than (or less than) the section 358 basis of the stock (as determined before any required adjustment to such basis under the proposed regulations). The proposed regulations provide special rules that apply if the control group member holds more than one block of stock received in the transaction. Comments are requested concerning whether, and the extent to which, an outside loss should limit the reduction to a control group member's section 358 basis in the stock received that is attributable to section 367(a) property. Consistent with the legislative history, the IRS and Treasury Department believe the basis reduction must be sufficient to preserve the control group member's share of inside gain (to the extent not otherwise recognized by the U.S. transferor) in the stock received that is attributable to section 367(a) property. The IRS and Treasury Department believe this rule to be appropriate even if a control group member has an outside loss, in part because a basis reduction is required only if an election is made to apply the exception from the general rule of section 367(a)(5) provided by the proposed regulations.

If the section 361 exchange is part of a divisive reorganization described in section 368(a)(1)(D) that is eligible for the exception (see part A.2.b of this preamble for additional conditions that must be satisfied in such a case), each affiliated group member that receives stock of the foreign acquiring corporation in the final section 355 distribution must reduce the section 358 basis of such stock to the same extent that the control group member that initially received the stock from the U.S. transferor would have reduced its section 358 basis in such stock. In such a case, the control group member that received the stock of the foreign acquiring corporation from the U.S. transferor is not required to reduce the section 358 basis of such stock.

A section 361 exchange that is subject to section 367(a)(5) may be part of a triangular reorganization in which the control group members receive stock of the corporation that controls the foreign acquiring corporation (the controlling corporation). In such a case, the proposed regulations require the control group members to adjust (if necessary) the section 358 basis of the stock of the controlling corporation (whether foreign or domestic) received in the transaction. The IRS and Treasury Department believe adjusting the basis of such stock to be appropriate even if the controlling corporation is domestic because the control group members' aggregate share of inside gain may not be preserved in the stock of the foreign acquiring corporation held by the controlling corporation in all cases. For example, liabilities assumed or incurred by the foreign acquiring corporation in connection with the transaction could reduce the amount of inside gain preserved in such stock. Moreover, even if the control group members' aggregate share of inside gain could be preserved in such stock, such an approach would shift the inside gain to the domestic controlling corporation, rather than to the control group members as intended by section 367(a)(5).

iv) *Agreement to recognize gain and file amended tax return*

The proposed regulations require the U.S. transferor to include a statement with its U.S. income tax return for the year of the section 361 exchange certifying that if the foreign acquiring corporation disposes of a significant amount of the section 367(a) property transferred in the section 361 exchange in one or more related transactions entered into with a principal purpose of avoiding the U.S. tax that would have been imposed on a sale of such property by the U.S. transferor at the time of the section 361 exchange, then the U.S. transferor (or the foreign acquiring corporation on behalf of the U.S. transferor) shall file a U.S. income tax return (or amended U.S. income tax return, as the case may be) for the year of the section 361 exchange reporting the gain realized but not recognized on the section 361 exchange. This requirement is intended to prevent the potential use of reorganizations subject to section 367(a)(5) to avoid the repeal of the "General Utilities" doctrine. Interest must be paid (determined under section 6621) on the amount of any additional tax due on such return. For this purpose, a disposition of a significant amount of the section 367(a) property occurs if the foreign acquiring corporation disposes of an amount of the section 367(a) property transferred in the section 361 exchange that is greater than forty percent of the fair market value of the section 367(a) property at the time of the section 361 exchange. Comments are requested regarding whether an exception from this rule should be provided for dispositions of section 367(a) property occurring in the ordinary course of business.

v) *Election and reporting requirements*

To elect to apply the exception, the proposed regulations require the U.S. transferor and the control group members to enter into a written agreement to make such election on or before the due date for the U.S. transferor's timely-filed return for the taxable year in which the section 361 exchange occurs. Each party to the written agreement must also include a statement with its timely-filed return for the year of the section 361 exchange reporting the election and other specified information. If the section 361 exchange is part of a divisive reorganization described in section 368(a)(1)(D) that is eligible for the exception (see part A.2.b of this preamble for additional conditions that must be satisfied in such a case), each affiliated group member that receives stock of the foreign acquiring corporation in the final section 355 distribution must enter into the written agreement and include the reporting statement with its timely-filed return (instead of the control group member that initially received the stock of the foreign acquiring corporation from the U.S. transferor.) Relief for reasonable cause may be available for the failure to comply with the election and reporting requirements.

3. *Special entities*

The proposed regulations apply to property transfers by U.S. transferors, including RICs, REITs, and subchapter S corporations. Comments are requested regarding whether and the extent to which the IRS and Treasury Department should exercise the authority under section 367(a)(6) to provide an exception from the general rule of section 367(a)(5) for a transfer of property by a RIC, a REIT, or a subchapter S corporation to a foreign corporation pursuant to a section 361 exchange.

B. *Section 367(b)*

1. *Overview*

Section 367(b)(1) provides that in the case of any exchange described in section 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in section 367(a)(1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes.

A fundamental policy of section 367(b) is to preserve the potential application of section 1248 following certain section 367(b) exchanges. H.R. Rep. No. 94–658, at 242 (1975). Thus, if the potential application of section 1248 cannot be preserved immediately following the acquisition of the stock or assets of a foreign acquired corporation by a foreign acquiring corporation in a section 367(b) exchange, the final regulations (T.D. 8862, 2000–1 C.B. 466) under section 367(b) issued on January 24, 2000 (2000 final regulations) require certain shareholders of the foreign acquired corporation to include in income as a dividend the section 1248 amount attributable to the stock of the foreign acquired corporation. See §1.367(b)–4(b). For example, the inclusion in income of the section 1248 amount is required if the section 367(b) exchange results in the loss of section 1248 shareholder status or if the foreign acquired corporation or foreign acquiring corporation is not a CFC immediately after the section 367(b) exchange. See §1.367(b)–4(b)(1)(i).

2. *Outbound asset reorganizations—in general*

The 2000 final regulations require a U.S. transferor that is a section 1248 shareholder of a foreign acquired corporation and that transfers the stock of such corporation to a foreign acquiring corporation in a section 361 exchange to include in income the section 1248 amount attributable to the stock of the foreign acquired corporation. The U.S. transferor must include

the section 1248 amount in income even if the foreign acquiring corporation and the foreign acquired corporation are CFCs with respect to which the U.S. transferor is a section 1248 shareholder immediately after the section 361 exchange. See §1.367(b)–4(b)(1)(iii), *Example 4*. Moreover, under section 1248(f)(1) the U.S. transferor generally would be required to include in income the section 1248 amount attributable to the stock of the foreign acquiring corporation distributed under section 361(c)(1). The section 1248 amount attributable to the stock of the foreign acquiring corporation would generally include the section 1248 amount attributable to the stock of the foreign acquired corporation. See generally §1.1248–8.

The final regulations (T.D. 9243, 2006–1 C.B. 475) under section 367(b) issued on January 26, 2006 (2006 final regulations) provided an exception to the general rule of §1.367(b)–4(b)(1)(i) that applies in certain triangular reorganizations where the exchanging shareholder receives stock of a domestic corporation that controls the foreign acquiring corporation. This exception only applies, however, to a shareholder that exchanges stock of the foreign acquired corporation for stock of the domestic corporation in an exchange described under section 354 or 356. Thus, the exception provided by the 2006 final regulations does not apply where the U.S. transferor receives stock of a domestic controlling corporation for stock of a foreign acquired corporation in a section 361 exchange.

After studying the issue further and in response to comments received, the IRS and Treasury Department have determined that requiring the U.S. transferor to include the section 1248 amount in income may not be necessary in cases where the section 1248 amount attributable to the stock of the foreign acquired corporation can be preserved. Accordingly, the proposed regulations under section 367(b) included in this document provide an additional exception to the general rule of the 2000 final regulations that applies to certain transfers of stock of a foreign acquired corporation by a U.S. transferor to a foreign acquiring corporation in a section 361 exchange.

In such a case, the proposed regulations provide that the U.S. transferor must include in income the section 1248 amount attributable to the stock of the foreign acquired corporation only if immediately after the section 361 exchange the foreign acquiring corporation or the foreign acquired corporation is not a CFC with respect to which the U.S. transferor is a section 1248 shareholder. *Example 4* in §1.367(b)–4(b)(1)(iii) is modified accordingly. The proposed regulations under section 1248(f) included in this document supplement this exception to ensure that the section 1248 amount can be preserved in the hands of a corporate section 1248 shareholder following the distribution of the stock of the foreign acquiring corporation by the U.S. transferor. See part C of this preamble for discussion of the proposed regulations under section 1248(f).

3. *Special rules for outbound triangular asset reorganizations*

As noted, the 2000 final regulations also require the U.S. transferor to include in income the section 1248 amount attributable to stock of a foreign acquired corporation transferred to a foreign acquiring corporation in a section 361 exchange that is part of triangular asset reorganization, even if the corporation that controls the foreign acquiring corporation is domestic. The provisions of §1.367(b)–13 (T.D. 9243) do not apply to preserve the section 1248 amount attributable to the stock of the foreign acquired corporation in such a case. The proposed regulations under section 367(b) included in this document, however, would provide an exception to the general rule of the final 2000 regulations in such triangular asset reorganizations.

If the controlling corporation is foreign, the exception applies if, immediately after the section 361 exchange, the foreign controlling corporation, the foreign acquiring corporation, and the foreign acquired corporation are CFCs with respect to which the U.S. transferor is a section 1248 shareholder. If the controlling corporation is domestic, the exception applies if, immediately after the section 361 exchange, the foreign acquired corporation is a CFC with respect to which the domestic controlling corporation is a section 1248 shareholder. In addition, in either case, the controlling corporation (foreign or domestic) must apply the principles of §1.367(b)–13 to determine the adjustment to the basis of the stock of the foreign acquiring corporation (instead of the over-the-top basis adjustment rules of §1.358–6) to ensure that the section 1248 amount attributable to the stock of the foreign acquired corporation at the time of the section 361 exchange is preserved in the stock of the foreign acquiring corporation immediately after the section 361 exchange. Under these principles, each share of stock of the foreign acquiring corporation would generally be divided into the portions necessary to preserve the pre-exchange section 1248 amounts attributable to the stock of the foreign acquired corporation and the foreign acquiring corporation, respectively. If the controlling corporation is foreign, the proposed regulations under section 1248(f) included in this document supplement this exception to ensure that the section 1248 amount can be preserved following the distribution of the stock of the foreign controlling corporation by the U.S. transferor to its shareholders.

C. *Section 1248(f)*

1. *Overview*

Section 1248(f)(1) provides that, except as provided in regulations, if a domestic corporation (domestic distributing corporation) that is a section 1248 shareholder with respect to a foreign corporation distributes the stock of such foreign corporation in a distribution described in section 311(a), 337, 355(c)(1), or 361(c)(1), then notwithstanding any other provisions of the Code, the domestic distributing corporation must include in income as a dividend the section 1248 amount attributable to such stock. Section 1248(f)(1) requires the inclusion of the section 1248 amount because the section 1248 amount attributable to the stock distributed may not be preserved in the hands of the distributee shareholders following the distribution. Section 1248(f)(1) does not apply to the extent the domestic distributing corporation otherwise recognizes gain on the distribution, in which case the gain recognized would be recharacterized as a dividend under section 1248(a), as appropriate.

Section 1248(f)(2), however, provides that section 1248(f)(1) shall not apply to a domestic distributing corporation's distribution of stock of a foreign corporation to a domestic corporation that is treated

as holding the stock for the period during which the stock was held by the domestic distributing corporation and that, immediately after the distribution, is a section 1248 shareholder with respect to the foreign corporation. The legislative history explains that where "the corporate distribute[e] does not receive a stepped up basis as a result of the distribution and...the potential for the future application of section 1248 still exists, it is not necessary to [apply section 1248(f)(1) to] override the nonrecognition provisions which otherwise apply to a corporate distribution." S. Rep. No. 94–938, at 270 (1976).

The legislative history provides that the Treasury Department may exercise the regulatory authority granted under section 1248(f)(1) to provide that, where section 1248(f)(2) does not otherwise apply, "the recipient corporation may be required to take a carryover basis in the stock received (rather than a substituted basis under section 358, for example, in the case of a section 355 or 361 distribution) and section 1248(f)(1) will not apply to such distribution." S. Rep. No. 100–445, at 64 (1988).

In Notice 87–64, 1987–2 C.B. 375, the IRS and Treasury Department announced that, in the case of section 355 distributions of CFC stock, regulations under section 1248(f) may limit the application of section 1248(f)(1) to distributions in which the CFC is no longer a CFC after the distribution or in which one or more of the distributees are not United States shareholders (within the meaning of section 951(b)) of the CFC after the distribution. The notice further states that the regulations would ensure that, subsequent to a section 355 distribution of CFC stock that would not be subject to section 1248(f)(1) under the regulations, the amount of gain recognized from a disposition of the CFC stock that would be recharacterized as a dividend under section 1248(a) would include the earnings and profits attributable to the CFC stock under section 1248 as of the date of the section 355 distribution. To achieve this result, the notice provides that the regulations may require appropriate adjustments to the basis and holding period of the CFC stock received by one or more of the distributees.

2. *General rules*

The proposed regulations under section 1248(f) included in this document provide that a domestic distributing corporation that is a section 1248 shareholder of a foreign corporation and that distributes stock of such foreign corporation in a distribution to which section 337 applies (section 337 distribution), shall generally include in income as a dividend the section 1248 amount attributable to the stock distributed.

The proposed regulations further provide that a domestic distributing corporation that is a section 1248 shareholder of a foreign corporation and that distributes stock of such foreign corporation in a section 355 distribution, other than stock received by the domestic distributing corporation in a section 361 exchange, shall generally include in income as a dividend the section 1248 amount attributable to the stock distributed. This rule applies, however, only to the extent the domestic distributing corporation does not otherwise recognize gain on the section 355 distribution, in which case the gain recognized would be recharacterized as a dividend under section 1248(a), as appropriate.

Finally, the proposed regulations provide that a domestic distributing corporation that is a section 1248 shareholder of a foreign distributed corporation and that distributes stock of such corporation received in a section 361 exchange, in a section 355 distribution or a distribution to which section 361 applies (section 361 distribution), shall, notwithstanding any other provision of the Code, include in income as a dividend the "section 1248(f) amount" attributable to the stock distributed. The section 1248(f) amount equals the aggregate amount that would be included in income as a dividend by the foreign distributed corporation under section 964(e) if, immediately after the section 361 exchange that preceded the section 355 distribution or section 361 distribution, the foreign distributed corporation sold the stock of each foreign corporation received in the section 361 exchange. This rule supplements the proposed regulations under section 367(b) which provide an exception to the general rule of §1.367(b)–4(b)(1)(i) in certain cases where stock of a foreign acquired corporation is transferred by a U.S. transferor in a section 361 exchange.

3. *Exceptions to the general rules*

The proposed regulations incorporate the statutory exception provided by section 1248(f)(2) for distributions that meet certain conditions. The proposed regulations also provide elective exceptions for section 355 distributions and section 361 distributions. The exceptions for such distributions are elective because applying the exceptions may reduce a corporate distributee's section 358 basis in the stock received in the distribution. The conditions of the exceptions carry out the policy of section 1248(f) by limiting the exceptions to distributions where the potential application of section 1248 and the relevant section 1248 amounts can be preserved following the distribution.

a) *Section 337 distributions*

The general rule will not apply to a section 337 distribution of the stock of a foreign corporation if immediately after the distribution the 80-percent distributee (described in section 337(c)) is a section 1248 shareholder with respect to the foreign corporation, the 80-percent distributee's holding period in the stock received in the distribution is the same as the domestic distributing corporation's holding period in such stock at the time of the distribution, and the 80-percent distributee's basis in the stock received in the distribution is not greater than the domestic distributing corporation's basis in such stock at the time of the distribution.

The IRS and Treasury Department believe the conditions should be satisfied in most section 337 distributions because of the application of sections 334 and 1223. However, comments are requested regarding any cases where these conditions may not be met and whether the 80-percent distributee should be permitted to adjust the basis or holding period of the stock received so that the conditions can be met.

b) *Certain section 355 distributions*

The proposed regulations provide an elective exception to the general rule for a section 355 distribution of stock of a foreign corporation not received by the do-

mestic distributing corporation in a section 361 exchange to a domestic corporation that is a section 1248 shareholder with respect to the foreign corporation immediately after the distribution. The election to apply the exception is irrevocable and must be made by the domestic distributing corporation and all such section 1248 shareholders. If the election is made, adjustments may be made to each section 1248 shareholder's section 358 basis and holding period in the stock received to preserve the section 1248 amount attributable to such stock at the time of the distribution.

To apply the exception, the proposed regulations require the domestic distributing corporation and the section 1248 shareholders to enter into a written agreement on or before the due date (including extensions) of the domestic distributing corporation's tax return for the taxable year during which the section 355 distribution occurs. The proposed regulations also require the domestic distributing corporation and each section 1248 shareholder to include a statement with its tax return for the taxable year during which the distribution occurs reporting that the election to apply the exception has been made and any required adjustments to stock basis or holding period. Each party to the agreement must retain the original or a copy of the agreement as part of its records. The proposed regulations provide relief for reasonable cause for the failure to comply with the election and reporting requirement.

If the exception applies, two adjustments may be required with respect to each section 1248 shareholder. First, solely for purposes of section 1248, immediately following the distribution the section 1248 shareholder's holding period in the stock received in the distribution shall equal the domestic distributing corporation's holding period in such stock at the time of the distribution. Second, if the section 1248 amount attributable to the stock of the foreign corporation at the time of the distribution exceeds the section 1248 shareholder's postdistribution amount attributable to such stock (excess amount), the section 1248 shareholder's section 358 basis in such stock is reduced by the excess amount. The postdistribution amount is the section 1248 shareholder's section 1248 amount attributable to the stock received in the distribution, computed immediately after the distribution and taking into account the adjustment to the shareholder's holding period in such stock.

c) *Distributions pursuant to a plan of reorganization*

The proposed regulations provide an elective exception to the general rule for a section 355 distribution or section 361 distribution of stock of a foreign corporation received by the domestic distributing corporation in the section 361 exchange that precedes such distribution to a domestic corporation that is a section 1248 shareholder with respect to the foreign corporation immediately after the distribution. The election to apply the exception is irrevocable and must be made by the domestic distributing corporation and all such section 1248 shareholders. If the exception applies, adjustments may be made to each section 1248 shareholder's section 358 basis (as adjusted under the proposed regulations under section 367(a)(5)) and the amount of earnings and profits attributable to the stock received for purposes of section 1248 to preserve the section 1248(f) amount attributable to such stock at the time of the distribution.

To apply the exception, the proposed regulations require the domestic distributing corporation and the section 1248 shareholders to enter into a written agreement on or before the due date (including extensions) of the domestic distributing corporation's tax return for the taxable year during which the distribution occurs. The proposed regulations also require the domestic distributing corporation and each section 1248 shareholder to include a statement with its tax return for the taxable year during which the distribution occurs reporting that the election to apply the exception has been made and any required adjustments to stock basis or the amount of earnings and profits attributable to the stock received for purposes of section 1248. Each party to the agreement must include the original or a copy of the agreement as part of its records. The proposed regulations provide relief for reasonable cause for the failure to comply with the election and reporting requirements.

If the exception applies, two adjustments may be required with respect to each section 1248 shareholder. First, each share of stock of the foreign corporation received by the section 1248 shareholder is divided into portions attributable to each block of stock of a foreign acquired corporation transferred by the domestic distributing corporation in the section 361 exchange with respect to which the domestic distributing corporation was a section 1248 shareholder at the time of the section 361 exchange, and to all other property transferred by the domestic distributing corporation in the section 361 exchange. For example, if in the section 361 exchange the domestic distributing corporation transfers a block of stock in each of three foreign corporations with respect to which it is a section 1248 shareholder, then each share of stock of the foreign distributed corporation received by the section 1248 shareholder must be divided into three portions. Alternatively, if multiple blocks of stock in each of the three foreign corporations were transferred in the section 361 exchange, then each share of the stock of the foreign distributed corporation would be divided into additional portions to account for the additional blocks of stock transferred. The proposed regulations further provide that, for purposes of section 1248, the earnings and profits attributable to each block of stock of a foreign acquired corporation transferred in the section 361 exchange that results in a divided portion of a share of stock of the foreign acquiring corporation (or whole share, if no division is required) are attributable to such portion (or whole share, if no division is required) based on the section 1248 shareholder's ownership interest (by value) in the domestic distributing corporation at the time of the section 361 exchange.

Second, if the section 1248(f) amount attributable to a portion of a share (or whole share, if no division is required) of stock of the foreign distributed corporation received in the distribution exceeds the section 1248 shareholder's postdistribution amount attributable to such portion (or whole share) (excess amount), then the section 1248 shareholder's section 358 basis in such portion (or whole share, if no division is required), as adjusted under the proposed regulations under section 367(a)(5) (discussed in part A.2.b.iii of this preamble), is reduced by such excess amount. This adjustment ensures that the section 1248 shareholder's share of the section 1248 amount attributable to the

stock of each foreign acquired corporation transferred in the section 361 exchange is preserved in the stock of the foreign distributed corporation received by such shareholder in the distribution.

The IRS and Treasury Department declined to adopt rules that would not require the division of shares to preserve section 1248 amounts because such rules could inappropriately increase or decrease the section 1248 amount attributable to the stock of the foreign distributed corporation received by a section 1248 shareholder in the distribution. For example, if in the section 361 exchange the domestic distributing corporation transferred appreciated tangible property and stock of a CFC with earnings and profits for purposes of section 1248(a) in excess of the built-in gain in such stock, then the appreciation in the tangible property could inappropriately increase the section 1248 amount attributable to the stock of the foreign distributed corporation received by a section 1248 shareholder in the distribution (to the extent the CFC's earnings and profits exceed the section 1248 amount attributable to the CFC stock at the time of the section 361 exchange). A similar inappropriate increase would result if the domestic distributing corporation transferred appreciated stock of two CFCs in the section 361 exchange, one CFC without a section 1248 amount and the other CFC with a section 1248 amount but with earnings and profits for purposes of section 1248 in excess of such section 1248 amount.

The IRS and Treasury Department also declined to adopt rules that would preserve any reduction to a section 1248 shareholder's section 358 basis in a portion of a share (or whole share, if no division is required) of stock of the foreign distributed corporation received in the distribution by increasing the basis of other portions of the share (or other whole shares, if no division is required) of stock or by establishing a suspended basis account equal to the basis reduction. Those rules were not adopted because a capital loss would be created that could economically offset the section 1248 amount, which would not be consistent with the policy underlying section 1248(f) and the regulations described in Notice 87–64. S. Rep. No. 94–938, at 270 (1976).

Comments are requested on how the rules of the proposed regulations can be simplified and how the rules should apply to different classes of stock.

4. *Section 964(e) and inclusions under section 367(b)*

Comments are requested regarding whether the IRS and Treasury Department should exercise the authority under section 367(b) to apply the principles of section 1248(f)(1) to section 355 distributions or section 361 distributions of stock of a foreign corporation by a CFC, to the extent the transaction does not otherwise result in an income inclusion to the exchanging shareholders of the CFC under section 367(b) and the regulations under that section. Comments should consider the appropriate balance between the policy of sections 1248(a) and 964(e) and the associated complexity and compliance burdens.

D. *Changes to Exception to Coordination Rule of §1.367(a)–3(d)(2)(vi)(A)*

1. *Overview*

Section 1.367(a)–3(d)(2)(vi)(A) (the coordination rule) provides that if, in connection with an indirect stock transfer, a U.S. person transfers assets to a foreign corporation (direct asset transfer) in an exchange described in section 351 or section 361, the rules of section 367 and the regulations under that section shall first apply to the direct asset transfer and then to the indirect stock transfer. However, an exception to the coordination rule (coordination rule exception) provides that section 367(a) and (d) shall not apply to a direct asset transfer otherwise subject to the coordination rule to the extent that assets transferred by a domestic acquired corporation to a foreign acquiring corporation in an asset reorganization are re-transferred to a domestic corporation controlled by the foreign acquiring corporation (domestic controlled corporation), but only if the domestic controlled corporation's basis in the retransferred assets is not greater than the domestic acquired corporation's basis in such assets and other conditions are satisfied. See §1.367(a)–3(d)(2)(vi)(B)(*1*).

The 2006 final regulations established the conditions for the application of the coordination rule exception. The preamble to the notice of proposed rulemaking that preceded the 2006 final regulations explained that the conditions were adopted to limit the use of asset reorganizations subject to the coordination rule that might facilitate inversion transactions and certain divisive transactions. See REG–125628–01, 2005–1 C.B. 536 (issued January 5, 2005).

2. *Clarification of conditions for application of the coordination rule exception*

In response to transactions intended to use the coordination rule exception inappropriately to repatriate earnings and profits of foreign corporations without the recognition of gain or a dividend inclusion, the IRS and Treasury Department issued Notice 2008–10, 2008–3 I.R.B. 277. The notice announced that the conditions for the application of the coordination rule exception would be revised to clarify that any adjustment to basis required under section 367(a)(5) must be made to the basis of stock of the foreign acquiring corporation received by the control group members in the asset reorganization such that the appropriate amount of built-in gain in the property transferred by the domestic acquired corporation to the foreign acquiring corporation is reflected in such stock. The notice clarifies that the control group members cannot satisfy the basis adjustment requirement by adjusting the basis of stock of the foreign acquiring corporation held before the reorganization. The notice further states that the revised regulations would confirm that to the extent the appropriate amount of built-in gain in the property transferred by the domestic acquired corporation cannot be preserved in the stock received by the control group members in the reorganization, then the domestic acquired corporation's transfer of property to the foreign acquiring corporation shall be subject to section 367(a) and (d).

The proposed regulations included in this document incorporate, with modifications, the clarifications to the conditions for the application of the coordination rule exception announced in the notice. The proposed regulations also provide that to the extent any of the re-transferred assets constitutes section 367(d) property, the coordination rule exception shall apply only if the section 367(d) property is treated as section 367(a) property for purposes of satisfying the conditions and requirements of

section 367(a)(5) and the regulations under that section. Thus, for example, any gain that the U.S. transferor must recognize on the direct asset transfer or any adjustment required to a control group member's section 358 basis in stock received in the transaction must take into account any inside gain attributable to section 367(d) property (treated as section 367(a) property for purposes of determining such inside gain) that is part of the re-transferred assets.

The IRS and Treasury Department continue to study transactions that have the effect of repatriating earnings and profits of foreign corporations without the recognition of gain or a dividend inclusion. Temporary regulations were recently issued (T.D. 9400, 2008–24 I.R.B. 1139, and T.D. 9402, 2008–31 I.R.B. 254) under sections 367(b) and 956(e) to address the inappropriate use of certain cross-border triangular reorganizations and other nonrecognition transactions to repatriate earnings and profits of a foreign corporation without the recognition of gain or a dividend inclusion. The IRS and Treasury Department are evaluating other transactions that have a similar effect to determine whether guidance is appropriate. In particular, the IRS and Treasury Department are analyzing whether it is appropriate for the gain limitation rule of section 356(a)(1) to apply in an acquisitive asset reorganization involving a foreign acquiring corporation, considering that a policy of section 367(b) is "to protect against tax avoidance in transfers to foreign corporations and upon the repatriation of previously untaxed foreign earnings." H.R. Rep. No. 94–658 (1975). Comments are requested in this regard, including whether the application of any such guidance should be limited to cases where section 356(a)(2) would otherwise apply to the shareholder's receipt of non-qualifying property.

The IRS and Treasury Department also continue to study whether appropriate modifications should be made to the "all earnings and profits" inclusion requirement of §1.367(b)–3(b) when a domestic corporation acquires the assets of a foreign corporation pursuant to an acquisitive asset reorganization under section 368(a)(1) and then transfers all or part of the acquired assets to another foreign corporation in a transaction described in §1.368–2(k). Comments are requested in this regard, including regarding the appropriate adjustment to the domestic corporation's basis in the stock of the foreign corporation to which the acquired assets are transferred to ensure that the basis of such stock reflects an after-tax amount.

E. *Other Proposed Regulations Under Section 367(a)*

The proposed regulations under section 367(a) would revise current §1.367(a)–1T(b)(4)(i)(B) to provide that an increase to basis for the amount of gain recognized by a U.S. person under section 367(a) in connection with a transfer of property to a foreign corporation is allocated among the transferred property with respect to which gain is recognized in proportion to the gain realized by the U.S. person on the transfer of such property. The IRS and Treasury Department believe the current temporary regulation may produce inappropriate results because it allocates the basis increase among the transferred property with respect to which gain is recognized in proportion to the amount realized by the U.S. person on the transfer of such property.

The proposed regulations also clarify that a transfer of property by a U.S. person to a foreign corporation that is subject to section 367(a) is not recharacterized for U.S. Federal tax purposes merely because the U.S. person is required to recognize gain in connection with such transfer under section 367(a). For example, if a U.S person transfers appreciated stock of a CFC to another CFC in a section 351 exchange, the section 351 exchange is not recharacterized as other than a section 351 exchange for U.S. Federal tax purposes merely because the U.S. person recognizes gain in connection with the exchange under section 367(a).

F. *Other Proposed Regulations Under Section 1248*

The proposed regulations under section 1248(a) remove as deadwood an exception from the application of section 1248(a) for gain recognized under section 356. In addition, consistent with Notice 87–64, the proposed regulations under section 1248(e) suspend the application of section 1248(e) for periods when capital gains are taxed at a rate that equals or exceeds the rate of tax on ordinary income.

G. *Effective/Applicability Dates*

1. *Sections 367(a)(5) and 6038B*

Section 1.367(a)–7 and the revisions to §1.6038B–1 apply to transfers occurring on or after the date that is 30 days after the date these regulations are published as final regulations in the **Federal Register**.

2. *Section 1248(e)*

In accordance with Notice 87–64, 1987–2 C.B. 375, §1.1248–6(d) (suspending application of section 1248(e)) applies to sales, exchanges, or other dispositions of stock of a domestic corporation occurring on or after September 21, 1987.

3. *Changes to coordination rule exception*

The revisions to §1.367(a)–3(d)(2)(vi)(B)(*1*) and (*2*) described in Notice 2008–10, 2008–3 I.R.B. 277, generally apply to transactions occurring on or after December 28, 2007. The requirement to treat section 367(d) property as section 367(a) property for purposes of the coordination rule exception (as discussed in part D.2 of this preamble) applies to transactions occurring on or after August 19, 2008.

4. *Sections 1248(f) and 367(b)*

Section 1.1248–8(b)(2)(iv), §§1.1248(f)–1 through 1.1248(f)–3, and the modifications to §1.367(b)–4 apply to transfers or distributions occurring on or after the date that is 30 days after the date these regulations are published as final regulations in the **Federal Register**.

H. *Adjustments under Section 367(a)(5) Before Final Regulations are Published*

The general rule of section 367(a)(5) is that the exceptions to section 367(a)(1) provided by section 367(a)(2) and (a)(3) are not available for a transfer of property by a domestic corporation to a foreign corporation in a section 361 exchange, including a section 351 exchange that also qualifies as a section 361 exchange. However, until the date that is 30 days after the date these regulations are published as final regulations, taxpayers may make reasonable adjustments, as described in the legislative history to section 367(a)(5), that are consistent with the policy of section

367(a)(5) so that the exceptions provided by section 367(a)(2) and (a)(3) may apply to the transfer of property by a U.S. transferor to a foreign corporation in a section 361 exchange.

Reasonable adjustments must include adjusting the basis of the stock received by the control group members in the transaction that is attributable to section 367(a) property so that each control group member's basis of such stock equals the lesser of (1) the control group member's section 358 basis in the stock or (2) the control group member's proportionate share of the basis of the section 367(a) property transferred by the U.S. transferor in the section 361 exchange. Adjusting the basis of stock of the foreign acquiring corporation held by a control group member before the section 361 exchange shall not be a reasonable adjustment.

In addition, the U.S. transferor must recognize gain to the extent it has shareholders that are not control group members and to the extent any built-in gain in the section 367(a) property transferred in the section 361 exchange cannot be preserved in the hands of the control group members through their ownership of stock received in the transaction in exchange for the stock or securities of the U.S. transferor. For example, the U.S. transferor may recognize gain if the control group members receive non-qualifying property in the transaction, if the foreign acquiring corporation assumes liabilities of the U.S. transferor in the section 361 exchange, or if the U.S. transferor distributes the stock received in the section 361 exchange disproportionately to its shareholders. For this purpose, the stock or other property received by the U.S. transferor in the section 361 exchange must be allocated between the section 367(a) property and all other property transferred in the section 361 exchange consistent with general tax principles, including the principles of Rev. Rul. 68–55, 1968–1 C.B. 140, and the authorities cited therein.

Adjustments made in accordance with the proposed regulations under section 367(a)(5) included in this document shall be considered reasonable and in accordance with the policy of section 367(a)(5).

Availability of IRS Documents

IRS notices cited in this preamble are made available by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Effect on Other Documents

The following publications are proposed to be obsolete as of the date 30 days after the date these regulations are published as final regulations in the **Federal Register**:

Notice 87–64, 1987–2 C.B. 375.

Notice 2008–10, 2008–3 I.R.B. 277.

Special Analyses

It has been determined that this Treasury Decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. Section 553(b) of the Administrative Procedure Act (5 U.S.C. Chapter 5) and the Regulatory Flexibility Act (5 U.S.C. Chapter 6) apply to these regulations.

It is hereby certified that the collection of information contained in this regulation will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. This regulation primarily will affect large domestic corporations engaged in cross-border corporate transactions. Thus, the number of affected small entities will not be substantial. A certain number of small domestic corporations may be shareholders of a larger domestic corporation the stock or assets of which are acquired by a foreign corporation in connection with an asset reorganization, and such shareholders may be required to make certain adjustments in the stock of the foreign acquiring corporation. Nonetheless, the IRS and Treasury Department do not anticipate the number of such shareholders to be substantial. Furthermore, the IRS and Treasury Department estimate that any small entities that are affected by the regulations will likely face a burden of approximately ten hours (at an hourly rate of $200) from the adjustments made to the basis of the stock received in the reorganization. Considering that the collections of information enable taxpayers to defer or avoid the recognition of potentially large amounts of gain, the IRS and Treasury Department believe that $2000 is not a significant economic impact. Comments about the accuracy of this certification may be submitted to the addresses provided in the preamble. Pursuant to section 7805(f) of the internal Revenue Code, this regulation has been submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Comments and Request for a Public Hearing

Before these 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. 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 will 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 the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is Daniel McCall of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service. Other personnel from offices of the IRS and Treasury Department participated in developing the regulations.

* * * * *

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 is amended by adding entries in numerical order to read in part as follows:

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

Section 1.367(a)–3(d)(2)(vi)(B)(*1*)(*i*) also issued under 26 U.S.C. 367(d).

Section 1.367(a)–7 also issued under 26 U.S.C. 367(a), (b), (c), and 337(d).

Section 1.1248–6 also issued under 26 U.S.C. 1248(e).

Section 1.1248–8(b)(2)(iv) also issued under 26 U.S.C. 1248(a), (c), and (f).

Section 1.1248(f)–1 also issued under 26 U.S.C. 367(b) and 1248(f).

Section 1.1248(f)–2 also issued under 26 U.S.C. 367(b) and 1248(f).

Section 1.1248(f)–3 also issued under 26 U.S.C. 367(b) and 1248(f).* * *

Par. 2. Section 1.358–6 is amended by adding a new sentence at the end of paragraph (e) to read as follows:

§1.358–6 Stock basis in certain triangular reorganizations.

* * * * *

(e) * * * For rules relating to certain triangular reorganizations involving transfers to which the exception provided in §1.367(a)–7(c) applies, see §1.367(b)–4(b)(1)(ii)(B).

* * * * *

Par. 3. Section 1.367(a)–1T is amended by:

1. Revising the second sentence of paragraph (b)(4)(i)(B).

2. Adding new paragraphs (b)(4)(i)(C) and (g)(4).

The revision and additions to read as follows:

§1.367(a)–1T Transfers to foreign corporations subject to section 367(a): In general (temporary).

* * * * *

(b) * * *

(4) * * *

(i) * * *

(B) * * * Any increase in the basis of the property received by the foreign corporation under section 362(a) or (b) for gain recognized by a U.S. person due to the application of section 367(a) shall be allocated to the transferred property with respect to which gain is recognized in proportion to the gain realized by the U.S. person on the transfer of such property. * * *

(C) A transfer of property by a U.S. person to a foreign corporation shall not be recharacterized for U.S. Federal tax purposes solely because the U.S. person recognizes gain in connection with the transfer under section 367(a)(1). For example, if a U.S. person transfers appreciated stock or securities to a foreign corporation in an exchange described in section 351, the transfer is not recharacterized as other than an exchange described in section 351 solely because the U.S. person recognizes gain in connection with the transfer under section 367(a)(1).

* * * * *

(g) * * *

(4) The rules in paragraphs (b)(4)(i)(B) and (C) of this section apply to transfers occurring on or after the date 30 days after the date these regulations are published as final regulations in the **Federal Register**. For guidance with respect to paragraph (b)(4)(i)(B) of this section before the date 30 days after the date these regulations are published as final regulations in the **Federal Register**, see 26 CFR part 1 revised as of April 1 for the year before the date these regulations are published as final regulations in the **Federal Register**.

Par. 4. Section 1.367(a)–3 is amended by:

1. Revising the third to the last sentence of paragraph (a).

2. Revising paragraphs (b)(1) and (c)(1).

3. Revising paragraphs (d)(2)(vi)(B)(*1*) and (d)(2)(vi)(B)(*1*)(*i*).

4. Adding two new sentences at the end of paragraph (d)(2)(vi)(B)(*2*).

5. Revising the first and fourth sentences of paragraph (d)(3), *Example 6A* (ii).

6. Revising the second and fifth sentences of paragraph (d)(3), *Example 6B* (ii), and adding two new sentences after the fifth sentence.

7. Revising the second and fourth sentences of paragraph (d)(3), *Example 6C* (ii).

8. Adding a new sentence between the second and third sentences of paragraph (d)(3), *Example 8* (ii).

9. Revising the first sentence of paragraph (d)(3), *Example 8B* (ii).

10. Revising the first sentence of paragraph (d)(3), *Example 8C* (ii).

11. Revising the second sentence of paragraph (d)(3), *Example 9* (ii), and removing the third sentence.

12. Revising the third sentence of paragraph (d)(3), *Example 10* (ii).

13. Revising the second to last sentence of paragraph (d)(3), *Example 11* (ii), and adding a new sentence after the second to last sentence.

14. Revising the second sentence of paragraph (d)(3), *Example 12* (ii), and removing the last sentence.

15. The heading for paragraph (g) is revised.

16. Paragraph (g)(1)(E) is revised.

The revisions and additions to read as follows:

§1.367(a)–3 Treatment of transfers of stock or securities to foreign corporations.

(a) * * * For additional rules regarding a transfer of stock or securities in an exchange described in section 361(a) or (b), see section 367(a)(5) and §1.367(a)–7. * * *

(b) *Transfers by U.S. persons of stock or securities of foreign corporations to foreign corporations*—(1) *General rule.* Except as provided in §1.367(a)–7, a transfer of stock or securities of a foreign corporation by a U.S. person to a foreign corporation that would otherwise be subject to section 367(a)(1) under paragraph (a) of this section shall not be subject to section 367(a)(1) if either—

* * * * *

(c) *Transfers by U.S. persons of stock or securities of domestic corporations to foreign corporations*—(1) *In general.* Except as provided in §1.367(a)–7, a transfer of stock or securities of a domestic corporation by a U.S. person to a foreign corporation that would otherwise be subject to section 367(a)(1) under paragraph (a) of this section shall not be subject to section 367(a)(1) if the domestic corporation the stock or securities of which are transferred (referred to as the U.S. target company) complies with the reporting requirements in paragraph (c)(6) of this section and if each of the following four conditions is met:

* * * * *

(d) * * *

(2) * * *

(vi) * * *

(B) *Exceptions.* (*1*) If a transaction is described in paragraph (d)(2)(vi)(A) of this section, section 367(a) and (d) shall not apply to the extent a domestic corporation (domestic acquired corporation) transfers assets to a foreign corporation (foreign

acquiring corporation) in an asset reorganization, and such assets (re-transferred assets) are transferred to a domestic corporation (domestic controlled corporation) in a controlled asset transfer, provided that the domestic controlled corporation's basis in the re-transferred assets is not greater than the domestic acquired corporation's basis in such assets and the conditions contained in paragraphs (d)(2)(vi)(B)(*1*)(*i*) or (d)(2)(vi)(B)(*1*)(*ii*) of this section are satisfied. For purposes of determining whether the domestic controlled corporation's basis in the re-transferred assets is not greater than the domestic acquired corporation's basis in such assets, the domestic acquired corporation's basis in the re-transferred assets shall reflect any increase in basis due to gain recognized by the domestic acquired corporation on the transfer of the re-transferred assets to the foreign acquiring corporation.

(*i*) The conditions and requirements of section 367(a)(5) and §1.367(a)–7(c) are satisfied with respect to the domestic acquired corporation's transfer of assets to the foreign acquiring corporation. To the extent any of the re-transferred assets constitutes property to which section 367(d) applies (section 367(d) property), however, the exception under paragraph (d)(2)(iv)(B)(*1*) shall apply only if such property is treated as property subject to section 367(a) for purposes of satisfying the conditions and requirements of section 367(a)(5) and §1.367(a)–7(c). The preceding sentences shall apply before the application of the exception under paragraph (d)(2)(vi)(B)(*1*) of this section. See paragraph (g)(1)(E)(*3*) of this section for rules under this paragraph (d)(2)(vi)(B)(*1*)(*i*) that apply to transactions that occur on or after December 28, 2007, and before the date 30 days after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

(*2*) * * * This paragraph (d)(2)(vi)(B)(*2*) shall not, however, apply to an exchange described in section 351 that is also an exchange described in section 361(a) or (b). An exchange described in section 351 that is also an exchange described in section 361(a) or (b) is only eligible for the exception in paragraph (d)(2)(vi)(B)(*1*) of this section.

* * * * *

(3) * * *

Example 6A. * * *

(ii) * * * The transfer of the Business A assets by Z to F does not constitute an indirect stock transfer under paragraph (d) of this section, and, subject to the conditions and requirements of section 367(a)(5) and §1.367(a)–7(c), the Business A assets qualify for the section 367(a)(3) active trade or business exception and are not subject to section 367(a)(1). * * *

* * * Subject to the conditions and requirements of section 367(a)(5) and §1.367(a)–7(c), the Business B assets qualify for the active trade or business exception under section 367(a)(3). * * *

Example 6B. * * *

(ii) * * * However, subject to the conditions and requirements of section 367(a)(5) and §1.367(a)–7(c), the Business A assets qualify for the section 367(a)(3) active trade or business exception and are not subject to section 367(a)(1). * * *

* * * However, pursuant to paragraph (d)(2)(vi)(B)(*1*) of this section and subject to the conditions and requirements of section 367(a)(5) and §1.367(a)–7(c), the Business B and C assets are not subject to section 367(a) or (d), provided that the basis of the Business B and C assets in the hands of R is no greater than the basis of the assets in the hands of Z. If all or a portion of the Business B and C assets constituted section 367(d) property, as defined in §1.367(a)–7(f)(10), then paragraph (d)(2)(vi)(B)(*1*) of this section would apply to Z's transfer of such property only if such property is treated as property subject to section 367(a) for purposes of satisfying the conditions and requirements of section 367(a)(5) and §1.367(a)–7(c). Treating such section 367(d) property as property subject to section 367(a) for this purpose could further reduce V's basis in the F stock received in the reorganization, or result in the recognition of additional gain by Z, under section 367(a)(5) and §1.367(a)–7(c). * * *

Example 6C. * * *

(ii) * * * However, gain must be recognized on the transfer of such assets under section 367(a)(1) because the section 367(a)(3) active trade or business exception is inapplicable pursuant to section 367(a)(5) and §1.367(a)–7(b). * * *

* * * The transfer of the Business B assets (which otherwise would satisfy the section 367(a)(3) active trade or business exception) generally is subject to section 367(a)(1) pursuant to section 367(a)(5) and §1.367(a)–7(b). * * *

* * * * *

Example 8. * * *

(ii) * * * Subject to the conditions and requirements of section 367(a)(5) and §1.367(a)–7(c), the Business B assets qualify for the active trade or business exception under section 367(a)(3). * * *

Example 8B. * * *

(ii) * * * Under section 367(a)(5) and §1.367(a)–7(b), the active trade or business exception under section 367(a)(3) does not apply to Z's transfer of assets to R. * * *

Example 8C. * * *

(ii) * * * Under section 367(a)(5) and §1.367(a)–7(b), the active trade or business exception under section 367(a)(3) does not apply to Z's transfer of assets to R. * * *

Example 9. * * *

(ii) * * * Subject to the conditions and requirements of section 367(a)(5) and §1.367(a)–7(c), Z's transfer of the Business B assets to R (which are not re-transferred to M) qualifies for the active trade or business exception under section 367(a)(3). * * *

Example 10. * * *

(ii) * * * Subject to the conditions and requirements of section 367(a)(5) and §1.367(a)–7(c), the Business B assets qualify for the active trade or business exception under section 367(a)(3). * * *

Example 11. * * *

(ii) * * * Because D is owned by F, a foreign corporation, the control requirement of section 367(a)(5) and §1.367(a)–7(c)(1) cannot be satisfied. Therefore, section 367(a)(5) and §1.367(a)–7(b) preclude the application of the active trade or business exception under section 367(a)(3) from applying to any assets transferred by D to Z. * * *

Example 12. * * *

(ii) * * * Subject to the conditions and requirements of section 367(a)(5) and §1.367(a)–7(c), the active trade or business exception under section 367(a)(3) applies to E's transfer of Business X assets. * * *

* * * * *

(g) *Effective/applicability dates.*

(1) * * *

(E)(*1*) Except as provided in paragraphs (g)(1)(E)(*2*) through (g)(1)(E)(*4*) of this section, the rules of paragraph (d)(2)(vi) of this section apply only to transactions occurring on or after January 23, 2006. See §1.367(a)–3(d)(2)(vi), as contained in 26 CFR part 1 revised as of April 1, 2005, for transactions occurring on or after July 20, 1998 and before January 23, 2006.

(*2*) Except to the extent provided in paragraph (g)(1)(E)(*3*) of this section, paragraph (d)(2)(vi)(B)(*1*)(*i*) of this section applies to transactions occurring on or after the date 30 days after the date these regulations are published as final regulations in the **Federal Register**.

(*3*)(*i*) For purposes of paragraph (d)(2)(vi)(B)(*1*) of this section, except as provided in paragraph (g)(1)(E)(*3*)(*iii*) of this section, the conditions of paragraph (d)(2)(vi)(B)(*1*)(*i*) of this section shall be satisfied for transactions occurring on or after December 28, 2007, and before the date 30 days after the date these regulations are published as final regulations in the **Federal Register**, provided the conditions in paragraph (g)(1)(E)(*3*)(*ii*) are satisfied.

(*ii*) The domestic acquired corporation is controlled (within the meaning of section 368(c)) by five or fewer (but at least one) domestic corporations (controlling domestic corporations) at the time of the section 361 exchange, appropriate basis

adjustments under section 367(a)(5) are made to the stock received (or deemed received) by the controlling domestic corporations in the reorganization, and any other conditions as provided in regulations under section 367(a)(5) are satisfied. For purposes of determining whether the domestic acquired corporation is controlled by five or fewer domestic corporations, all members of the same affiliated group within the meaning of section 1504 shall be treated as one corporation. Any adjustments to stock basis required under section 367(a)(5) must be made to the stock received (or deemed received) by the controlling domestic corporations in the reorganization such that the appropriate amount of built-in gain in the property transferred by the domestic acquired corporation to the foreign acquiring corporation in the section 361 exchange is reflected in such stock. The basis adjustment requirement cannot be satisfied by adjusting the basis in stock of the foreign acquiring corporation held by the controlling domestic corporations before the reorganization. To the extent the appropriate amount of built-in gain in the property transferred by the domestic acquired corporation to the foreign acquiring corporation in the section 361 exchange cannot be preserved in the stock received (or deemed received) by the controlling domestic corporations in the reorganization, the domestic acquired corporation's transfer of property to the foreign acquiring corporation shall be subject to section 367(a) and (d).

(*iii*) The second sentence of paragraph (d)(2)(vi)(B)(*1*)(*i*) shall apply to transactions occurring on or after August 19, 2008 and before the date 30 days after the date these regulations are published as final regulations in the **Federal Register.**

(*4*) The last two sentences of paragraph (d)(2)(vi)(B)(*2*) shall apply to transactions occurring on or after December 28, 2007.

* * * * *

Par. 5. Section 1.367(a)–7 is added to read as follows:

§1.367(a)–7 Rules under section 367(a)(5) applicable to exchanges described in section 361(a) or (b).

(a) *Scope and purpose*. This section provides rules under section 367(a)(5) that apply to a transfer of certain property, including stock and securities, by a domestic corporation (U.S. transferor) to a foreign corporation (foreign acquiring corporation) in an exchange described in section 361(a) or (b), or in an exchange described in section 351 that is also described in section 361(a) or (b) (collectively, a section 361 exchange). The purpose of this section is to ensure that the net gain realized by the U.S. transferor in connection with the transfer of certain property to the foreign acquiring corporation in the section 361 exchange is, in the aggregate, recognized currently by the U.S. transferor or, to the extent permitted under the rules of this section, preserved in the stock received (or deemed received) in the reorganization by certain domestic corporate shareholders of the U.S. transferor in exchange for stock or securities of the U.S. transferor. This section applies only to the transfer of section 367(a) property in the section 361 exchange. See section 367(d) and the regulations under that section for rules applicable to transfers of section 367(d) property.

(b) *General rule*. Except as provided in paragraph (c) of this section, the exceptions to section 367(a)(1) provided in section 367(a) and the regulations under that section shall not apply to a transfer of section 367(a) property by a U.S. transferor to a foreign acquiring corporation in a section 361 exchange.

(c) *Exception*. Except to the extent provided in paragraph (d) of this section, paragraph (b) of this section shall not apply to the transfer of section 367(a) property in a section 361 exchange if the conditions of paragraphs (c)(1) through (c)(4) of this section are satisfied and an election to apply the exception provided by this paragraph (c) is made in the manner provided by paragraph (c)(5) of this section. If paragraph (b) of this section does not apply to a section 361 exchange, see, for example, §§1.367(a)–2T, 1.367(a)–3, 1.367(a)–4T, or 1.367(a)–5T, as applicable, for additional requirements that must be satisfied to avoid the application of section 367(a)(1) to the transfer of section 367(a) property in the section 361 exchange. Nothing in this section shall permit the nonrecognition of gain not otherwise permitted under another provision of the Internal Revenue Code or the regulations under that section. See, for example, section 367(a)(3)(B) and §1.367(a)–5T.

(1) *Control*. At the time of the section 361 exchange, the U.S. transferor is controlled (within the meaning of section 368(c)) by five or fewer, but at least one, control group members.

(2) *Gain recognition*—(i) *Gain recognition due to non-control group members*. The U.S. transferor recognizes gain equal to the product of the inside gain and the aggregate ownership interest (by value) in the U.S. transferor by all shareholders of the U.S. transferor at the time of the section 361 exchange that are not control group members.

(ii) *Gain recognition where control group member is unable to preserve gain*. With respect to each control group member, the U.S. transferor recognizes gain equal to the amount, if any, by which—

(A) The product of the inside gain and the control group member's ownership interest (by value) in the U.S. transferor at the time of the section 361 exchange; exceeds

(B) The product of the section 367(a) percentage and the fair market value of the stock received (or deemed received) by the control group member in exchange for stock or securities of the U.S. transferor under section 354, 355, or 356. For an illustration of gain recognition under this paragraph, see paragraph (g) of this section, *Example 2*.

(3) *Basis adjustments*—(i) *General rule*. Except as provided in paragraphs (c)(3)(ii)(A) and (C) of this section, each control group member's aggregate basis in the stock received (or deemed received) in exchange for stock or securities of the U.S. transferor under section 354, 355, or 356, as determined under section 358 and the regulations under that section (section 358 basis), is reduced by the amount, if any, by which—

(A) The product of the inside gain and the control group member's ownership interest (by value) in the U.S. transferor at the time of the section 361 exchange, reduced by any gain recognized by the U.S. transferor with respect to such control group member under paragraph (c)(2)(ii) of this section; exceeds

(B) The control group member's outside gain (or loss).

(ii) *Special rules*—(A) *General applicability*. Paragraph (c)(3)(i) of this section shall apply only to stock that was received by the U.S. transferor in the section 361 ex-

change and distributed to the control group member.

(B) *Multiple blocks of stock*. If a control group member holds multiple blocks of stock received (or deemed received) in the transaction, the section 358 basis of each block of stock must be reduced *pro rata* based on the relative section 358 basis of each block of stock.

(C) *Successive distributions to which section 355 applies*. Paragraph (c)(3)(i) of this section shall not apply to a control group member that distributes the stock of a foreign acquiring corporation received from the U.S. transferor in a distribution to which section 355 applies (section 355 distribution), that is in connection with a transaction described in paragraph (d) of this section. If paragraph (c)(3)(i) of this section does not apply to a control group member pursuant to the previous sentence, then paragraph (c)(3)(i) of this section shall apply to the final distributee (as defined in paragraph (d) of this section) that receives the stock of the foreign acquiring corporation in the final section 355 distribution described in paragraph (d) of this section. If the final distributee holds multiple blocks of stock of the foreign acquiring corporation after the final section 355 distribution, the rules of paragraph (c)(3)(ii)(B) of this section shall apply to reduce the section 358 basis of such blocks of stock.

(iii) *Applicable cross-references*. For illustrations of the adjustment to stock basis under paragraph (c)(3)(i) of this section, see paragraph (g) of this section, *Example 1* and *Example 2*, and §1.1248(f)–2(d), *Example 2*. For an illustration of the adjustment to stock basis under paragraph (c)(3)(ii)(A) of this section, see §1.1248(f)–2(d), *Example 4*. For an illustration of the adjustment to stock basis under paragraph (c)(3)(ii)(B) of this section, see paragraph (g) of this section, *Example 3*.

(4) *Agreement to amend or file a U.S. income tax return*—(i) *General rule*. Except as provided in paragraph (c)(4)(ii) of this section, the U.S. transferor complies with the requirements of §1.6038B–1(c)(6)(iii).

(ii) *Exception*. Section 1.6038B–1 (c)(6)(iii) shall not apply to the extent any section 367(a) property transferred in the section 361 exchange is transferred in connection with a transaction described in §1.367(a)–3(e) and a gain recognition agreement is filed pursuant to §1.367(a)–8 with respect to the transfer of such property.

(5) *Election and reporting requirements*—(i) *General rule*. The U.S. transferor and each control group member elect to apply the provisions of paragraph (c) of this section in the manner provided under paragraph (c)(5)(ii) or (iii) of this section, as applicable, and by entering into a written agreement described in paragraph (c)(5)(iv) of this section. If a control group member distributes the stock of the foreign acquiring corporation received from the U.S. transferor in a section 355 distribution that is in connection with a transaction described in paragraph (d) of this section, the final distributee that receives such stock in the final section 355 distribution elects to apply the provisions of this paragraph (c) and enters into the written agreement instead of the control group member.

(ii) *Election and reporting by control group member or final distributee*—(A) *Time and manner of making election*. Each control group member (or final distributee) elects to apply the provisions of paragraph (c) of this section by including a statement (in the form and with the content specified in paragraph (c)(5)(ii)(B) of this section) on or with its timely-filed return for the taxable year in which the section 361 exchange occurs. If the control group member (or final distributee) is a member of a consolidated group for the taxable year of the section 361 exchange, the common parent of the consolidated group makes the election on behalf of the control group member (or final distrubutee).

(B) *Form and content of election statement*. The statement shall be entitled, STATEMENT TO ELECT TO APPLY EXCEPTION UNDER §1.367(a)–7(c) and must set forth:

(1) The name and taxpayer identification number of the control group member (or final distributee);

(2) The name and taxpayer identification number of the common parent of the consolidated group, if any;

(3) The amount of the adjustment (if any) to stock basis required under paragraph (c)(3)(i) of this section, the resulting adjusted basis in such stock, and the fair market value of such stock; and

(4) The date on which the written agreement described in paragraph (c)(5)(iv) of this section was entered into.

(iii) *Statement by U.S. transferor*. The U.S. transferor elects to apply the provisions of paragraph (c) of this section in the form and manner set forth in §1.6038B–1(c)(6)(ii).

(iv) *Written agreement*. The U.S. transferor and each control group member (or final distributee) must enter into a written agreement on or before the due date (including extensions) for the U.S. transferor's tax return for the taxable year during which the section 361 exchange occurs. Each party to the agreement must retain the original or a copy of the agreement in the manner specified by §1.6001–1(e). Each party to the agreement must provide a copy of the agreement to the Internal Revenue Service within 30 days of the receipt of a request for the copy of the agreement in connection with an examination of the taxable year during which the section 361 exchange occurs. The written agreement must—

(A) State the document constitutes an agreement entered into pursuant to paragraph (c)(5) of this section;

(B) Identify the U.S. transferor and each control group member (or final distributee);

(C) State the amount of gain (if any) recognized by the U.S. transferor under paragraph (c)(2) of this section; and

(D) With respect to each control group member (or final distributee), state the amount of the adjustment (if any) to stock basis required under paragraph (c)(3)(i) of this section, the resulting adjusted basis in such stock, and the fair market value of such stock.

(d) *Section 361 exchange followed by successive distributions to which section 355 applies*. If the U.S. transferor distributes stock of the foreign acquiring corporation received in the section 361 exchange to a control group member in a section 355 distribution and, as part of a plan or series of related transactions, such stock is further distributed in one or more successive section 355 distributions, paragraph (c) of this section shall apply to the section 361 exchange only to the extent each subsequent section 355 distribution is to a member of the affiliated group (within the meaning of section 1504) that includes the U.S. transferor at the time of the section

361 exchange. In such a case, each affiliated group member that receives stock of the foreign acquiring corporation in the final section 355 distribution (final distributee) shall be subject to the requirements of paragraphs (c)(3) and (c)(5) of this section.

(e) *Other rules*—(1) *Section 367(a) property on which gain is recognized*. Gain recognized by the U.S. transferor pursuant to paragraph (c)(2) of this section shall be treated as recognized with respect to the section 367(a) property transferred in the section 361 exchange in proportion to the amount of gain realized by the U.S. transferor on the transfer of each item of section 367(a) property. This paragraph (e)(1) shall be applied after taking into account any gain recognized by the U.S. transferor on the transfer of the section 367(a) property in the section 361 exchange pursuant to all other provisions under section 367(a) and the regulations under that section. See, for example, section 367(a)(3)(B) and §1.367(a)–4T. See §1.367(a)–1T(b)(4) for additional rules on the character, source, and adjustments relating to gain recognized under section 367(a).

(2) *Reasonable cause exception for failure to comply*—(i) *Request for relief*. If a control group member (or final distributee) fails to comply with any requirement of this section, the control group member (or final distributee) shall be considered to have complied with such requirement if it submits a request for relief as provided under paragraph (e)(2)(ii) of this section and can demonstrate to the Area Director, Field Examination, Small Business/Self Employed or the Director of Field Operations, Large and Mid-Size Business (Director) having jurisdiction of the control group member's (or final distributee's) tax return for the taxable year, that such failure was due to reasonable cause and not willful neglect. Whether the failure to comply was due to reasonable cause and not willful neglect will be determined by the Director after considering all the facts and circumstances. The Director shall notify the control group member (or final distributee) in writing within 120 days if it is determined that the failure to comply was not due to reasonable cause, or if additional time will be needed to make such determination. For this purpose, the 120-day period shall begin on the date the Internal Revenue Service notifies the control group member (or final distributee) in writing that the request for relief has been received and assigned for review. Once such period commences, if the control group member (or final distributee) is not again notified within 120 days, then the control group member (or final distributee) shall be deemed to have established reasonable cause.

(ii) *Requirements for reasonable cause relief*—(A) *Time of submission*. Requests for reasonable cause relief under paragraph (e)(2)(i) of this section will be considered only if as soon as the control group member (or final distributee) becomes aware of the failure to comply with any requirement of this section, the control group member (or final distributee) attaches the statements or other documents that should have been filed, as well as a complete written statement setting forth the reasons for the failure to comply, to an amended return that amends the return to which the documents should have been attached pursuant to this section. The amended return and all required attachments must be filed with the applicable Internal Revenue Service Center with which the control group member (or final distributee) filed its original return to which the documents should have been attached.

(B) *Notice requirement*. In addition to the requirement of paragraph (e)(2)(ii)(A) of this section, the control group member (or final distributee) must comply with the requirements of paragraph (e)(2)(ii)(B)(*1*) or (*2*) of this section, as applicable.

(*1*) If the control group member (or final distributee) is under examination for any taxable year when the request for reasonable cause relief is filed, a copy of the amended return and attachments must be provided to the Internal Revenue Service personnel conducting the examination.

(*2*) If the control group member (or final distributee) is not under examination for any taxable year when the request for reasonable cause relief is filed, a copy of the amended return and attachments must be provided to the Director having jurisdiction over the return.

(iii) *Cross-reference for reasonable cause relief requests by U.S. transferor*. If the U.S. transferor fails to comply with any requirement of this section, the U.S. transferor shall be treated as having complied with such requirement if the U.S. transferor (or the foreign acquiring corporation on behalf of the U.S. transferor) complies with the reasonable cause exception procedures described in §1.6038B–1(f)(3).

(f) *Definitions*. The following definitions apply for purposes of this section:

(1) *Block of stock* is a group of shares of the same class of stock and that have an identical basis.

(2) *Control group and control group member*—(i) *General rule*. Except as provided in paragraph (f)(2)(ii) of this section, the *control group* is the five or fewer, but at least one, domestic corporations that control (within the meaning of section 368(c)) the U.S. transferor at the time of the section 361 exchange. If the U.S. transferor is controlled by more than five domestic corporations at the time of the section 361 exchange, but some combination of five or fewer domestic corporations control the U.S. transferor at such time, the U.S. transferor shall designate the five domestic corporations that comprise the control group on Form 926, "*Return by a U.S. Transferor of Property to a Foreign Corporation*." For purposes of this paragraph, members of the same affiliated group (within the meaning of section 1504) shall be treated as one corporation. Except as provided in paragraph (f)(2)(ii) of this section, a *control group member* is a domestic corporation that is part of the control group.

(ii) *Exception for certain entities*. Neither a regulated investment company (as defined in section 851(a)), nor a real estate investment trust (as defined in section 856(a)), nor an S corporation (as defined in section 1361(a)) shall be a control group member.

(3) *Deductible liability* is any liability of the U.S. transferor that is assumed in the section 361 exchange or satisfied in connection with the reorganization (within the meaning of section 361(c)(3)), but only if the payment of such liability would give rise to a deduction.

(4) *Gross fair market value* means fair market value determined without regard to mortgages, liens, pledges, or other liabilities. The fair market value of any property subject to a nonrecourse indebtedness shall not be less than the amount of such indebtedness.

(5) *Inside basis* is the amount equal to the aggregate bases of the section 367(a) property transferred by the U.S. transferor in the section 361 exchange, increased by

any gain recognized by the U.S. transferor on the transfer of such property in the section 361 exchange, including gain treated as a dividend under section 1248(a), but not including any gain recognized under paragraph (c)(2) of this section (including any such gain treated as a dividend under section 1248(a)).

(6) *Inside gain* is the amount by which the aggregate gross fair market value of the section 367(a) property transferred in the section 361 exchange exceeds the sum of the inside basis and the product of the section 367(a) percentage and the aggregate deductible liabilities of the U.S. transferor.

(7) *Outside gain (or loss)* is the product of the section 367(a) percentage and the amount by which—

(i) The aggregate fair market value of the stock received (or deemed received) by a control group member in exchange for stock or securities of the U.S. transferor under section 354, 355, or 356; is greater than (or less than),

(ii) The control group member's aggregate section 358 basis of such stock (as determined without regard to any adjustment to such basis required under paragraph (c)(3) of this section).

(8) *Section 367(a) percentage* is the ratio of the aggregate gross fair market value of the section 367(a) property transferred by the U.S. transferor in the section 361 exchange to the aggregate gross fair market value of all property transferred by the U.S. transferor in the section 361 exchange.

(9) *Section 367(a) property*—(i) *General rule*. Except as provided in paragraph (f)(9)(ii) of this section, *section 367(a) property* is any property other than section 367(d) property.

(ii) *Special rule*. Any property that would otherwise constitute section 367(a) property under paragraph (f)(9)(i) of this section shall not constitute section 367(a) property for purposes of any determination under this section for which the amount of section 367(a) property transferred in the section 361 exchange is relevant, if such property is acquired by the U.S. transferor in connection with the section 361 exchange with a principal purpose of affecting any such determination, including, for example, the section 367(a) percentage, inside gain, and inside basis.

(10) *Section 367(d) property* is property to which section 367(d) applies.

(11) *Timely-filed return* is a U.S. income tax return filed on or before the due date set forth in section 6072(b), plus any extension of time to file such return granted under section 6081.

(g) *Examples*. The rules of this section are illustrated by the following examples. The analysis of the following examples is limited to a discussion of issues under this section. Unless otherwise indicated, for purposes of the following examples assume: DP1, DP2, and DC are domestic corporations that do not join in the filing of a consolidated return; FP and FA are foreign corporations that are unrelated to DP1, DP2, and DC; each corporation has a single class of stock outstanding; each shareholder of DC owns one block of stock in DC; DC's Business A constitutes section 367(a) property that could qualify for the exception to section 367(a)(1) under §1.367(a)–2T; DC has no liabilities, and the requirements in paragraph (c)(5) of this section and §1.6038B–1(c)(6)(ii) are satisfied.

Example 1. Tainted assets and non-control group ownership. (i) *Facts.* DP1, DP2, and FP own 50%, 30%, and 20%, respectively, of the outstanding stock of DC. DP1's DC stock has a $120x basis and $100x fair market value. DP2's DC stock has a $50x basis and $60x fair market value. DC owns inventory with a $40x basis and a $100x fair market value. DC also owns Business A with a $10x basis and $100x fair market value. In a reorganization described in section 368(a)(1)(F), DC transfers the inventory and Business A to FA, a newly formed corporation, in exchange for all of the outstanding stock of FA. DC's transfer of the inventory and Business A to FA qualifies as a section 361 exchange. DP1, DP2, and FP exchange the DC stock for a proportionate amount of FA stock pursuant to section 354.

(ii) *Result.* (A) Under section 367(a)(3)(B), DC must recognize $60x gain on the transfer of the inventory to FA. Under §1.367(a)–1T(b)(4)(i)(B), the section 362 basis increase is allocated to the inventory such that FA's basis in the inventory is $100x. Under section 367(a)(5) and paragraph (b) of this section, DC's transfer of Business A to FA is subject to the general rule of section 367(a)(1). As a result, DC must also generally recognize $90x gain on the transfer of Business A to FA notwithstanding the application of section 351 or section 361. However, if the conditions and requirements of paragraph (c) of this section are met, DC's transfer of Business A to FA may be partially eligible for the active foreign trade or business exception provided by section 367(a)(3) and §1.367(a)–2T. See §1.367(a)–2T for the requirements of the active foreign trade or business exception.

(B) The requirement of paragraph (c)(1) of this section is satisfied because DC is controlled (within the meaning of section 368(c)) by DP1 and DP2 at the time of the section 361 exchange.

(C) Under paragraph (c)(2)(i) of this section, DC must recognize $18x gain on the transfer of Business A with respect to FP, a non-control group member. The $18x gain equals the product of the inside gain ($90x) and FP's 20% ownership interest (by value) in DC at the time of the section 361 exchange. Under paragraph (f)(6) of this section, the $90x inside gain is the amount by which the aggregate gross fair market value ($200x) of the section 367(a) property (the inventory and Business A) exceeds the $110x inside basis. Under paragraph (f)(5) of this section, the inside basis equals the $50x aggregate basis of the section 367(a) property transferred in the section 361 exchange, increased by the $60x gain recognized by DC on the transfer of the inventory to FA, but not by the $18x gain recognized by DC under paragraph (c)(2)(i) of this section with respect to FP. Under paragraph (e)(1) of this section, the $18x gain recognized under paragraph (c)(2)(i) of this section is treated as recognized with respect to Business A.

(D) DC is not required to recognize gain under paragraph (c)(2)(ii) of this section with respect to either DP1 or DP2. DP1's share of inside gain ($45x) does not exceed the product of the section 367(a) percentage (100%) and the fair market value of the FA stock ($100x) received in exchange for its DC stock. DP1's share of inside gain is determined based on its 50% ownership interest (by value) in DC at the time of the section 361 exchange. DP2's share of inside gain ($27x) does not exceed the product of the section 367(a) percentage (100%) and the fair market value of the FA stock ($60x) received in exchange for its DC stock. DP2's share of inside gain is determined based on its 30% ownership interest (by value) in DC at the time of the section 361 exchange.

(E) Under paragraph (c)(3) of this section, DP1's section 358 basis in the FA stock ($120x) received in exchange for its DC stock must be reduced by $65x, the amount by which DP1's share of inside gain ($45x) exceeds DP1's $20x outside gain. DP1's share of inside gain is determined based on its 50% ownership interest (by value) in DC at the time of the section 361 exchange. Because DC does not recognize gain on the section 361 exchange with respect to DP1, DP1's share of inside gain is not reduced under paragraph (c)(3)(i)(A) of this section. DP1's $20x outside loss equals the product of the section 367(a) percentage (100%) and the amount by which the fair market value ($100x) of the FA stock received by DP1 in exchange for its DC stock is less than the section 358 basis of such FA stock ($120x). As adjusted, DP1's basis in its FA stock is $55x. Similarly, under paragraph (c)(3) of this section, DP2's section 358 basis in the FA stock ($50x) received in exchange for its DC stock must be reduced by $17x, the amount by which DP2's share of inside gain ($27x) exceeds DP1's $10x outside gain. DP2's share of inside gain is determined based on its 30% ownership interest (by value) in DC at the time of the section 361 exchange. Because DC does not recognize gain on the section 361 exchange with respect to DP2, DP2's share of inside gain is not reduced under paragraph (c)(3)(i)(A) of this section. DP2's $10x outside gain equals the product of the section 367(a) percentage (100%) and the amount by which the fair market value ($60x) of the FA stock received by DP2 in exchange for its DC stock is greater than the section 358 basis of such stock ($50x). As adjusted, DP2's basis in its FA stock is $33x.

(F) Under paragraph (c)(4) of this section, DC must comply with the requirements of §1.6038B–1(c)(6)(iii).

Example 2. Triangular reorganization involving the exchange of section 367(d) property for stock and cash. (i) *Facts.* (A) DP1 wholly owns DC. DP1 and DC file a consolidated return. DP1's DC stock has a $175x basis and $200x fair market value. DC owns Business A ($10x basis and $150x fair market value) and a patent ($0x basis and $50x fair market value). The patent is section 367(d) property. FP wholly owns FA.

(B) In a triangular reorganization described in section 368(a)(1)(A) by reason of section 368(a)(2)(D), DC transfers Business A and the patent to FA in exchange for $180x of FP stock and $20x cash. DC's transfer of Business A and the patent to FA is a section 361 exchange. DP1 exchanges its DC stock for the $180x of FP stock and the $20x cash pursuant to section 356. The triangular reorganization constitutes an indirect stock transfer under §1.367(a)–3(d)(1)(i), and DP1 files a gain recognition agreement under §1.367(a)–8 with respect to such transfer.

(ii) *Result.* (A) Under section 367(a)(5) and paragraph (b) of this section, DC's transfer of Business A to FA is subject to the general rule of section 367(a)(1). As a result, DC must generally recognize $140x gain on the transfer of Business A to FA notwithstanding the application of section 361. However, if the requirements of paragraph (c) of this section are satisfied, DC's transfer of Business A to FA may be eligible for the active foreign trade or business exception provided by section 367(a)(3) and §1.367(a)–2T. See §1.367(a)–2T for the requirements of the active foreign trade or business exception. For rules applicable to DC's transfer of the patent to FA, see section 367(d) and the regulations under that section.

(B) The requirement of paragraph (c)(1) of this section is satisfied because DC is controlled (within the meaning of section 368(c)) by DP1 at the time of the section 361 exchange.

(C) DC is not required to recognize gain under paragraph (c)(2)(i) of this section because at the time of the section 361 exchange DC is wholly owned by DP1, a control group member. Under paragraph (c)(2)(ii) of this section, DC must recognize $5x gain, the amount by which the product of the inside gain ($140x) and DP1's 100% ownership interest (by value) in DC at the time of the section 361 exchange exceeds the product of the section 367(a) percentage (75%) and the fair market value ($180x) of the FP stock received by DP1 in exchange for DC stock. The $140x inside gain equals the aggregate gross fair market value of Business A ($150x) less the inside basis ($10x). Under paragraph (e)(1) of this section, the $5x gain recognized is allocated to Business A. Under §1.1502–32(b)(2), DP1 increases the basis of its DC stock by $5x.

(D) Under paragraph (c)(3) of this section, DP1's section 358 basis ($180x) in the FP stock ($180x basis of DC stock, decreased by $20x cash received, and increased by the $20x gain recognized under section 356) is reduced by $135x, the amount by which the product of the $140x inside gain, reduced by the $5x recognized by DC under paragraph (c)(2)(ii) ($135x) and DP1's 100% ownership interest (by value) in DC at the time of the exchange exceeds DP1's outside gain ($0x). The $0x outside gain equals the product of the section 367(a) percentage (75%) and the amount by which the fair market value of the FP stock received by DP1 ($180x) is greater than the section 358 basis of such stock ($180x). As adjusted, DP1's basis in the FP stock is $45x.

(E) Under paragraph (c)(4)(i) of this section, DC must comply with the requirements of §1.6038B–1(c)(6)(iii).

Example 3. Adjustment to basis of multiple blocks of stock. (i) *Facts.* (A) DP1 wholly owns DC. DP1's DC stock is divided into two blocks of stock (Block 1 and Block 2). Block 1 has a $60x basis and $100x fair market value. Block 2 has a $120x basis and $100x fair market value. DC owns Business A ($15x basis and $150x fair market value) and a patent ($0x basis and $50x fair market value). The patent is section 367(d) property.

(B) In a reorganization described in section 368(a)(1)(F), DC transfers Business A and the patent to FA, a newly-formed corporation, in exchange for 2 shares of FA stock. DC's transfer of Business A and the patent to FA qualifies as a section 361 exchange. DP1 exchanges Block 1 and Block 2 for the two shares of FA stock pursuant to section 354. Pursuant to §1.358–2(a)(2)(i), one share of the FA stock corresponds to Block 1 (Share 1) and the other share of FA stock corresponds to Block 2 (Share 2). The basis and holding period of Share 1 and Share 2 correspond to the basis and holding period of Block 1 and Block 2, respectively.

(ii) *Result.* (A) Under section 367(a)(5) and paragraph (b) of this section, DC's transfer of Business A to FA is subject to the general rule of section 367(a)(1). As a result, DC must generally recognize $135x gain on the transfer of Business A to FA notwithstanding the application of section 351 or section 361. However, if the requirements of paragraph (c) of this section are met, DC's transfer of Business A to FA may be eligible for the active foreign trade or business exception provided in section 367(a)(3). See §1.367(a)–2T for the requirements of the active foreign trade or business exception. For rules applicable to DC's transfer of the patent to FA, see section 367(d) and the regulations under that section.

(B) The requirement of paragraph (c)(1) of this section is satisfied because DC is controlled (within the meaning of section 368(c)) by DP1 at the time of the section 361 exchange.

(C) DC is not required to recognize gain under paragraph (c)(2)(i) of this section because, at the time of the section 361 exchange, DC is wholly owned by DP1. DC is not required to recognize gain under paragraph (c)(2)(ii) of this section because DP1's 100% share of inside gain ($135x) does not exceed the product of the section 367(a) percentage (75%) and the fair market value ($200x) of the FA stock received by DP1 in exchange for its DC stock ($150x). Under paragraph (f)(6) of this section, the $135x inside gain equals the aggregate gross fair market value of the section 367(a) property ($150x) less the inside basis ($15x).

(D) Under paragraph (c)(3) of this section, DP1's aggregate section 358 basis in Share 1 ($60x) and Share 2 ($120x) must be reduced by $120x, the amount by which DP1's 100% share of inside gain ($135x) exceeds DP1's $15x outside gain. The $15x outside gain equals the product of the section 367(a) percentage (75%) and the amount by which the fair market value of the FA stock received by DP1 ($200x) is greater than the section 358 basis of the FA stock ($180x) (75% of $20x).

(E) Under paragraph (c)(3)(ii)(B) of this section, the $120x reduction to basis is allocated between Share 1 and Share 2 based on the relative section 358 basis of each share. Therefore, the basis in Share 1 is reduced by $40x ($120x multiplied by $60x/$180x). As adjusted, DP1's basis in Share 1 is $20x. The basis in Share 2 is reduced by $80x ($120x multiplied by $120x/$180x). As adjusted, DP1's basis in Share 2 is $40x.

(F) Under paragraph (c)(4)(i) of this section, DC must comply with the requirements of §1.6038B–1(c)(6)(iii).

(h) *Applicable cross-references.* For rules relating to the character, source, and adjustments resulting from gain recognized by a U.S. transferor under section 367(a), see §1.367(a)–1T(b)(4). For rules relating to the acquisition of the stock or assets of a foreign corporation by another foreign corporation, see §1.367(b)–4. For rules relating to transfers of section 367(d) property by a U.S. transferor to a foreign corporation, see section 367(d) and the regulations under that section. For rules relating to distributions of stock of a foreign corporation by a domestic corporation under section 355 or 361, see §§1.1248(f)–1 through –3. For additional rules relating to certain reporting requirements of a U.S. transferor, see §1.6038B–1.

(i) [Reserved.]

(j) *Effective/applicability date.* This section shall apply to transfers occurring on or after the date 30 days after the date these regulations are published as final regulations in the **Federal Register**.

Par. 6. Section 1.367(b)–4 is amended by:

1. Revising paragraphs (b)(1)(i)(B)(*2*), (b)(1)(ii), and (b)(1)(iii), *Example 4* (ii).

2. Adding paragraph (b)(1)(iii), *Example 5*.

The revisions and additions to read as follows:

§1.367(b)–4 Acquisition of foreign corporate stock or assets by a foreign corporation in certain nonrecognition transactions.

* * * * *

(b) * * *

(1) * * * (i) * * *

(B) * * *

(*2*) Immediately after the exchange, the foreign acquiring corporation or the for-

eign acquired corporation (if any, such as in the case of the acquisition of the stock of a foreign acquired corporation) is not a controlled foreign corporation as to which the United States person described in paragraph (b)(1)(i)(A) of this section is a section 1248 shareholder.

(ii) *Special rules for certain triangular reorganizations*—(A) *Exception for receipt of domestic stock*. In the case of a triangular reorganization described in §1.358–6(b)(2), or a reorganization described in section 368(a)(1)(G) and (a)(2)(D), an exchange is not described in paragraph (b)(1)(i) of this section if—

(*1*) The stock received in the exchange is stock of a domestic corporation that immediately after the exchange is a section 1248 shareholder of—

(*i*) The foreign acquired corporation, in the case of a triangular B reorganization or a reorganization in which stock of the foreign acquired corporation is acquired pursuant to a transfer to which the exception provided in §1.367(a)–7(c) applies; or

(*ii*) The surviving corporation, in the case of a transaction that is not described in paragraph (b)(1)(ii)(A)(*1*)(*i*) of this section and that is a triangular C reorganization, a forward triangular merger, a reorganization described in section 368(a)(1)(G) and (a)(2)(D), or a reverse triangular merger; and

(*2*) The foreign acquired corporation or surviving corporation is a controlled foreign corporation. See paragraph (b)(1)(iii) of this section, *Example 3B* for an illustration of this rule.

(B) *Adjustments to basis of stock of foreign acquiring corporation*—(*1*) *Transfers to which exception under §1.367(a)–7(c) applies*. If the stock of the foreign acquired corporation is acquired by the foreign acquiring corporation pursuant to a triangular reorganization described in §1.358–6(b)(2)(i) through (iii), or a reorganization described in section 368(a)(1)(G) and (a)(2)(D), to which the exception provided in §1.367(a)–7(c) applies and that is not described in paragraph (b)(1)(i) of this section, the corporation (foreign or domestic) that controls the foreign acquiring corporation shall apply the principles of §1.367(b)–13 to adjust the basis of the stock of the foreign acquiring corporation so that the section 1248 amount attributable to the stock of the foreign acquired corporation (determined when the foreign acquiring corporation acquires such stock) is reflected in the stock of the foreign acquiring corporation immediately after the exchange. See paragraph (b)(1)(iii) of this section, *Example 5*, for an illustration of this rule.

(*2*) *Other triangular reorganizations*. See §1.367(b)–13(c) for rules regarding the adjustment to the basis of the stock of the foreign acquiring corporation in other triangular reorganizations described in paragraph (b)(1)(ii)(A)(*1*)(*ii*) of this section.

(iii) * * *

Example 4. * * *

(ii) *Result*. DC2, the exchanging shareholder, is a U.S. person and a section 1248 shareholder with respect to FC2, the foreign acquired corporation. Whether DC2 is required to include in income the section 1248 amount attributable to the FC2 stock under paragraph (b)(1)(i) of this section depends on whether, immediately after DC2's exchange of the FC2 stock for FC1 stock (and before the distribution of the FC1 stock to DC1 under section 361(c)(1)), FC1 and FC2 are controlled foreign corporations as to which DC2 is a section 1248 shareholder. If, immediately after the exchange, FC1 and FC2 are both controlled foreign corporations as to which DC2 is a section 1248 shareholder, then DC2 is not required to include in income the section 1248 amount attributable to the FC2 stock under paragraph (b)(1)(i) because neither condition in paragraph (b)(1)(i)(B) is satisfied. Alternatively, if immediately after the exchange either FC1 or FC2 is not a controlled foreign corporation as to which DC2 is a section 1248 shareholder then, pursuant to paragraph (b)(1)(i) of this section, DC2 must include in income the section 1248 amount attributable to the FC2 stock exchanged. For the treatment of DC2's transfer of assets to FC1, see also section 367(a)(1) and (a)(3) and the regulations under that section. Because DC2's transfer of assets to FC1 is described in section 361(a) or (b), see section 367(a)(5) and §1.367(a)–7. If any of the assets transferred are intangible assets, see section 367(d) and the regulations under that section. With respect to DC2's distribution of the FC1 stock to DC1 under section 361(c)(1), see section 1248(f)(1), §1.1248(f)–1 and §1.1248(f)–2.

Example 5. (i) *Facts*. DC1, a domestic corporation, wholly owns DC2, a domestic corporation. DC1's DC2 stock has a $30 basis and a $100 fair market value. DC2's only asset is all the outstanding stock of FC2, a foreign corporation. DC2's FC2 stock has a $30 basis, $100 fair market value and a $20 section 1248 amount. USP, a domestic corporation unrelated to DC1, DC2 or FC2, wholly owns FC1, a foreign corporation. In a triangular reorganization described in section 368(a)(1)(C), DC2 transfers all the FC2 stock to FC1 in exchange solely for voting stock of USP and then distributes the USP stock to DC1 under section 361(c)(1). DC1 exchanges its DC2 stock for the USP stock under section 354. DC2's transfer of the FC2 stock to FC1 is described in section 361(a) and therefore, under section 367(a)(5) and §1.367(a)–7, is generally subject to section 367(a)(1). However, DC2's transfer of the FC2 stock to FC1 qualifies for the exception provided in §1.367(a)–7(c). DC1 and DC2 elect to apply the rules of §1.367(a)–7(c) in accordance with §1.367(a)–7(c)(5). DC1 is not required to adjust the basis of its USP stock (determined under section 358) under section 367(a)(5) and §1.367(a)–7(c)(3).

(ii) *Result*. Under paragraph (b)(1)(ii)(A) of this section, because the stock received by DC2 in exchange for its FC2 stock is stock of a domestic corporation (USP) and, immediately after the exchange, USP is a section 1248 shareholder of FC2 (the foreign acquired corporation) and FC2 is a controlled foreign corporation, DC2's exchange of its FC2 stock for USP stock is not described in paragraph (b)(1)(i) of this section. Therefore, DC2 is not required to include in income the section 1248 amount attributable to the FC2 stock. Under paragraph (b)(1)(ii)(B)(*1*) of this section, USP must apply the principles of §1.367(b)–13 to adjust the basis of its FC1 stock so that the $20 section 1248 amount attributable to the FC2 stock at the time of the exchange is reflected in the FC1 stock immediately after the exchange. Under the principles of §1.367(b)–13, each share of FC1 stock held by USP after the exchange must be divided into one portion attributable to the FC1 stock immediately before the exchange and one portion attributable to the FC2 stock acquired in the exchange. The $30 basis in the FC2 stock and the earnings and profits attributable to the FC2 stock before the exchange are attributable to the divided portions of the FC1 stock to which the FC2 stock relates.

* * * * *

Par. 7. Section 1.367(b)–6 is amended by revising paragraph (a)(1) to read as follows:

§1.367(b)–6 Effective dates and coordination rules.

(a) *Effective date*—(1) *In general*—(A) Except as otherwise provided in this paragraph (a)(1) and paragraph (a)(2) of this section, §§1.367(b)–1 through 1.367(b)–5, and this section, apply to section 367(b) exchanges that occur on or after February 23, 2000.

(B) The rules of §§1.367(b)–3 and 1.367(b)–4, as they apply to reorganizations described in section 368(a)(1)(A) (including reorganizations described in section 368(a)(2)(D) or (E)) involving a foreign acquiring or foreign acquired corporation, apply only to transfers occurring on or after January 23, 2006.

(C) The second sentence of paragraph (a) in §1.367(b)–4 applies to section 304(a)(1) transactions occurring on or after February 23, 2006; however, taxpayers may rely on this sentence for all section 304(a)(1) transactions occurring in open taxable years.

(D) Section 1.367(b)–1(c)(2)(v), (c)(3)(ii)(A), (c)(4)(iv), (c)(4)(v),

§1.367(b)–2(j)(1)(i), (l), and §1.367(b)–3(e) and (f), apply to section 367(b) exchanges that occur on or after November 6, 2006. For guidance with respect to §1.367(b)–1(c)(3)(ii)(A) and (c)(4)(iv) and (v) and §1.367(b)–2(j)(1)(i) for exchanges that occur before November 6, 2006, see 26 CFR part 1 revised as of April 1, 2006.

(E) Section 1.367(b)–4(b)(1)(ii) and §1.367(b)–4(b)(1)(iii), *Examples 4* and *5* apply to section 367(b) exchanges that occur on or after the date that is 30 days after the date these regulations are published as final regulations in the **Federal Register**. For guidance with respect to §1.367(b)–4(b)(1)(ii) and §1.367(b)–4(b)(1)(iii), *Example 4*, for exchanges that occur before the date 30 days after the date these regulations are published as final regulations in the **Federal Register**, see 26 CFR part 1 revised as of April 1 for the year before the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

Par. 8. For each entry in the table in the "Section" column, remove the language in the "Remove" column and add the language in the "Add" column in its place.

Section	Remove	Add
1.1248–1(a)(1), second to last sentence	1248(f)	1248(g)
1.1248–1(a)(1), last sentence	1248(g)	1248(h)
1.1248–3(a)(6), first sentence	1.1248–4	1.1248–2
1.1248–3(a)(6), first sentence	1.1248–7	1.1248–8
1.1248–7(a)(1), second to last sentence	1248(g)	1248(h)

Par. 9. Section 1.1248–1 is amended by:

1. Revising paragraphs (b) and (e).

2. Revising the second sentence of paragraph (c).

The revisions to read as follows.

§1.1248–1 Treatment of gain from certain sales or exchanges of stock in certain foreign corporations.

* * * * *

(b) *Sale or exchange.* For purposes of this section and §§1.1248–2 through 1.1248–8, the term *sale or exchange* includes the receipt of a distribution that is treated as in exchange for stock under section 302(a) (relating to distributions in redemption of stock) or section 331(a) (relating to distributions in complete liquidation of a corporation).

(c) * * * Thus, for example, if a United States person exchanges stock in a foreign corporation and no gain is recognized on such exchange under section 332, 351, 354, 355, or 361, taking into account the application of section 367, then no amount is includible in the gross income of such person as a dividend under section 1248(a).

* * * * *

(e) *Exceptions.* Under section 1248(g), this section and §§1.1248–2 through 1.1248–8 shall not apply to:

(1) Distributions to which section 303 (relating to distributions in redemption of stock to pay death taxes) applies; or

(2) Any amount to the extent that such amount is, under any other provision of the Internal Revenue Code (Code), treated as (i) a dividend, (ii) gain from the sale of an asset which is not a capital asset, or (iii) gain from the sale of an asset held for not more than 1 year.

* * * * *

Par. 10. Section 1.1248–6 is amended by:

1. Adding a new sentence at the end of paragraph (a).

2. Adding paragraphs (d) and (e).

The additions to read as follows:

§1.1248–6 Sale or exchange of stock in certain domestic corporations.

(a) * * * See paragraph (d) of this section for a rule suspending the application of this section in certain circumstances.

* * * * *

(d) *Temporary suspension of section 1248(e).* Section 1248(e) and the rules of this section shall not apply to a sale, exchange, or other disposition of the stock of a domestic corporation during a period when capital gains are taxed at a rate that equals or exceeds the rate at which ordinary income is taxed.

(e) *Effective/applicability date.* Paragraph (d) of this section shall apply to a sale, exchange, or other disposition of the stock of a domestic corporation on or after September 21, 1987.

Par. 11. Section 1.1248–8 is amended by:

1. Revising paragraphs (a)(3), (b)(1)(iv)(A), (b)(2)(i), and (d).

2. Adding new paragraph (b)(2)(iv).

The revisions and addition to read as follows:

§1.1248–8 Earnings and profits attributable to stock following certain non-recognition transactions.

(a) * * *

(3) *Application of section 381.* Stock of a foreign corporation that receives assets in a transfer to which section 361(a) or (b) applies in connection with a reorganization described in section 368(a)(1)(A), (C), (D), (F), or (G), or in a distribution to which section 332 applies, and to which section 381(c)(2)(A) and §1.381(c)(2)–1(a) apply. See paragraph (b)(6) of this section; or

* * * * *

(b) * * *

(1) * * *

(iv) * * *

(A) In a restructuring transaction qualifying as a nonrecognition transaction within the meaning of section 7701(a)(45) and described in section 354, 356, or 361(a) or (b), stock in an acquired corporation for stock in either a foreign acquiring corporation or a foreign corporation that

is in control, within the meaning of section 368(c), of an acquiring corporation (whether domestic or foreign); or

* * * * *

(2) * * *

(i) *Exchanging shareholder exchanges property that is not stock of a foreign acquired corporation with respect to which the exchanging shareholder is a section 1248 shareholder or a foreign corporate shareholder*. Except as provided in paragraph (b)(2)(iv) of this section, where the exchanging shareholder exchanges in a restructuring transaction property that is not stock of a foreign acquired corporation with respect to which the exchanging shareholder is a section 1248 shareholder or a foreign corporate shareholder immediately before such transaction, the earnings and profits attributable to the stock that the exchanging shareholder receives in the restructuring transaction shall be determined in accordance with §1.1248–2 or §1.1248–3, whichever is applicable, without regard to any portion of the section 1223(1) holding period in that stock that is before the restructuring transaction. See paragraph (b)(7) *Example 1* of this section.

* * * * *

(iv) *Exchanging shareholder exchanges stock of a domestic acquired corporation for stock of a foreign corporation with respect to which the exchanging shareholder is a section 1248 shareholder after the exchange*. If in a restructuring transaction described in §1.1248(f)–2(c) and to which the exception provided by §1.1248(f)–2(c)(1) applies, the earnings and profits attributable to a portion of a share of stock of a foreign corporation created pursuant to §1.1248(f)–2(c)(2) (or a whole share, if no division is required) shall be determined pursuant to paragraphs (b)(2)(iv)(A) and (B) of this section.

(A) The earnings and profits attributable to a portion of a share of stock created pursuant to §1.1248(f)–2(c)(2)(i) (or a whole share, if no division is required) shall be the earnings and profits attributable to the stock of the foreign corporation received by the section 1248 shareholder under section 354, 355, or 356 determined in accordance with §1.1248–2 or §1.1248–3, whichever is applicable, without regard to any portion of the section 1223(1) holding period in that stock that is before the restructuring transaction.

(B) The earnings and profits attributable to a portion of a share of stock created under §1.1248(f)–2(c)(2)(ii) (or whole share, if no division is required) shall be the sum of—

(*1*) The earnings and profits attributable to the stock of the foreign corporation transferred in the section 361 exchange that relates to such portion (or share) multiplied by the section 1248 shareholder's ownership interest (by value) in the domestic distributing corporation at the time of the restructuring transaction; and

(*2*) The earnings and profits attributable to the stock of the foreign corporation received by the section 1248 shareholder under section 354, 355, or 356 determined in accordance with §1.1248–2 or §1.1248–3, whichever is applicable, without regard to any portion of the section 1223(1) holding period in that stock that is before the restructuring transaction. See §1.1248(f)–2(d), *Examples 2* through *4*.

* * * * *

(d) *Effective/applicability dates*—(1) *General rule*. Except as provided in paragraph (d)(2) of this section, this section applies to income inclusions that occur on or after July 30, 2007.

(2) *Exception*. Paragraph (b)(2)(iv) of this section applies to restructuring transactions occurring on or after the date 30 days after the date these regulations are published as final regulations in the **Federal Register**.

Par. 12. Section 1.1248(f)–1 is added to read as follows:

§1.1248(f)–1 Certain nonrecognition distributions.

(a) *Scope and purpose*. This section and §§1.1248(f)–2 and 1.1248(f)–3 provide rules that apply when a domestic corporation (domestic distributing corporation) distributes stock of a foreign corporation (foreign distributed corporation) in a distribution to which section 337, 355, or 361 applies. The purpose of this section is to confirm the general rule of section 1248(f)(1) that requires the domestic distributing corporation to include in gross income the section 1248 amount or section 1248(f) amount, as applicable, that is attributable to the stock of the foreign distributed corporation distributed under section 337, 355, or 361, and to provide exceptions to the general rule to the extent the section 1248 amount or section 1248(f) amount, as applicable, can be preserved immediately following the distribution in the hands of a distributee that is a domestic corporation. This section provides the general rule and definitions. Section 1.1248(f)–2 provides the exceptions to the general rule. Section 1.1248(f)–3 provides a reasonable cause exception for a failure to comply with certain requirements of §1.1248(f)–2. Section 1.1248(f)–3 also provides the effective dates of this section and §1.1248(f)–2.

(b) *General rule*—(1) *Section 337 distributions*. Except as provided in §1.1248(f)–2(a), a domestic distributing corporation that is a section 1248 shareholder of a foreign distributed corporation and that distributes stock of such corporation in a distribution to which section 337 applies (section 337 distribution), shall, notwithstanding any other provision of subtitle A, include in gross income as a dividend the section 1248 amount attributable to the distributed stock. This paragraph (b)(1) shall apply only to the extent the domestic distributing corporation does not recognize gain on the section 337 distribution under any other provision of subtitle A.

(2) *Certain section 355 distributions*. Except as provided in §1.1248(f)–2(b), a domestic distributing corporation that is a section 1248 shareholder of a foreign distributed corporation and that distributes stock of such corporation, other than stock received in a section 361 exchange, in a distribution to which section 355 applies (section 355 distribution), shall, notwithstanding any other provision of subtitle A, include in gross income as a dividend the section 1248 amount attributable to the distributed stock. This paragraph (b)(2) shall apply only to the extent the domestic distributing corporation does not recognize gain on the section 355 distribution under any other provision of subtitle A.

(3) *Distributions pursuant to a plan of reorganization*. Except as provided in §1.1248(f)–2(c), a domestic distributing corporation that is a section 1248 shareholder of a foreign distributed corporation and that distributes stock of such corporation received in a section 361 exchange in a section 355 distribution or a distribution to which section 361 applies (section 361 distribution), shall, notwithstanding any other provision of subtitle A, include in

gross income as a dividend the section 1248(f) amount attributable to the stock distributed. This paragraph (b)(3) shall apply without regard to the amount of gain realized by the domestic distributing corporation on the distribution.

(c) *Definitions*. Except as otherwise provided, the following definitions apply for purposes of this section and §§1.1248(f)–2 and 1.1248(f)–3.

(1) *80-percent distributee* is a corporation described in section 337(c).

(2) *Block of stock* has the meaning set forth in §1.1248–2(b).

(3) *Distributee* is a shareholder of the domestic distributing corporation that receives stock of a foreign distributed corporation in a section 355 distribution or section 361 distribution.

(4) *Postdistribution amount* is the section 1248 amount attributable to the stock of a foreign distributed corporation received (or deemed received) by a distributee, computed immediately after the distribution but without taking into account any adjustments to the basis of such stock under §1.1248(f)–2(b)(3) or (c)(3). The postdistribution amount attributable to stock of a foreign distributed corporation received in a section 355 distribution described in paragraph (b)(2) of this section shall be determined based on the distributee's holding period in such stock as adjusted under §1.1248(f)–2(b)(2). The postdistribution amount attributable to stock of a foreign distributed corporation received in a section 355 distribution or section 361 distribution described in paragraph (b)(3) of this section shall be determined after applying the rules in §§1.1248–8(b)(2)(iv) and 1.1248(f)–2(c)(2).

(5) *Section 358 basis* is the basis of stock determined under section 358 and the regulations under that section.

(6) *Section 361 exchange* is an exchange described in section 361(a) or (b).

(7) *Section 1248 amount* is the net positive earnings and profits (if any) attributable to the stock of the foreign distributed corporation under §1.1248–2 or §1.1248–3 (as adjusted by §1.1248–8) and that would be included in gross income as a dividend under section 1248(a) if the stock were sold by the holder of such stock.

(8) *Section 1248(f) amount* is the aggregate amount of the net positive earnings and profits (if any) attributable to the stock of each foreign corporation, under §1.1248–2 or §1.1248–3 (as adjusted by §1.1248–8), transferred by the domestic distributing corporation to the foreign distributed corporation in the section 361 exchange that precedes the section 355 distribution or section 361 distribution of the stock of the foreign distributed corporation, and that would be included in gross income as a dividend under section 964(e) by the foreign distributed corporation if it sold such stock immediately after the section 361 exchange. The section 1248(f) amount is attributable to the stock of the foreign distributed corporation received in the section 361 exchange.

(9) *Section 1248 shareholder* is a domestic corporation that satisfies the ownership requirements of section 1248(a)(2) with respect to a foreign corporation.

(10) *Timely-filed return* is a U.S. income tax return filed on or before the due date set forth in section 6072(b), plus any extension of time to file such return granted under section 6081.

Par. 13. Section 1.1248(f)–2 is added to read as follows:

§1.1248(f)–2 Exceptions for certain distributions.

(a) *Section 337 distributions*. Section 1.1248(f)–1(b)(1) shall not apply to a section 337 distribution of stock of the foreign distributed corporation if the conditions of paragraphs (a)(1) through (a)(3) of this section are satisfied.

(1) *80-percent distributee is a section 1248 shareholder*. Immediately after the section 337 distribution, the 80-percent distributee is a section 1248 shareholder with respect to the foreign distributed corporation.

(2) *Holding period*. The 80-percent distributee is treated as holding the stock of the foreign distributed corporation received in the section 337 distribution for the period during which the stock was held by the domestic distributing corporation.

(3) *Basis*. The 80-percent distributee's basis in the stock of the foreign distributed corporation received in the section 337 distribution does not exceed the domestic distributing corporation's basis in such stock at the time of the section 337 distribution.

(b) *Certain section 355 distributions*. Section 1.1248(f)–1(b)(2) shall not apply to a section 355 distribution of stock of the foreign distributed corporation not received by the domestic distributing corporation in a section 361 exchange to a distributee that is a section 1248 shareholder with respect to the foreign distributed corporation immediately after the distribution, if the domestic distributing corporation and all such section 1248 shareholders elect to apply the provisions of this paragraph (b) in accordance with paragraph (b)(1) of this section. See paragraphs (b)(2) and (b)(3) of this section for adjustments that occur as a result of electing to apply the provisions of this paragraph (b).

(1) *Election and reporting*—(i) *Statement required by section 1248 shareholders and domestic distributing corporation*—(A) *In general*. The domestic distributing corporation and the section 1248 shareholders elect to apply the provisions of paragraph (b) of this section by each including a statement, described in paragraph (b)(1)(i)(B) of this section, with its timely-filed return for the taxable year during which the section 355 distribution occurs and by entering into a written agreement described in paragraph (b)(1)(ii) of this section. If the domestic distributing corporation or a section 1248 shareholder is a member of a consolidated group at the time of the section 355 distribution, the common parent of the consolidated group makes the election on behalf of the domestic distributing corporation or section 1248 shareholder. The election made under this paragraph (b)(1) is irrevocable.

(B) *Form and content*. The statement of election must be entitled, STATEMENT TO ELECT TO APPLY EXCEPTION UNDER §1.1248(f)–2(b). The statement must state that the domestic distributing corporation and each section 1248 shareholder have entered into a written agreement described in paragraph (b)(1)(ii) of this section and must set forth the adjustment to each section 1248 shareholder's holding period or section 358 basis (if any) in the stock of the foreign distributed corporation received in the section 355 distribution required under paragraph (b)(2) or (b)(3) of this section.

(ii) *Written agreement*. The domestic distributing corporation and the section 1248 shareholders must enter into a written agreement described in this paragraph (b)(1)(ii) on or before the due date (including extensions) of the domestic distribut-

ing corporation's U.S. income tax return for the taxable year during which the section 355 distribution occurs. Each party to the agreement must retain the original or a copy of the agreement as part of its records in the manner specified by §1.6001–1(e). Each party to the agreement must provide a copy of the agreement to the Internal Revenue Service within 30 days of the receipt of a request for the agreement in connection with an examination of the taxable year during which the section 355 distribution occurs. The agreement must—

(A) State the document is an agreement under paragraph (b)(1)(ii) of this section;

(B) Identify the domestic distributing corporation and each section 1248 shareholder;

(C) With respect to each section 1248 shareholder, state the holding period in the stock of the foreign distributed corporation received in the section 355 distribution as adjusted under paragraph (b)(2) of this section; and

(D) With respect to each section 1248 shareholder, identify the section 358 basis of the stock of the foreign distributed corporation received in the section 355 distribution and the adjustment (if any) to such basis under paragraph (b)(3) of this section.

(2) *Holding period adjustment*. For purposes of section 1248, immediately after the section 355 distribution, each section 1248 shareholder's holding period in the stock of the foreign distributed corporation received in the section 355 distribution shall equal the domestic distributing corporation's holding period in such stock at the time of the distribution.

(3) *Basis adjustments*. If the domestic distributing corporation's section 1248 amount attributable to the stock of the foreign distributed corporation received by a section 1248 shareholder in the section 355 distribution exceeds the section 1248 shareholder's postdistribution amount attributable to such stock (excess amount), the section 1248 shareholder's section 358 basis in such stock is reduced by such excess amount. For an illustration of the rule in this paragraph (b)(3), see paragraph (d) of this section, *Examples 1* and *4*.

(c) *Distributions pursuant to a plan of reorganization*. Section 1.1248(f)–1(b)(3) shall not apply to a section 355 distribution or section 361 distribution of stock of the foreign distributed corporation received by the domestic distributing corporation in the section 361 exchange that precedes the distribution, to a distributee that is a section 1248 shareholder with respect to the foreign distributed corporation immediately after the distribution, if the domestic distributing corporation and all such section 1248 shareholders elect to apply the provisions of this paragraph (c) in accordance with paragraph (c)(1) of this section. See paragraphs (c)(2) and (c)(3) of this section for the adjustments that result from electing to apply the provisions of this paragraph (c). The adjustments provided in paragraphs (c)(2) and (c)(3) of this section shall apply after any adjustments required under section 367(a)(5) and §1.367(a)–7(c). For illustrations of this exception, see paragraph (d) of this section, *Examples 2* through *4*.

(1) *Election and reporting*—(i) *Statement required by section 1248 shareholders and domestic distributing corporation*—(A) *In general*. The domestic distributing corporation and the section 1248 shareholders elect to apply the provisions of paragraph (c) of this section by each including a statement, in the form and with the content listed in paragraph (c)(1)(i)(B) of this section, with its timely-filed return for the taxable year during which the distribution occurs and by entering into a written agreement described in paragraph (c)(1)(ii) of this section. If the domestic distributing corporation or a section 1248 shareholder is a member of a consolidated group at the time of the distribution, the common parent of the consolidated group makes the election on behalf of the domestic distributing corporation or section 1248 shareholder. The election made under this paragraph (c)(1) is irrevocable.

(B) *Form and content*. The statement of election must be entitled, STATEMENT TO APPLY EXCEPTION UNDER §1.1248(f)–2(c). The statement must state that the domestic distributing corporation and each section 1248 shareholder have entered into a written agreement described in paragraph (c)(1)(ii) of this section and must describe, with respect to each section 1248 shareholder, the extent to which the shares of stock of the foreign distributed corporation received in the section 361 distribution are divided into portions under paragraph (c)(2) of this section and any adjustments to the section 358 basis of such stock under paragraph (c)(3) of this section.

(ii) *Written agreement*. The domestic distributing corporation and the section 1248 shareholders must enter into a written agreement described in this paragraph (c)(1)(ii) on or before the due date (including extensions) of the U.S. transferor's U.S. income tax return for the taxable year during which the distribution occurs. Each party to the agreement must retain the original or a copy of the agreement as part of its records in the manner specified by §1.6001–1(e). Each party to the agreement must provide a copy of the agreement to the Internal Revenue Service within 30 days of the receipt of a request for the agreement in connection with an examination of the taxable year during which the distribution occurs. The agreement must—

(A) State the document is an agreement under paragraph (c)(1)(ii) of this section;

(B) Identify the domestic distributing corporation and each section 1248 shareholder;

(C) With respect to each section 1248 shareholder, describe the extent to which the shares of stock of the foreign distributed corporation are divided into portions under paragraph (c)(2) of this section;

(D) With respect to each section 1248 shareholder, state the amount of any adjustment to the section 358 basis of the stock of the foreign distributed corporation under paragraph (c)(3) of this section; and

(E) With respect to each section 1248 shareholder, state the amount of earnings and profits attributable to the stock of the foreign distributed corporation received in the distribution. See §1.1248–8(b)(2)(iv).

(2) *Portions*. If the domestic distributing corporation transfers property to the foreign distributed corporation in the section 361 exchange that precedes the section 355 distribution or section 361 distribution, other than a single block of stock of a foreign corporation with respect to which the domestic distributing corporation is a section 1248 shareholder at the time of the section 361 exchange, then each share of stock of the foreign distributed corporation received by a section 1248 shareholder in the distribution must be divided into portions as follows:

(i) One portion attributable to all property transferred in the section 361 ex-

change, other than stock of a foreign corporation with respect to which the domestic distributing corporation is a section 1248 shareholder at the time of the section 361 exchange; and

(ii) One portion attributable to each block of stock of a foreign corporation transferred in the section 361 exchange with respect to which the domestic distributing corporation is a section 1248 shareholder at the time of the section 361 exchange. For the determination of the earnings and profits attributable to a portion of a share of stock of the foreign distributed corporation, see §1.1248–8(b)(2)(iv).

(3) *Basis adjustments*. If the section 1248(f) amount attributable to a portion of a share of stock (or whole share, if no division is required) of the foreign distributed corporation received (or deemed received) by a section 1248 shareholder in the distribution exceeds the section 1248 shareholder's postdistribution amount attributable to such portion (or whole share, if no division is required) (excess amount), then the section 1248 shareholder's section 358 basis in such portion (or whole share, if no division is required) as adjusted under §1.367(a)–7(c)(3), is reduced by such excess amount. For an illustration of this rule, see paragraph (d) of this section, *Example 3*.

(4) *Rules applicable to divided shares of stock*—(i) *Basis*. The basis of a portion of a share of stock of the foreign distributed corporation created under paragraph (c)(2) of this section is that amount of the section 1248 shareholder's section 358 basis (as adjusted under §1.367(a)–7(c)(3)) in the share of stock that bears the same ratio that the fair market value of the property received by the foreign distributed corporation in the section 361 exchange to which such portion relates bears to the aggregate fair market value of all property received by the foreign distributed corporation in the section 361 exchange. For illustrations of this rule, see paragraph (d) of this section, *Examples 2* and *3*.

(ii) *Fair market value*. The fair market value of a portion of a share of stock of the foreign distributed corporation created under paragraph (c)(2) of this section is that amount of the fair market value of the share of stock of the foreign corporation that bears the same ratio that the fair market value of the property received by the foreign distributed corporation in the section 361 exchange to which such portion relates bears to the aggregate fair market value of all property received by the foreign distributed corporation in the section 361 exchange. For illustrations of this rule, see paragraph (d) of this section, *Examples 2* and *3*.

(iii) *Rules for subsequent exchanges*. For purposes of determining the gain realized on the sale or exchange of a share of stock of the foreign distributed corporation that has a divided portion pursuant to paragraph (c)(2) of this section, the amount realized on the sale or exchange of such share shall be allocated to each divided portion based on the relative fair market value of the property to which such portion relates as determined at the time of the section 361 exchange.

(iv) *Duration of divided shares*. Shares of stock of the foreign distributed corporation that are divided into portions under paragraph (c)(2) of this section are not required to be divided as of the date on which section 1248(a) would not apply to a sale or exchange of such shares.

(d) *Examples*. The rules of this section are illustrated by the following examples. The analysis of the examples is limited to a discussion of issues under this section. For purposes of the examples, unless otherwise indicated, assume: DP1, DP2, DP3, DC, and USD are domestic corporations; X is a United States resident individual; FP and FA are foreign corporations that are not, and have never been, controlled foreign corporations; CFC1, CFC2, and FC are controlled foreign corporations; each corporation has a single class of stock outstanding and uses the calendar year as its taxable year; each shareholder owns a single block of stock in each corporation; DC owns Business A, which consists solely of section 367(a) property that could satisfy the requirements of the active foreign trade or business exception under section 367(a)(3) and §1.367(a)–2T; and DC owns no other assets and has no liabilities. Further assume the requirements in §1.367(a)–7(c)(5) are satisfied, any requirement to file a gain recognition agreement is satisfied, and no earnings and profits of a foreign corporation are described in section 1248(d).

Example 1. Section 355 distribution, gain recognition, and adjustment to stock basis—(i) *Facts*. DP1, FP, and X own 80%, 10%, and 10%, respectively, of the outstanding stock of USD. DP1's USD stock has a $140x basis, a $160x fair market value, and a 2 year holding period. USD wholly owns FC. USD's FC stock has a $50x basis, a $100x fair market value, a $25x section 1248 amount, and a 3 year holding period. On December 31, Year 3, USD distributes all of the FC stock to DP1, FP, and X on a *pro-rata* basis in a section 355 distribution. The fair market value of the FC stock received by DP1, FP and X is $80x, $10x, and $10x, respectively. After the distribution, DP1's section 358 basis in its FC stock is $70x.

(ii) *Result*. (A) Under §1.367(e)–1(b)(1), USD must recognize $5x gain on the distribution of FC stock to FP (10% of the $50x gain in the FC stock). Under §1.367(b)–5(b)(1)(ii), USD must recognize $5x gain on the distribution of FC stock to X (10% of the $50x gain in the FC stock). Of the aggregate $10x gain recognized by USD, $5x is recharacterized as a dividend under section 1248(a) (20% of the section 1248 amount ($25x) attributable to the FC stock). See §1.1248–1 for additional consequences.

(B) USD's distribution of FC stock to DP1 is described in section 1248(f)(1) and §1.1248(f)–1(b)(2). As a result, USD must generally include in gross income as a dividend the section 1248 amount attributable to such stock ($20x, or 80% of the $25x section 1248 amount). However, if DP1 and USD elect to apply the rules of paragraph (b) of this section (as provided in paragraph (b)(1) of this section), §1.1248(f)–1(b)(2) shall not apply to USD's distribution of FC stock to DP1. If DP1 and USD make that election, then:

(*1*) Under paragraph (b)(2) of this section, for purposes of section 1248, immediately after the distribution DP1 will have a 3 year holding period in the FC stock received in the section 355 distribution, the same holding period USD had in such stock at the time of the distribution.

(*2*) Under paragraph (b)(3) of this section, DP1's section 358 basis in the FC stock ($70x) received in the distribution is reduced by $10x, the amount by which USD's section 1248 amount ($20x) attributable to such FC stock exceeds DP1's postdistribution amount ($10x) attributable to such stock. As adjusted under paragraph (b)(3) of this section, DP1's basis in the FC stock is $60x. Under §1.1248(f)–1(c)(4), DP1's postdistribution amount ($10x) equals the amount that DP1 would include in gross income as a dividend under section 1248(a) if it sold the FC stock immediately after the distribution ($80x fair market value, $70x basis, and $20x earnings and profits attributable to the FC stock for purposes of section 1248 taking into account DP1's 3-year holding period in such stock as required by paragraph (b)(2) of this section).

Example 2. Section 361 distribution—(i) *Facts*. DP1, DP2, and FP own 50, 30, and 20, respectively, of the 100 outstanding shares of stock of DC. DP1's DC stock has a $180x basis and a $200x fair market value. DP2's DC stock has a $100x basis and $120x fair market value. DC owns Business A and wholly owns CFC1 and CFC2. DC's Business A has a $10x basis and a $200x fair market value. DC's CFC1 stock has a $20x basis, a $40x fair market value, and $30x of earnings and profits attributable to it for purposes of section 1248(a). DC's CFC2 stock has a $30x basis, a $160x fair market value and $150x of earnings and profits attributable to it for purposes of

section 1248(a). On December 31, Year 3, in a reorganization described in section 368(a)(1)(D), DC transfers CFC1, CFC2 and Business A to FA in exchange for 60 shares of FA stock. DC's transfer of CFC1, CFC2 and Business A to FA in exchange for the 60 shares of FA stock qualifies as a section 361 exchange. DC distributes the FA stock to DP1, DP2 and FP on a *pro-rata* basis in a section 361 distribution. DP1, DP2 and FP exchange their DC stock for 30, 18, and 12 shares, respectively, of FA stock pursuant to section 354. After the reorganization, FA has 100 shares of stock outstanding. DP3 owns the other 40 shares of FA stock.

(ii) *Result*. (A) In general, under section 367(a)(5) and §1.367(a)–7(b), DC's transfer of the stock of CFC1 and CFC2 and Business A to FA is subject to the general rule of section 367(a)(1). As a result, DC must generally recognize gain on the transfer of such property to FA in the section 361 exchange. However, if the conditions and requirements of §1.367(a)–7(c) are met (which includes the making of the election under §1.367(a)–7(c)(5)), DC's transfer of the stock of CFC1 and CFC2 and Business A to FA may, in part, be eligible for the exceptions to section 367(a)(1) provided by §§1.367(a)–2T and –3. See §§1.367(a)–2T and –3(b) for additional requirements. In addition, DC may not be required to include in income the section 1248 amount attributable to the CFC1 and CFC2 stock under §1.367(b)–4(b)(1). However, if the exception provided under paragraph (c) of this section does not apply, then under §1.1248(f)–1(b)(3) DC must include in gross income as a dividend the section 1248(f) amounts attributable to the FA stock distributed. DC must include in income as a dividend the section 1248(f) amount attributable to the FA stock distributed to FP even if the exception provided by §1.367(a)–7(c) applies.

(B) The requirement of §1.367(a)–7(c)(1) is satisfied because DC is controlled (within the meaning of section 368(c)) by DP1 and DP2 at the time of the section 361 exchange.

(C) Under §1.367(a)–7(c)(2)(i), DC must recognize $68x gain on the section 361 exchange with respect to FP. The $68x gain equals the product of FP's 20% ownership interest in DC (by value) at the time of the section 361 exchange and the $340x inside gain. The inside gain equals the excess of the aggregate gross fair market value of the section 367(a) property ($400x) over the $60x inside basis. Under §1.367(a)–7(e)(1), the $68x gain recognized is allocated among the CFC1 stock, the CFC2 stock and Business A in proportion to the amount of gain realized by DC on the transfer of such property. The amount allocated to the CFC1 stock is $4x ($68x gain multiplied by $20x/$340x). The amount allocated to the CFC2 stock is $26x ($68x gain multiplied by $130x/$340x). The amount allocated to Business A is $38x ($68x gain multiplied by $190x/$340x). Under §1.367(a)–1T(b)(4)(i)(B) and section 362(b), the basis of each asset is increased by the amount of gain allocated to such asset. Under section 1248(a), DC must include in gross income as a dividend the $4x gain recognized with respect to the CFC1 stock (20% of the $20x section 1248 amount attributable to such stock) and the $26x gain recognized with respect to CFC2 stock (20% of the $130x section 1248 amount attributable to such stock). If the built-in gain in the CFC1 stock or CFC2 stock exceeded the section 1248 amount attributable to such stock, the amount of the gain recognized by DC on the transfer of such stock in the section 361 exchange recharacterized as a dividend under section 1248(a) would be less.

(D) DC is not required to recognize gain on the section 361 exchange under §1.367(a)–7(c)(2)(ii) with respect to DP1 or DP2. With respect to DP1, the product of the inside gain ($340x) and DP1's 50% ownership interest (by value) in DC at the time of the section 361 exchange (or $170x) does not exceed the product of the section 367(a) percentage (100%) and the fair market value of the FA stock received by DP1 ($200x). With respect to DP2, the product of the inside gain ($340x) and DP2's 30% ownership percentage (by value) in DC at the time of the section 361 exchange (or $102x) does not exceed the product of the section 367(a) percentage (100%) and the fair market value of the FA stock received by DP2 ($120x).

(E) Under §1.367(a)–7(c)(3), DP1's section 358 basis ($180x) in the FA stock received in the section 361 distribution is reduced by $150x, the amount by which DP1's 50% share of inside gain ($170x) exceeds DP1's $20x outside gain. DP1's share of inside gain is not reduced under §1.367(a)–7(c)(2)(ii) because DC did not recognize gain with respect to DP1. DP1's $20x outside gain equals the product of the section 367(a) percentage (100%) and the amount by which the fair market value of the FA stock received by DP1 ($200x) is greater than the section 358 basis of such stock ($180x). As adjusted, DP1's basis in the FA stock is $30x. Similarly, DP2's section 358 basis ($100x) in the FA stock received in the section 361 distribution is reduced by $82x, the amount by which DP2's 30% share of inside gain ($102x) exceeds DP1's $20x outside gain. DP2's share of inside gain is not reduced under §1.367(a)–7(c)(2)(ii) because DC did not recognize gain with respect to DP2. DP2's $20x outside gain equals the product of the section 367(a) percentage (100%) and the amount by which the fair market value of the FA stock received by DP2 ($120x) is greater than the section 358 basis of such stock ($100x). As adjusted, DP2's basis in the FA stock is $18x.

(F) Under §1.367(a)–7(c)(4)(i), DC must comply with the requirements of §1.6038B–1(c)(6)(iii) with respect to Business A. Under §1.367(a)–7(c)(4)(ii), DC is not required to comply with the requirements of §1.6038B–1(c)(6)(iii) with respect to the stock of CFC1 or CFC2.

(G) DC is not required to include in income as a dividend the remaining section 1248 amount attributable to the stock of CFC1 ($16x) or CFC2 ($104x) under §1.367(b)–4(b)(1)(i) because immediately after the section 361 exchange, FA, CFC1, and CFC2 are controlled foreign corporations with respect to which DC is a section 1248 shareholder.

(H) Under §1.1248(f)–1(b)(3), DC must generally include in gross income as a dividend the section 1248(f) amount ($120x) attributable to the FA stock distributed to DP1, DP2 and FP in the section 361 distribution. The section 1248(f) amount equals the sum of the amounts that FA would include in income as a dividend under section 964(e) if it sold the CFC1 stock ($16x gain and $26x earnings and profits attributable to such stock—calculated in paragraph (K)(3) of this *Example*) and CFC2 stock ($104x gain and $124x earnings and profits attributable to such stock—calculated in paragraph (K)(3) of this *Example*) immediately after the section 361 exchange.

(I) [Reserved.]

(J) However, if DP1, DP2, and DC elect to apply the provisions of paragraph (c) of this section (as provided in paragraph (c)(1) of this section), then §1.1248(f)–1(b)(3) shall not apply to DC's distribution of FA stock to DP1 and DP2. Even if such election is made, however, DC must include in gross income as a dividend the section 1248(f) amount ($24x) attributable to the 12 shares of FA stock distributed to FP (20% of the $120x section 1248(f) amount.)

(K) If DP1, DP2, and DC elect to apply the provisions of paragraph (c) of this section, then under paragraph (c)(2) of this section each share of FA stock received by DP1 (30 shares) and DP2 (18 shares) is divided into portions attributable to the CFC1 stock, the CFC2 stock and Business A. Under paragraphs (c)(4)(i) and (ii) of this section, the basis and fair market value of each portion of each share of FA stock is that amount of the total basis and fair market value of the FA stock that bears the same ratio that the fair market value of the property (exchanged for such FA stock) to which such portion relates bears to the aggregate fair market value of all property exchanged for the FA stock in the section 361 exchange.

(*1*) With respect to DP1's 30 shares of FA stock, the portions attributable to the CFC1 stock have an aggregate basis of $3x ($30x multiplied by $40x/$400x) and a fair market value of $20x ($200x multiplied by $40x/$400x); the portions attributable to the CFC2 stock have an aggregate basis of $12x ($30x multiplied by $160x/$400x) and a fair market value of $80x ($200x multiplied by $160x/$400x), and the portions attributable to Business A have an aggregate basis of $15x ($30x multiplied by $200x/$400x) and a fair market value of $100x (50% of $200x).

(*2*) With respect to DP2's 18 shares of FA stock, the portions attributable to the CFC1 stock have an aggregate basis of $1.8x ($18x multiplied by $40x/$400x) and a fair market value of $12x ($120x multiplied by $40x/$400x); the portions attributable to the CFC2 stock have an aggregate basis of $7.2x ($18x multiplied by $160x/$400x) and a fair market value of $48x ($120x multiplied by $160x/$400x); and the portions attributable to Business A have an aggregate basis of $9x ($18x multiplied by $200x/$400x) and a fair market value of $60x ($120x multiplied by $200x/$400x).

(*3*) Under §1.1248–8(b)(2)(iv), the earnings and profits of CFC1 attributable to the portions of DP1's 30 shares of FA stock attributable to the CFC1 stock is $13x ($26x earnings and profits amount multiplied by DP1's 50% ownership interest (by value) in DC at the time of the section 361 exchange), and the earnings and profits of CFC2 attributable to the portions of DP1's 30 shares of FA stock attributable to the CFC2 stock is $62x ($124x earnings and profits amount multiplied by DP1's 50% ownership interest in DC at the time of the section 361 exchange). Similarly, the earnings and profits of CFC1 attributable to the portions of DP2's 18 shares of FA stock attributable to the CFC1 stock is $7.8x ($26x earnings and profits amount multiplied by DP2's 30% ownership interest (by value) in DC at the time of the section 361 exchange), and the amount of earnings and profits of CFC2 attributable to the portions of DP2's 18 shares of FA stock attributable to the CFC2 stock is $37.2x ($124x earnings and profits amount multiplied by DP2's 30% ownership interest (by value)

in DC at the time of the section 361 exchange). The $26x earnings and profits with respect to the CFC1 stock equals the $30x earnings and profits amount attributable to the CFC1 stock immediately before the section 361 exchange reduced by the $4x included in income by DC as a dividend under section 1248(a) on the transfer of the CFC1 stock to FA in the section 361 exchange. The $124x earnings and profits with respect to CFC2 equals the $150x earnings and profits attributable to the CFC2 stock immediately before the section 361 exchange reduced by the $26x amount included in income by DC as a dividend under section 1248(a) on the transfer of the CFC2 stock to FA in the section 361 exchange. See sections 959(e) and 1248(d)(1).

(L) Under paragraph (c)(3) of this section, DP1 is not required to reduce the aggregate section 358 basis of the portions of its 30 shares of FA stock attributable to the CFC1 stock or CFC2 stock. DP1's postdistribution amount ($13x) attributable to the portions of its FA shares attributable to the CFC1 stock exceeds its allocable share of the section 1248(f) amount attributable to the CFC1 stock immediately after the section 361 exchange ($8x, or 50% of $16x). DP1's postdistribution amount ($62x) attributable to the portions of its FA shares attributable to the CFC2 stock exceeds its allocable share of the section 1248(f) amount attributable to the CFC2 stock immediately after the section 361 exchange ($52x, or 50% of $104x).

(M) Similarly, DP2 is not required to reduce the aggregate section 358 basis of the portions of its 18 shares of FA stock attributable to the CFC1 stock or CFC2 stock. DP2's postdistribution amount ($7.8x) attributable to the portions of its FA shares attributable to the CFC1 stock exceeds its allocable share of the section 1248(f) amount attributable to the CFC1 stock immediately after the section 361 exchange ($4.8x, or 30% of $16x). DP2's postdistribution amount ($37.2x) attributable to the portions of its FA shares attributable to the CFC2 stock exceeds its allocable share of the section 1248(f) amount attributable to the CFC2 stock immediately after the section 361 exchange ($31.2x, or 30% of $104x).

Example 3. Section 361 distribution and adjustment to stock basis. (i) *Facts.* DP1 wholly owns DC. DP1's DC stock has a $180x basis and a $200x fair market value. DC wholly owns CFC1 and CFC2. DC's CFC1 stock has a $70x basis, a $100x fair market value, and $40x of earnings and profits attributable to it for purposes of section 1248. DC's CFC2 stock has a $130x basis, a $100x fair market value, and $80x of earnings and profits attributable to it for purposes of section 1248. On December 31, Year 1, in a reorganization described in section 368(a)(1)(F), DC transfers the CFC1 stock and the CFC2 stock to FA, a newly formed corporation, in exchange for 100 shares of FA stock. DC distributes the 100 shares of FA stock to DP1 in a section 361 distribution. DC's transfer of the stock of CFC1 and CFC2 to FA in exchange for FA stock qualifies as a section 361 exchange. DP1 exchanges its DC stock for the 100 shares of FA stock pursuant to section 354. DP1 and DC elect to apply the rules of §1.367(a)–7(c) in accordance with §1.367(a)–7(c)(5). DC is not required to recognize gain under §1.367(a)–7(c)(2), and DP1 is not required to reduce its section 358 basis in the FA shares under §1.367(a)–7(c)(3).

(ii) *Result.* (A) DC is not required to include in income as a dividend the section 1248 amount attributable to the CFC1 stock under §1.367(b)–4(b)(1)(i) because, immediately after the section 361 exchange, FA and CFC1 are controlled foreign corporations with respect to which DC is a section 1248 shareholder. At the time of the section 361 exchange the section 1248 amount attributable to the CFC2 stock is zero.

(B) Under §1.1248(f)–1(b)(3), DC must generally include in income as a dividend the section 1248(f) amount ($30x) attributable to the FA stock upon its distribution of such stock to DP1 in the section 361 distribution. The section 1248(f) amount is the amount that FA would include in income as a dividend under section 964(e) if it sold the CFC1 stock immediately after the section 361 exchange. Immediately after the section 361 exchange, the section 1248(f) amount attributable to the CFC2 stock is zero.

(C) However, if DP1 and DC elect to apply the rules of paragraph (c) of this section (as provided in paragraph (c)(1) of this section), then §1.1248(f)–1(b)(3) shall not apply to DC's distribution of the FA stock to DP1. If that election is made then:

(*1*) Under paragraph (c)(2)(ii) of this section each share of FA stock received by DP1 is divided into one portion attributable to the CFC1 stock and one portion attributable to the CFC2 stock. Under paragraphs (c)(4)(i) and (ii) of this section, the basis and fair market value of each portion is that amount of the total section 358 basis and fair market value, respectively, of the FA stock that bears the same ratio that the fair market value of the property (the CFC1 stock and CFC2 stock) to which such portion relates bears to the aggregate fair market value of all property exchanged by DC for the FA stock in the section 361 exchange. Therefore, the portions attributable to the CFC1 stock have an aggregate basis of $90x ($180x multiplied by $100x/$200x) and a fair market value of $100x ($200x multiplied by $100x/$200x). The portions attributable to the CFC2 stock also have an aggregate basis of $90x ($180x multiplied by $100x/$200x) and a fair market value of $100x ($200x multiplied by $100x/$200x).

(*2*) Under §1.1248–8(b)(2)(iv), the $40x earnings and profits attributable to the CFC1 stock at the time of the section 361 exchange are attributed to the portions of the shares of FA stock that relate to the CFC1 stock. Similarly, the $80x of earnings and profits attributable to the CFC2 stock are attributed to the portions of the 100 shares of the FA stock that relate to the CFC2 stock.

(*3*) Under paragraph (c)(3) of this section, DP1's aggregate section 358 basis in the portions of the 100 shares of FA stock attributable to the CFC1 stock ($90x) is reduced by $20x, the amount by which the section 1248(f) amount attributable to the CFC1 stock ($30x) exceeds DP1's postdistribution amount ($10x) with respect to the portions of the shares of FA stock attributable to the CFC1 stock. The postdistribution amount is the section 1248 amount attributable to the portions of the FA stock attributable to the CFC1 stock immediately after the section 361 distribution ($100x fair market value less $90x basis, and $40x earnings and profits attributable to such portions). As adjusted, DP1's aggregate basis in the portions of the shares of FA stock attributable to the CFC1 stock is $70x. No adjustment is required to DP1's aggregate basis in the portions of the FA stock attributable to the CFC2 stock because no portion of the $30x section 1248(f) amount is attributable to the CFC2 stock.

Example 4. Section 361 exchange followed by distribution of stock pursuant to plan of reorganization. (i) *Facts.* DP1 owns all 100 outstanding shares of stock of DC. DP1's DC stock has a $180x basis, $200x fair market value, and 2 year holding period. DC owns all 60 shares of the outstanding stock of CFC1. DC's CFC1 stock has a $50x basis, a $60x fair market value, $30x of earnings and profits attributable to it for purposes of section 1248, and a 3 year holding period. DC also owns all 40 shares of the outstanding stock of CFC2. DC's CFC2 stock has a $30x basis, a $40x fair market value, and $20x of earnings and profits attributable to it for purposes of section 1248. DC also owns Business A that has a fair market value of $100x. On December 31, Year 4, in a divisive reorganization described in section 368(a)(1)(D), DC transfers the CFC2 stock to CFC1 in exchange for 40 additional shares of CFC1 stock. DC then distributes the 100 shares of CFC1 stock to DP1. DC's transfer of the CFC2 stock to CFC1 qualifies as a section 361 exchange. DP1 and DC are eligible to and make the elections provided in §1.367(a)–7(c)(5) and paragraphs (b) and (c) of this section.

(ii) *Result.* (A) DC is not required to recognize gain under §1.367(a)–7(c)(2).

(B) Under section 358, DP1 must allocate the $180x pre-distribution section 358 basis in its DC stock between the shares of DC stock and the shares of CFC1 stock held after the distribution based on the relative fair market values of such shares. After the allocation of the pre-distribution basis, the basis of DP1's DC stock is $90x, and the basis of DP1's CFC1 stock is $90x. With respect to the $90x basis in the CFC1 stock, $36x is attributable to the 40 shares of CFC1 stock received by DC in the section 361 exchange, and $54x is attributable to the 60 shares of CFC1 stock owned by DC before the section 361 exchange.

(C) Pursuant to §1.367(a)–7(c)(3)(ii)(A), any adjustment to basis required under §1.367(a)–7(c)(3) applies only to the 40 shares of CFC1 stock received by DC in the section 361 exchange. Under §1.367(a)–7(c)(3)(i), DP1 must reduce its section 358 basis ($36x) in the 40 shares of CFC1 stock by $6x, the amount by which DP1's 100% share of the inside gain ($10x) exceeds DP2's outside gain ($4x). DP1's share of inside gain is not reduced under §1.367(a)–7(c)(2)(ii) because DC does not recognize gain on the transfer of the section 367(a) property in the section 361 exchange. The outside gain equals the product of the section 367(a) percentage (100%) and the amount by which the fair market value ($40x) of the 40 shares of CFC1 stock is greater than DP1's section 358 basis of such stock ($36x). After the $6x reduction to stock basis required under §1.367(a)–7(c)(3), but before the application of §1.1248(f)–2(c)(2), DP1's basis in such 40 shares of CFC1 stock is $30x.

(D) DC is not required to include in income as a dividend the section 1248 amount attributable to the CFC2 stock under §1.367(b)–4(b)(1)(i), because immediately after the section 361 exchange CFC1 and CFC2 are both controlled foreign corporations with respect to which DC is a section 1248 shareholder.

(E) Because DP1 and DC elect to apply the rules under paragraph (c) of this section, §1.1248(f)–1(b)(3) does not apply to DC's distribu-

tion to DP of the 40 shares of CFC1 stock received in the section 361 exchange.

(*1*) Under paragraph (c)(2) of this section, the 40 shares of CFC1 stock received by DC in the section 361 exchange are attributable to the CFC2 stock. Thus, the 40 shares are not required to be divided into portions under paragraph (c)(2) of this section because DC exchanged a single block of stock of CFC2 for the 40 shares of CFC1 stock in the section 361 exchange. The 40 shares of CFC1 stock have an aggregate basis of $30x (after the adjustment described in paragraph (C) of this *Example*) and fair market value of $40x.

(*2*) Under §1.1248–8(b)(2)(iv), the $20x of earnings and profits attributable to the CFC2 stock at the time of the section 361 exchange are attributable to the 40 shares of CFC1 stock.

(*3*) DP1's basis ($30x) in the 40 shares of CFC1 stock attributable to the CFC2 stock is not required to be reduced under paragraph (c)(3) of this section because the section 1248(f) amount ($10x) attributable to the 40 shares of CFC1 stock does not exceed DP1's postdistribution amount ($10x) attributable to such stock. The postdistribution amount equals the amount that DP1 would be required to include in income as a dividend under section 1248(a) if it sold the 40 shares of CFC1 stock immediately after the distribution ($40x fair market value, $30x basis, and $20x earnings and profits attributable to such stock for purposes of section 1248). The $10x section 1248(f) amount equals the amount CFC1 would include in income as a dividend under section 964(e) if it sold the CFC2 stock received from DC immediately after the section 361 exchange.

(F) Because DP1 and DC make the election provided in paragraph (b)(1) of this section, §1.1248(f)–1(b)(2) does not apply to DC's distribution to DP1 of the 60 shares of CFC1 stock it owned before the section 361 exchange.

(*1*) Under paragraph (b)(2) of this section, for purposes of section 1248, DP1 has a 3 year holding period in the 60 shares of CFC1 stock immediately after the distribution, the same holding period that DC had in such shares at the time of the distribution.

(*2*) Under paragraph (b)(3) of this section, DP1's section 358 basis in the 60 shares of CFC1 stock ($54x) must be reduced by $4x, the amount by which DC's section 1248 amount ($10x) attributable to such shares immediately before the distribution exceeds DP1's postdistribution amount ($6x) attributable to such shares immediately after the distribution. The $6x postdistribution amount equals the amount that DP1 would be required to include in income as a dividend under section 1248(a) if it sold the 60 shares of CFC1 stock immediately after the distribution ($60x fair market value, $54x basis, and $30x earnings and profits attributable to such stock for purposes of section 1248). After the reduction, DP1's basis in the 60 shares of CFC1 stock is $50x.

(e) *Applicable cross-references*. For rules relating to the attribution of earnings and profits to the stock of a foreign corporation following certain nonrecognition transactions, see §1.1248–8. For rules relating to a transfer of property by a domestic corporation to a foreign corporation in a section 361 exchange that precedes a section 355 distribution or section 361 distribution to which section 1248(f)(1) applies, see §1.367(a)–7. For rules relating to an acquisition of the stock of a foreign corporation by another foreign corporation in a section 361 exchange, see §1.367(b)–4. For rules relating to a section 355 distribution of stock of a foreign corporation by a domestic corporation, see §§1.367(b)–5(b)(1) and 1.367(e)–1.

Par. 14. Section 1.1248(f)–3 is added to read as follows:

§1.1248(f)–3 Reasonable cause exception and effective dates.

(a) *Reasonable cause exception for failure to comply*—(1) *General rule*. If a section 1248 shareholder or the domestic distributing corporation fails to comply with any requirement under §1.1248(f)–2, the section 1248 shareholder or the domestic distributing corporation shall be considered to have complied with such requirement if it submits a request for relief as provided under paragraph (a)(2) of this section and can demonstrate to the Area Director, Field Examination, Small Business/Self Employed or the Director of Field Operations, Large and Mid-Size Business (Director) having jurisdiction of the section 1248 shareholder's or domestic distributing corporation's tax return for the taxable year during which the distribution occurs, that such failure was due to reasonable cause and not willful neglect. Whether the failure to comply was due to reasonable cause and not willful neglect will be determined by the Director after considering all the facts and circumstances. The Director shall notify the section 1248 shareholder or domestic distributing corporation in writing within 120 days if it is determined that the failure to comply was not due to reasonable cause, or if additional time will be needed to make such determination. For this purpose, the 120-day period shall begin on the date the Internal Revenue Service notifies the section 1248 shareholder or domestic distributing corporation in writing that the request for relief has been received and assigned for review. Once such period commences, if the section 1248 shareholder or domestic distributing corporation is not again notified within 120 days, then the section 1248 shareholder or domestic distributing corporation shall be deemed to have established reasonable cause.

(2) *Requirements for reasonable cause relief*—(i) *Time of submission*. Requests for reasonable cause relief will only be considered if as soon as the section 1248 shareholder or domestic distributing corporation becomes aware of the failure to comply with any requirement of §1.1248(f)–2, the section 1248 shareholder or domestic distributing corporation attaches the statements or other documents that should have been filed, as well as a complete written statement setting forth the reasons for the failure to comply, to an amended return that amends the return to which the documents should have been attached pursuant to §1.1248(f)–2. The amended return and all required attachments must be filed with the applicable Internal Revenue Service Center with which the section 1248 shareholder or domestic distributing corporation filed its original return to which the documents should have been attached.

(ii) *Notice requirement*. In addition to the requirement of paragraph (a)(2)(i) of this section, the section 1248 shareholder or domestic distributing corporation must comply with the requirements of paragraph (a)(2)(ii)(A) or (B) of this section, as applicable.

(A) If the section 1248 shareholder or domestic distributing corporation is under examination for any taxable year when the request for reasonable cause relief is filed, a copy of the amended return and attachments must be provided to the Internal Revenue Service personnel conducting the examination.

(B) If the section 1248 shareholder or domestic distributing corporation is not under examination for any taxable year when the request for reasonable cause relief is filed, a copy of the amended return and attachments must be provided to the Director having jurisdiction over the return.

(b) *Effective/applicability date*. Sections 1.1248(f)–1 and 1.1248(f)–2 and this section shall apply to distributions occurring on or after the date 30 days after the date these regulations are published as final regulations in the **Federal Register**.

Par. 15. Section 1.6038B–1 is amended by revising paragraphs (c)(6), (f)(3), and the heading and the first sentence of para-

graph (g)(1), and adding paragraph (g)(5), to read as follows:

§1.6038B–1 Reporting of certain transfers to foreign corporations.

* * * * *

(c) * * *

(6) *Transfers subject to section 367(a)(5)*—(i) *In general.* This paragraph applies to a domestic corporation (U.S. transferor) that transfers section 367(a) property (as defined in §1.367(a)–7(f)(9)) to a foreign corporation in an exchange described in section 361(a) or (b) or in an exchange described in section 351 that is also described in section 361(a) or (b) (collectively, a section 361 exchange) and to which the provisions of §1.367(a)–7(c) apply. Paragraph (c)(6)(ii) of this section establishes the time and manner for the U.S. transferor to elect to apply the provisions of §1.367(a)–7(c). Paragraph (c)(6)(iii) of this section establishes the manner for the U.S. transferor to satisfy the requirement of §1.367(a)–7(c)(4).

(ii) *Election.* The U.S. transferor elects to apply the provisions of §1.367(a)–7(c) by including a statement entitled, STATEMENT TO ELECT TO APPLY EXCEPTION UNDER §1.367(a)–7(c) with its timely-filed return (within the meaning of §1.367(a)–7(f)(11)) for the taxable year during which the section 361 exchange occurs, that includes the information described in paragraphs (c)(6)(ii)(A) through (c)(6)(ii)(C) of this section. See §1.367(a)–7(c)(5)(ii) for the statement required to be filed by a control group member, as defined in §1.367(a)–7(f)(2), or final distributee, as defined in §1.367(a)–7(d).

(A) The name and taxpayer identification number of each control group member and final distributee (if any), and the aggregate ownership interest (by value) in the U.S. transferor of each control group member or final distributee.

(B) A calculation of the gain recognized (if any) by the U.S. transferor under §1.367(a)–7(c)(2)(i) and (ii).

(C) The date on which the U.S. transferor and each control group member or final distributee entered into the written agreement described in §1.367(a)–7(c)(5)(iv).

(iii) *Agreement to amend U.S. transferor's tax return.* The U.S. transferor complies with the requirement of §1.367(a)–7(c)(4)(i) by attaching a statement to its timely-filed return (within the meaning of §1.367(a)–7(f)(11)) for the taxable year in which the section 361 exchange occurs, entitled STATEMENT UNDER §1.367(a)–7(c)(4) FOR TRANSFERS OF ASSETS TO A FOREIGN CORPORATION IN A SECTION 361 EXCHANGE. The statement must certify that if the foreign acquiring corporation disposes of a significant amount (as defined in paragraph (c)(6)(iii)(A) of this section) of the section 367(a) property received from the U.S. transferor in the section 361 exchange in one or more related transactions described in paragraph (c)(6)(iii)(B) of this section, then the exception provided in §1.367(a)–7(c) shall not apply to the section 361 exchange and the U.S. transferor shall recognize the gain realized but not recognized in the section 361 exchange. The U.S. transferor (or the foreign acquiring corporation on behalf of the U.S. transferor) shall file a U.S. income tax return (or amended U.S. income tax return, as the case may be) for the year of the section 361 exchange, reporting such gain.

(A) *Disposition of significant amount.* For purposes of this paragraph (c)(6)(iii), a disposition of a significant amount occurs if, in one or more related transactions, the foreign acquiring corporation disposes of an amount of the section 367(a) property received from the U.S. transferor in the section 361 exchange that is greater than 40 percent of the fair market value of all of the property transferred in the section 361 exchange.

(B) *Gain recognition transaction*—(*1*) *General rule.* A transaction is described in this paragraph (c)(6)(iii)(B) if the transaction is entered into with a principal purpose of avoiding the U.S. tax that would have been imposed on the U.S. transferor on the disposition of the property transferred to the foreign acquiring corporation in the section 361 exchange. A disposition may have a principal purpose of tax avoidance even if the tax avoidance purpose is outweighed by other purposes when taken together.

(*2*) *Presumptive tax avoidance.* For purposes of this paragraph (c)(6)(iii)(B), the principal purpose of the foreign acquiring corporation's disposition of a significant amount of the section 367(a) property within two years of the section 361 exchange (whether in a recognition or nonrecognition transaction) shall be presumed to be the avoidance of the U.S. tax that would have been imposed on the U.S. transferor on the disposition of the property transferred to the foreign acquiring corporation in the section 361 exchange. However, this presumption shall not apply if it is demonstrated to the satisfaction of the Area Director, Field Examination, Small Business/Self Employed or the Director of Field Operations, Large and Mid-Size Business (Director) that the avoidance of U.S. tax was not a principal purpose of the disposition.

(*3*) *Interest.* If additional tax is required to be paid as a result of a transaction described in paragraph (c)(6)(iii)(B) of this section, then interest must be paid on that amount at rates determined under section 6621 with respect to the period between the date prescribed for filing the U.S. transferor's income tax return for the year of the section 361 exchange and the date on which the additional tax for that year is paid.

* * * * *

(f) * * *

(3) *Reasonable cause exception for failure to comply*—(i) *Request for relief.* The provisions of paragraph (f)(1) of this section shall not apply if the U.S. transferor can demonstrate to the Area Director, Field Examination, Small Business/Self Employed or the Director of Field Operations, Large and Mid-Size Business (Director) having jurisdiction of the U.S. transferor's tax return for the taxable year, that a failure to comply was due to reasonable cause and not willful neglect. Whether the failure to comply was due to reasonable cause and not willful neglect will be determined by the Director after considering all the facts and circumstances. The Director shall notify the U.S. transferor in writing within 120 days if it is determined that the failure to comply was not due to reasonable cause, or if additional time will be needed to make such determination. For this purpose, the 120-day period shall begin on the date the Internal Revenue Service notifies the U.S. transferor in writing that the request for relief has been received and assigned for review. Once such period commences, if the U.S. transferor is not again notified

within 120 days, then the U.S. transferor shall be deemed to have established reasonable cause.

(ii) *Requirements for reasonable cause relief*—(A) *Time of submission*. Requests for reasonable cause relief will only be considered if, as soon as the U.S. transferor becomes aware of the failure to comply, the U.S. transferor attaches all the documents that should have been filed, as well as a complete written statement setting forth the reasons for the failure to timely comply, to an amended return that amends the return to which the documents should have been attached pursuant to the rules of section 6038B and the regulations under that section. The amended return and all required attachments must be filed with the applicable Internal Revenue Service Center with which the U.S. transferor filed its original return to which the documents should have been attached.

(B) *Notice requirement*. In addition to the requirement of paragraph (f)(3)(ii)(A) of this section, the U.S. transferor must comply with the requirements of paragraph (f)(3)(ii)(B)(*1*) or (*2*), as applicable.

(*1*) If the U.S. transferor is under examination for any taxable year when it requests relief, the U.S. transferor must provide a copy of the amended return and attachments to the Internal Revenue Service personnel conducting the examination.

(*2*) If the U.S. transferor is not under examination for any taxable year when it requests relief, the U.S. transferor must provide a copy of the amended return and attachments to the Director having jurisdiction over the U.S. transferor's return.

* * * * *

(g) *Effective/applicability dates*. (1) Except as provided in paragraphs (g)(2) through (5) of this section, this section applies to transfers occurring on or after July 20, 1998, except for transfers of cash made in tax years beginning on or before February 5, 1999 (which are not required to be reported under section 6038B), and except for transfers described in paragraph (e) of this section, which applies to transfers that are subject to §§1.367(e)–1(f) and 1.367(e)–2(e). * * *

(5) Paragraphs (c)(6) and (f)(3) of this section shall apply to transfers occurring on or after the date 30 days after the date these regulations are published as final regulations in the **Federal Register**. For guidance with respect to paragraphs (c)(6) and (f)(3) of this section before the date 30 days after the date these regulations are published as final regulations in the **Federal Register**, see 26 CFR part 1 revised as of April 1 for the year before the date these regulations are published as final regulations in the **Federal Register**.

Linda E. Stiff,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on August 19, 2008, 8:45 a.m., and published in the issue of the Federal Register for August 20, 2008, 73 F.R. 49277)

Deletions From Cumulative List of Organizations Contributions to Which are Deductible Under Section 170 of the Code

Announcement 2008–90

The Internal Revenue Service has revoked its determination that the organizations listed below qualify as organizations described in sections 501(c)(3) and 170(c)(2) of the Internal Revenue Code of 1986.

Generally, the Service will not disallow deductions for contributions made to a listed organization on or before the date of announcement in the Internal Revenue Bulletin that an organization no longer qualifies. However, the Service is not precluded from disallowing a deduction for any contributions made after an organization ceases to qualify under section 170(c)(2) if the organization has not timely filed a suit for declaratory judgment under section 7428 and if the contributor (1) had knowledge of the revocation of the ruling or determination letter, (2) was aware that such revocation was imminent, or (3) was in part responsible for or was aware of the activities or omissions of the organization that brought about this revocation.

If on the other hand a suit for declaratory judgment has been timely filed, contributions from individuals and organizations described in section 170(c)(2) that are otherwise allowable will continue to be deductible. Protection under section 7428(c) would begin on October 14, 2008, and would end on the date the court first determines that the organization is not described in section 170(c)(2) as more particularly set forth in section 7428(c)(1). For individual contributors, the maximum deduction protected is $1,000, with a husband and wife treated as one contributor. This benefit is not extended to any individual, in whole or in part, for the acts or omissions of the organizations that were the basis for revocation.

Heavens Hand Foundation
McCordsville, IN
Airport Working Group of Orange County
Newport Beach, CA
Portland Fathering Center
Portland, OR

Section 7428(c) Validation of Certain Contributions Made During Pendency of Declaratory Judgment Proceedings

Announcement 2008–93

This announcement serves notice to potential donors that the organization listed below has recently filed a timely declaratory judgment suit under section 7428 of the Code, challenging revocation of its status as an eligible donee under section 170(c)(2).

Protection under section 7428(c) of the Code begins on the date that the notice of revocation is published in the Internal Revenue Bulletin and ends on the date on which a court first determines that an organization is not described in section 170(c)(2), as more particularly set forth in section 7428(c)(1).

In the case of individual contributors, the maximum amount of contributions protected during this period is limited to $1,000.00, with a husband and wife being treated as one contributor. This protection is not extended to any individual who was responsible, in whole or in part, for the acts or omissions of the organization that were the basis for the revocation. This protection also applies (but without limitation as to amount) to organizations described in section 170(c)(2) which are

exempt from tax under section 501(a). If the organization ultimately prevails in its declaratory judgment suit, deductibility of contributions would be subject to the normal limitations set forth under section 170.

Airport Working Group of Orange County
Newport Beach, CA

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D. —Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z —Corporation.

Numerical Finding List[1]

Bulletins 2008–27 through 2008–41

Announcements:

Court Decisions:

Notices:

Notices— Continued:

Proposed Regulations:

Revenue Procedures:

Revenue Procedures— Continued:

Revenue Rulings:

Treasury Decisions:

[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2008–1 through 2008–26 is in Internal Revenue Bulletin 2008–26, dated June 30, 2008.

Finding List of Current Actions on Previously Published Items[1]

Bulletins 2008–27 through 2008–41

Announcements:

2008-64
Corrected by
Ann. 2008-71, 2008-32 I.R.B. *321*

2008-72
Corrected by
Ann. 2008-78, 2008-34 I.R.B. *453*

Notices:

88-80
Modified by
Notice 2008-79, 2008-40 I.R.B. *815*

99-48
Superseded by
Rev. Proc. 2008-40, 2008-29 I.R.B. *151*

2000-9
Obsoleted by
Rev. Proc. 2008-41, 2008-29 I.R.B. *155*

2004-2
Amplified by
Notice 2008-59, 2008-29 I.R.B. *123*

2004-50
Amplified by
Notice 2008-59, 2008-29 I.R.B. *123*

2006-88
Modified and superseded by
Notice 2008-60, 2008-30 I.R.B. *178*

2007-22
Amplified by
Notice 2008-59, 2008-29 I.R.B. *123*

2007-36
Clarified, modified, and amplified by
Rev. Proc. 2008-54, 2008-38 I.R.B. *722*

Proposed Regulations:

REG-129243-07
Corrected by
Ann. 2008-75, 2008-33 I.R.B. *392*

REG-151135-07
Hearing scheduled by
Ann. 2008-64, 2008-28 I.R.B. *114*

REG-101258-08
Corrected by
Ann. 2008-73, 2008-33 I.R.B. *391*

Revenue Procedures:

92-25
Superseded by
Rev. Proc. 2008-41, 2008-29 I.R.B. *155*

Revenue Procedures— Continued:

92-83
Obsoleted by
Rev. Proc. 2008-37, 2008-29 I.R.B. *137*

2001-10
Section 6.02(1)(a) modified and amplified by
Rev. Proc. 2008-52, 2008-36 I.R.B. *587*

2001-42
Superseded by
Rev. Proc. 2008-39, 2008-29 I.R.B. *143*

2002-9
Clarified, modified, amplified, and superseded by
Rev. Proc. 2008-52, 2008-36 I.R.B. *587*
Modified and amplified by
Rev. Proc. 2008-43, 2008-30 I.R.B. *186*

2002-28
Section 7.02(1)(a) modified and amplified by
Rev. Proc. 2008-52, 2008-36 I.R.B. *587*

2002-64
Superseded by
Rev. Proc. 2008-55, 2008-39 I.R.B. *768*

2005-29
Superseded by
Rev. Proc. 2008-49, 2008-34 I.R.B. *423*

2006-27
Modified and superseded by
Rev. Proc. 2008-50, 2008-35 I.R.B. *464*

2006-29
Superseded by
Rev. Proc. 2008-34, 2008-27 I.R.B. *13*

2006-34
Superseded by
Rev. Proc. 2008-44, 2008-30 I.R.B. *187*

2007-14
Superseded by
Rev. Proc. 2008-52, 2008-36 I.R.B. *587*

2007-19
Superseded by
Rev. Proc. 2008-39, 2008-29 I.R.B. *143*

2007-42
Superseded by
Rev. Proc. 2008-32, 2008-28 I.R.B. *82*

2007-43
Superseded by
Rev. Proc. 2008-33, 2008-28 I.R.B. *93*

2007-44
Modified by
Rev. Proc. 2008-56, 2008-40 I.R.B. *826*

2007-49
Section 3 modified and superseded by
Rev. Proc. 2008-50, 2008-35 I.R.B. *464*

Revenue Procedures— Continued:

2007-50
Superseded by
Rev. Proc. 2008-36, 2008-33 I.R.B. *340*

2007-63
Superseded by
Rev. Proc. 2008-59, 2008-41 I.R.B. *857*

2007-66
Modified and superseded by
Rev. Proc. 2008-54, 2008-38 I.R.B. *722*

2007-70
Modified by
Ann. 2008-63, 2008-28 I.R.B. *114*

2007-72
Amplified and superseded by
Rev. Proc. 2008-47, 2008-31 I.R.B. *272*

2008-12
Modified and superseded by
Rev. Proc. 2008-35, 2008-29 I.R.B. *132*

2008-43
Modified by
Rev. Proc. 2008-52, 2008-36 I.R.B. *587*

2008-52
Modified by
Ann. 2008-84, 2008-38 I.R.B. *748*

Revenue Rulings:

67-213
Amplified by
Rev. Rul. 2008-40, 2008-30 I.R.B. *166*

71-234
Modified by
Rev. Proc. 2008-43, 2008-30 I.R.B. *186*

76-273
Obsoleted by
T.D. 9414, 2008-35 I.R.B. *454*

77-480
Modified by
Rev. Proc. 2008-43, 2008-30 I.R.B. *186*

82-105
Obsoleted by
T.D. 9414, 2008-35 I.R.B. *454*

91-17
Amplified by
Rev. Proc. 2008-41, 2008-29 I.R.B. *155*
Rev. Proc. 2008-42, 2008-29 I.R.B. *160*
Superseded in part by
Rev. Proc. 2008-40, 2008-29 I.R.B. *151*

2005-6
Amplified by
Rev. Proc. 2008-38, 2008-29 I.R.B. *139*

[1] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2008–1 through 2008–26 is in Internal Revenue Bulletin 2008–26, dated June 30, 2008.

Revenue Rulings— Continued:

2006-57

Modified by

Notice 2008-74, 2008-38 I.R.B. *718*

2008-12

Amplified by

Rev. Rul. 2008-38, 2008-31 I.R.B. *249*

Clarified by

Ann. 2008-65, 2008-31 I.R.B. *279*

Treasury Decisions:

9391

Corrected by

Ann. 2008-74, 2008-33 I.R.B. *392*

U.S. GOVERNMENT PRINTING OFFICE
KEEPING AMERICA INFORMED

Internal Revenue Cumulative Bulletins Publications and Subscription Order Form

Order Processing Code: 3465

Easy Secure Internet: bookstore.gpo.gov

Toll Free: 866 512-1800
DC Area: 202 512-2800
Fax: 202 512-2250

Mail: Superintendent of Documents
P.O. Box 371954
Pittsburgh, PA 15250-7954

Publications

Qty.	Stock Number	Title	Price Each	Total Price
	048–004–02467–5	Cum. Bulletin 1999–3	20.40	
	048–004–02462–4	Cum. Bulletin 2001–2 (Jul-Dec)	24.00	
	048–004–02480–2	Cum. Bulletin 2001–3	71.00	
	048–004–02470–5	Cum. Bulletin 2002–2 (Jul-Dec)	28.80	
	048–004–02486–1	Cum. Bulletin 2002–3	54.00	
	048–004–02483–7	Cum. Bulletin 2004–2 (July–Dec)	54.00	
	048–004–02488–8	Cum. Bulletin 2005–2	56.00	
			Total for Publications	

Subscriptions

Qty.	List ID	Title	Price Each	Total Price
	IRS	Internal Revenue Bulletin	$247	
		Optional – Add $50 to open Deposit Account		
			Total for Subscriptions	
			Total for Publications and Subscriptions	

NOTE: Price includes regular shipping and handling and is subject to change. International customers please add 40 percent.

Standing Order Service*

To automatically receive future editions of *Internal Revenue Cumulative Bulletins* without having to initiate a new purchase order, sign below for Standing Order Service.

Qty.	Standing Order	Title
	ZIRSC	Internal Revenue Cumulative Bulletins

Authorization

I hereby authorize the Superintendent of Documents to charge my account for Standing Order Service:
(enter account information at right)

❑ VISA ❑ MasterCard ❑ Discover/NOVUS ❑ American Express

❑ Superintendent of Documents (SOD) Deposit Account

Authorizing signature (Standing orders not valid unless signed.)

_____

Please print or type your name.

Daytime phone number (_____) _____

SuDocs Deposit Account

A Deposit Account will enable you to use Standing Order Service to receive subsequent volumes quickly and automatically. For an initial deposit of $50 you can establish your Superintendent of Documents Deposit Account.

❑ **YES!** Open a SOD Deposit Account for me so I can order future publications quickly and easily.
I am enclosing the $50 initial deposit.

Check method of payment:

❑ Check payable to Superintendent of Documents

❑ SOD Deposit Account ☐☐☐☐☐☐☐ – ☐

❑ VISA ❑ MasterCard ❑ Discover/Novus ❑ American Express

☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐

☐☐☐☐ (expiration date)

Thank you for your Order!

Authorizing signature 06/06

Company or personal name (Please type or print)

Additional address/attention line

Street address

City, State, Zip Code

E-mail address

Daytime phone including area code

Purchase order number (optional)

*Standing Order Service

Just sign the authorization above to charge selected items to your existing Deposit Account, VISA or MasterCard, Discover/NOVUS, or American Express account. Or open a Deposit Account with an initial deposit of $50 or more. Your account will be charged only as each volume is issued and mailed. Sufficient money must be kept in your account to insure that items are shipped. Service begins with the next issue released of each item you select.

You will receive written acknowledgement for each item you choose to receive by Standing Order Service.

If you wish to cancel your Standing Order Service, please notify the Superintendent of Documents in writing (telephone cancellations are accepted, but must be followed up with a written cancellation within 10 days).

Important: Please include this completed order form with your payment.

INTERNAL REVENUE BULLETIN

The Introduction at the beginning of this issue describes the purpose and content of this publication. The weekly Internal Revenue Bulletin is sold on a yearly subscription basis by the Superintendent of Documents. Current subscribers are notified by the Superintendent of Documents when their subscriptions must be renewed.

CUMULATIVE BULLETINS

The contents of this weekly Bulletin are consolidated semiannually into a permanent, indexed, Cumulative Bulletin. These are sold on a single copy basis and *are not* included as part of the subscription to the Internal Revenue Bulletin. Subscribers to the weekly Bulletin are notified when copies of the Cumulative Bulletin are available. Certain issues of Cumulative Bulletins are out of print and are not available. Persons desiring available Cumulative Bulletins, which are listed on the reverse, may purchase them from the Superintendent of Documents.

ACCESS THE INTERNAL REVENUE BULLETIN ON THE INTERNET

You may view the Internal Revenue Bulletin on the Internet at www.irs.gov. Under information for: select Businesses. Under related topics, select More Topics. Then select Internal Revenue Bulletins.

INTERNAL REVENUE BULLETINS ON CD-ROM

Internal Revenue Bulletins are available annually as part of Publication 1796 (Tax Products CD-ROM). The CD-ROM can be purchased from National Technical Information Service (NTIS) on the Internet at www.irs.gov/cdorders (discount for online orders) or by calling 1-877-233-6767. The first release is available in mid-December and the final release is available in late January.

HOW TO ORDER

Check the publications and/or subscription(s) desired on the reverse, complete the order blank, enclose the proper remittance, detach entire page, and mail to the Superintendent of Documents, P.O. Box 371954, Pittsburgh PA, 15250–7954. Please allow two to six weeks, plus mailing time, for delivery.

WE WELCOME COMMENTS ABOUT THE INTERNAL REVENUE BULLETIN

If you have comments concerning the format or production of the Internal Revenue Bulletin or suggestions for improving it, we would be pleased to hear from you. You can e-mail us your suggestions or comments through the IRS Internet Home Page (www.irs.gov) or write to the IRS Bulletin Unit, SE:W:CAR:MP:T:T:SP, Washington, DC 20224

Internal Revenue Service
Washington, DC 20224

Official Business
Penalty for Private Use, $300