Internal Revenue bulletin

Bulletin No. 2006-8
February 21, 2006

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

T.D. 9243, page 475.

Final and temporary regulations under section 367 of the Code amend income tax regulations under sections 367, 884, and 6038B dealing with statutory mergers or consolidations under section 368(a)(1)(A) involving one or more foreign corporations, and provide guidance necessary to facilitate business electronic filing under section 6038B.

T.D. 9244, page 463.
REG–138879–05, page 503.

Final regulations under section 358 of the Code provide a tracing approach for the determination of basis of stock or securities received in exchange for or with respect to stock and securities in certain transactions. Temporary and proposed regulations under section 1502 of the Code provide additional guidance on the treatment of an excess loss account when a consolidated group member's original shares have an excess loss account or the member would otherwise determine that new shares would have an excess loss account at the time of a basis adjustment or determination under the Internal Revenue Code. Rev. Rul. 55–355 obsoleted.

Notice 2006–13, page 496.

This notice announces that the IRS and Treasury intend to issue final regulations under section 1503(d) of the Code to provide that a reasonable cause standard similar to proposed regulations section 1.1503(d)–1(c)(1) will apply to cure all late filings under section 1503(d). Prior to issuance of those regulations, taxpayers may rely on the reasonable cause procedure set forth in proposed regulations section 1.1503(d)–1(c)(1), as modified by this notice, to cure late filings under the current regulations. Additionally, until the final regulations are issued, taxpayers may choose to apply for relief for untimely section 1503(d) filings under the provisions of regulations sections 301.9100–1 through 301.9100–3 or elect to use the reasonable cause standard set forth in the proposed regulations as modified by this notice.

Notice 2006–14, page 498.

This notice invites public comments on certain distributions treated as sales or exchanges under section 751(b) of the Code. The Treasury Department and the Service are conducting a study of the current section 751(b) regulations and are considering alternative approaches to achieving the purpose of the statute.

EMPLOYEE PLANS

REG–146459–05, page 504.

Proposed regulations under sections 402A, 408A, and 402(g) of the Code set forth the tax treatment of designated Roth contributions (and related earnings) that are distributed from an eligible retirement plan, the requirements that must be satisfied for tax-free treatment of these amounts, and the applicable restrictions on rollovers of such amounts to a tax-favored retirement plan or Roth individual retirement account (Roth IRA). The regulations also set forth the requirements for designated Roth contributions under a section 403(b) plan and address the application of the universal availability requirement to the right of any employee to make designated Roth contributions under a section 403(b) plan.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

EXEMPT ORGANIZATIONS

Announcement 2006–14, page 516.
A list is provided of organizations now classified as private foundations.

GIFT TAX

Notice 2006–15, page 501.
Until further guidance is issued, the Service will disregard a spousal right of election for purposes of determining whether a charitable remainder annuity trust (CRAT) or charitable remainder unitrust (CRUT) meets the requirements of section 664(d)(1)(B) or (d)(2)(B) of the Code, provided that the right of election is not exercised. Rev. Proc. 2005–24 modified.

ADMINISTRATIVE

Notice 2006–18, page 502.
The recomputed differential earnings rate for 2004 is tentatively determined for use by mutual life insurance companies to compute their income tax liability for 2005.

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.

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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 358.—Basis to Distributees

26 CFR 1.358–1: Basis to distributees.

T.D. 9244

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Determination of Basis of Stock or Securities Received In Exchange For, or With Respect to, Stock or Securities in Certain Transactions; Treatment of Excess Loss Accounts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations under section 358 that provide guidance regarding the determination of the basis of stock or securities received in exchange for, or with respect to, stock or securities in certain transactions. This document also contains temporary regulations under section 1502 that govern certain basis determinations and adjustments of subsidiary stock in certain transactions involving members of a consolidated group. The text of the temporary regulations also serves as the text of the proposed regulations (REG–138879–05) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin. The final and temporary regulations affect shareholders of corporations.

DATES: *Effective Date:* The final and temporary regulations are effective on January 23, 2006.

Applicability Dates: Section 1.1502–19T applies to adjustments and determinations of basis of (including an excess loss account in) the stock of a member occurring on or after January 23, 2006. The applicability of §1.1502–19T will expire on January 23, 2009.

FOR FURTHER INFORMATION CONTACT: Theresa M. Kolish, (202) 622–7530 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Section 358(a)(1) of the Internal Revenue Code (Code) generally provides that the basis of property received pursuant to an exchange to which section 351, 354, 355, 356, or 361 applies is the same as that of the property exchanged, decreased by the fair market value of any other property (except money) received by the taxpayer, the amount of any money received by the taxpayer, and the amount of loss to the taxpayer which was recognized on such exchange, and increased by the amount which was treated as a dividend, and the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend). Section 358(b)(1) provides that, under regulations prescribed by the Secretary, the basis determined under section 358(a)(1) must be allocated among the properties received in the exchange or distribution.

On May 3, 2004, the IRS and Treasury Department published a notice of proposed rulemaking (REG–116564–03, 2004–1 C.B. 927) in the **Federal Register** (69 FR 24107) that included regulations under section 358 (the proposed regulations) providing guidance regarding the determination of the basis of shares or securities received in a reorganization described in section 368 and a distribution to which section 355 applies. The proposed regulations adopt a tracing method pursuant to which the basis of each share of stock or security received in a reorganization under section 368 is traced to the basis of each surrendered share of stock or security, and each share of stock or security received in a distribution under section 355 is allocated basis from a share of stock or security of the distributing corporation. In the course of developing the proposed regulations, the IRS and Treasury Department considered whether a tracing method or an averaging method should be used to determine the basis of stock and securities received in such transactions. The proposed regulations' adoption of the tracing method is based on the view of the IRS and Treasury Department that, in light of the carryover basis rule of section 358, a reorganization is not an event that justifies averaging the bases of exchanged stock or securities that have been purchased at different times and at different prices. Moreover, the adoption of the tracing method reflects the concern of the IRS and Treasury Department that averaging the bases of exchanged blocks of stock or securities may inappropriately limit the ability of taxpayers to arrange their affairs and may afford opportunities for the avoidance of certain provisions of the Code.

Under the proposed regulations, the basis of each share of stock or security received in an exchange to which section 354, 355, or 356 applies is generally the same as the basis of the share or shares of stock or security or securities exchanged therefor. In the case of a distribution to which section 355 applies, the proposed regulations provide that the basis of each share of stock or security of the distributing corporation is allocated between the share of stock or security of the distributing corporation and the share of stock or security received with respect to such share of stock or security of the distributing corporation in proportion to their fair market values.

If a shareholder or security holder is unable to identify which particular share (or portion of a share) of stock or security is exchanged for, or received with respect to, a particular share (or portion of a share) of stock or security, the proposed regulations permit the shareholder or security holder to designate which share or security is received in exchange for, or in respect of, which share or security. Such designation, however, must be consistent with the terms of the exchange or distribution and must be made on or before the first date on which the basis of a share or security received is relevant, for example, the date on which a share or security received is sold,

or is transferred in an exchange described in section 351 or section 721 or a reorganization described in section 368.

No public hearing regarding the proposed regulations was requested or held. However, several written and electronic comments regarding the proposed regulations were received. After consideration of the comments, the proposed regulations are adopted as amended by this Treasury decision.

Explanation of Provisions

These final regulations retain the tracing method of the proposed regulations, but make several modifications to the proposed regulations in response to the comments received. The following paragraphs describe the most significant comments received and the extent to which they have been incorporated into these final and temporary regulations.

A. *Allocation of Consideration Received*

As described above, in certain cases, the proposed regulations permit a shareholder to designate which share or security is received in exchange for, or with respect to, which share or security, provided that the designation is consistent with the terms of the exchange or distribution. One commentator observed that in certain cases in which more than one class of stock or securities is received in exchange for more than one block of stock, more than one designation may be consistent with the terms of the exchange. For example, suppose that A owns two blocks of 100 shares of Corporation X common stock. Each block has a value of $100. A has an aggregate basis of $50 in one block and an aggregate basis of $250 in the other block. Pursuant to the terms of a reorganization, A transfers both blocks in exchange for 100 shares of Corporation Y common stock with a value of $100 and 100 shares of Corporation Y preferred stock with a value of $100. Under the proposed regulations, A's designation could reflect that each of the Corporation Y common stock and the Corporation Y preferred stock are allocated to the shares exchanged in proportion to their fair market values. Therefore, Corporation Y common stock with a fair market value of $50 and Corporation Y preferred stock with a fair market value of $50 would be treated as received for each block of Corporation X common stock. Alternatively, A's designation could reflect that the low basis Corporation X shares were exchanged for Corporation Y common stock and the high basis Corporation X shares were exchanged for Corporation Y preferred stock or vice versa. Other designations would also seemingly be permitted under the proposed regulations. The commentator requested clarification regarding whether these designations would, in fact, be permitted.

The IRS and Treasury Department have considered the extent to which taxpayers should be permitted to designate which type of consideration is received in exchange for particular shares of stock or securities when more than one designation is consistent with the terms of the exchange. The IRS and Treasury Department believe that this issue is likely to arise only in cases in which the target corporation is closely held. In these cases, the shareholders will likely have the ability to control the terms of the exchange. These final regulations confirm that, to the extent the terms of the exchange specify which shares of stock or securities are received in exchange for a particular share of stock or security or a particular class of stock or securities, provided that such terms are economically reasonable, such terms will control for purposes of determining the basis of the stock or securities received. In addition, these final regulations provide that, to the extent the terms of the exchange do not specify which shares of stock or securities are received in exchange for a particular share of stock or security or a particular class of stock or securities, a *pro rata* portion of the shares of stock and securities of each class received is treated as received in exchange for each share of stock and security surrendered, based on the fair market value of the surrendered stock and securities. The final regulations also include similar rules that apply to distributions under section 355.

B. *Allocation of Boot Received*

A number of commentators requested guidance regarding the proper method for allocating boot among the stock and securities surrendered in an exchange or the stock and securities with respect to which a distribution is made. An allocation of boot may be necessary to compute the taxpayer's gain recognized in connection with a transaction and, therefore, its basis in stock and securities received. One commentator suggested that a facts and circumstances analysis (presumably one that examines the terms of the exchange) should be used to determine what nonrecognition property received in an exchange is allocable to particular shares or securities surrendered. In cases in which the facts and circumstances do not suggest a particular allocation, the commentator suggested that the boot should be allocated *pro rata* among the surrendered stock and securities. For example, suppose A holds 100 shares of Corporation T common stock and 100 shares of Corporation T preferred stock. The common shares have an aggregate basis of $10 and an aggregate fair market value of $100 and the preferred shares have an aggregate basis of $20 and an aggregate fair market value of $100. Corporation T merges with and into Corporation X in a reorganization under section 368. In the reorganization, A exchanges its shares of Corporation T common and preferred stock for 100 shares of Corporation X common stock with an aggregate fair market value of $100 and $100 of cash. If the cash were allocated proportionately between the common and preferred shares based on their relative values, A would recognize $50 of gain on its common shares and $50 of gain on its preferred shares. If the cash were allocated solely to the common shares, A would recognize $90 of gain. If the cash were allocated solely to the preferred shares, A would recognize $80 of gain.

These final regulations adopt rules governing the allocation of boot among stock and securities surrendered (or with respect to which a distribution is made) that are consistent with those rules described above regarding designations of exchanges and distributions when more than one class of stock or securities is received in exchange for, or received with respect to, more than one block of stock. In particular, this Treasury decision includes regulations under section 356 that provide that, for purposes of computing the gain, if any, recognized on an exchange, to the extent the terms of the exchange specify the other property or money that is received in exchange for a particular share of stock or security surrendered, provided that such

terms are economically reasonable, such terms control. This position is consistent with the conclusions reached in Revenue Ruling 74–515, 1974–2 C.B. 118 (suggesting that, for purposes of computing gain recognized under section 356 in the context of an exchange the terms of which provided for the exchange of common stock for common stock and preferred stock for cash, the terms of the exchange governed). To the extent the terms of the exchange do not specify the other property or money that is received in exchange for a particular share of stock or security surrendered, a *pro rata* portion of the other property and money received is treated as received in exchange for each share of stock and security surrendered, based on the fair market value of such surrendered share of stock or security.

The IRS and Treasury Department are aware that there is a question as to the proper treatment of the basis of stock exchanged for boot in the following circumstances. This question arises, in part, as a result of the operation of section 356. Section 356 generally applies if section 354 would apply to an exchange but for the fact that the property received in the exchange consists not only of property permitted by section 354 to be received without the recognition of gain but also of other property or money. Section 356(c) provides that no loss realized from such an exchange may be recognized.

Suppose A holds 100 shares of Corporation T common stock and 100 shares of Corporation T preferred stock. The common shares have an aggregate basis of $10 and an aggregate fair market value of $100 and the preferred shares have an aggregate basis of $150 and an aggregate fair market value of $100. Corporation T merges with and into Corporation X in a reorganization under section 368. The terms of the exchange specify that A exchanges its shares of Corporation T common stock for 100 shares of Corporation X common stock with an aggregate fair market value of $100 and exchanges its shares of Corporation T preferred stock for $100 of cash. Under these final regulations, the terms of the exchange control for purposes of determining gain under section 356 and basis under section 358. Under section 356(c), A realizes a gain of $90 on the exchange of Corporation T common stock for Corporation X common stock, none of which is recognized under section 356 and A takes an aggregate basis of $10 in the shares of Corporation X common stock received in the exchange. However, A realizes a loss of $50 on the exchange of Corporation T preferred stock for cash. Therefore, A would not be entitled to recognize any of the loss realized. This conclusion is consistent with Revenue Ruling 74–515. In that ruling, a shareholder surrenders common stock of the target corporation in exchange for common stock of the acquiring corporation and preferred stock of the target corporation in exchange for cash. The ruling concludes that the tax consequences of the shareholder's exchange of preferred shares for cash are governed by section 356 and any loss realized is not recognized by reason of section 356(c).

The IRS and Treasury Department are considering, and request comments regarding, whether regulations should be adopted interpreting section 356 in a manner that would permit a taxpayer, such as A, in the circumstances described above to recognize the loss in these types of fact patterns. If an approach permitting recognition of loss in these cases is not adopted, then an issue arises as to the proper treatment of the basis of the shares with respect to which the loss is realized but not recognized, at least to the extent that such basis exceeds the cash received in respect of such shares. The IRS and Treasury Department request comments on the proper treatment of such basis.

C. *Retained Shares of Stock or Securities in Section 355 Exchanges*

As described above, the proposed regulations provide that the basis of each share of stock or security received in an exchange to which section 355 applies is generally the same as the basis of the share or shares of stock or security or securities exchanged therefor. This rule applies even if the exchanging shareholder or security holder retains shares of stock or securities in the distributing corporation. If the shareholder or security shareholder retains shares of stock or securities in the distributing corporation, the basis of those instruments remains unaffected. One commentator suggested that this approach might be viewed as inconsistent with the statutory language of section 358(b)(2).

Section 358(b)(2) generally provides that in allocating basis among the property permitted to be received without the recognition of gain or loss in an exchange to which section 355 applies, there shall be taken into account not only the property so permitted to be received without the recognition of gain or loss, but also the stock or securities (if any) of the distributing corporation that are retained and the allocation of basis must be made among all such properties. Neither the statutory language of section 358(b)(2) nor its legislative history indicates the method of allocation that Congress contemplated when it enacted this provision.

The IRS and Treasury Department believe that the rule of the proposed regulations is a reasonable approach to the implementation of section 358(b)(2). Nonetheless, the IRS and Treasury Department did consider alternative approaches.

For example, the IRS and Treasury Department considered adopting an approach that would aggregate the basis of the shares of stock and securities of the distributing corporation owned by a particular shareholder and then would allocate such basis among the shares of stock and securities in the distributing and controlled corporations owned by that shareholder immediately after the distribution based on their fair market values. Such an approach would effectively be an averaging approach for certain types of exchanges, an approach that is inconsistent with the view that a reorganization is not an event that justifies averaging the bases of exchanged stock that had been purchased at different times and at different prices and that would result in the inconsistent treatment of exchanges under section 354, 355, and 356.

The IRS and Treasury Department also considered adopting an approach that would have treated the shareholder or security holder as receiving a distribution of stock or securities on each share of stock or security that it owned in the distributing corporation, followed by a recapitalization of both the distributing and controlled corporations to reflect the shareholders' and security holders' actual stock and security ownership immediately after the transaction. The IRS and Treasury Department, however, were concerned that this approach would be complex and inadministrable, especially in cases in which a

shareholder holds stock of the distributing corporation in multiple accounts.

For the reasons described above, these two alternative approaches were rejected. Therefore, these final regulations do not alter the operation of the rules of the proposed regulations in this context.

D. *Stockless Reorganizations*

A number of commentators observed that it is not clear how basis should be determined in the case of a reorganization in which no stock is issued. Such a situation may arise in reorganizations involving commonly controlled acquiring and target corporations where the issuance of additional stock of the acquiring corporation would constitute a meaningless gesture. One commentator suggested an approach that would treat the acquiring corporation as issuing an amount of stock equal to the fair market value of the stock surrendered. The basis of that deemed issued stock would have a basis traced from the shares surrendered in the reorganization under the rules that would have applied had the shareholder actually received such stock. Then, the shareholder's stock in the acquiring corporation would be treated as recapitalized. In the recapitalization, the shareholder would be treated as surrendering all of its shares of the acquiring corporation, including those shares owned immediately prior to the reorganization and those shares the shareholder is deemed to receive, in exchange for the shares that the shareholder actually holds immediately after the reorganization. The basis of the shares that the shareholder actually owns would be determined under the rules that would have applied had the recapitalization actually occurred with respect to the shareholder's actual shares and the shares the shareholder is deemed to have received.

For example, suppose P wholly owns S1 and S2. P owns 100 shares of S1, each of which has a basis of $1 and was acquired on Date 1, and 100 shares of S2, each of which has a basis of $2 and was acquired on Date 2. The fair market value of each share of the stock of each of S1 and S2 is $1. S1 merges into S2 in a reorganization under section 368(a)(1)(D) in which P does not receive any additional stock of S2. Under the suggested approach, P would be treated as receiving 100 shares of S2, each of which has a fair market value of $1. The basis of those additional 100 shares would be determined as if P had actually received those shares. Therefore, each of those shares would have a basis of $1. Then, to reflect that P has only 100 shares of S2 stock rather than 200 shares, S2 would be treated as undergoing a reverse stock split in which it exchanges two shares of its stock for one share. The basis of each of the 100 shares would be determined as if the reverse stock split had actually occurred. Therefore, 50 shares of P's S2 stock would each have a basis of $2 and would be treated as having been acquired on Date 1 and the remaining 50 shares of P's S2 stock would each have a basis of $4 and would be treated as having been acquired on Date 2.

The IRS and Treasury Department believe that the approach suggested is consistent with the general tracing approach of the proposed regulations. Accordingly, these final regulations adopt the suggested approach for cases in which a shareholder of the target corporation receives no property or property with a fair market value less than that of the stock or securities the shareholder surrendered in the transaction.

E. *Single Versus Split Basis Approaches*

The proposed regulations provide that if one share of stock or security is received in exchange for, or with respect to, more than one share of stock or security or a fraction of a share of stock or security is received, the basis of the shares of surrendered stock or securities must be allocated to the shares of stock or securities received in a manner that reflects, to the greatest extent possible, that a share of stock or security received is received in exchange for, or with respect to, shares of stock or securities that were acquired on the same date and at the same price. The preamble states that this rule avoids, to the greatest extent possible, creating shares of stock or securities with split holding periods. Several commentators have requested guidance regarding whether a share that reflects the basis of several shares with differing bases has a single, aggregated basis or a split basis. For example, suppose B has two shares of stock of T. One of those shares has a basis of $1 and was acquired on Date 1. The other share has a basis of $2 and was acquired on Date 2. A, a corporation, acquires the assets of T in a reorganization under section 368(a)(1)(A). In the reorganization, B exchanges its two shares of T stock for one share of A stock. One possibility is that B has a single, undivided $3 basis in its share of A stock. Another possibility is that B has a split basis in its share of A stock such that half of the share is treated as having a basis of $1 and the other half is treated as having a basis of $2.

The IRS and Treasury Department believe that because the single, aggregated basis approach has the effect of averaging the basis of more than one share, it is inconsistent with the tracing regime adopted in these final regulations. Moreover, as suggested in the preamble of the proposed regulations, the IRS and Treasury Department believe that it is possible for a share to have a split holding period. The IRS and Treasury Department believe that the split basis approach is a logical corollary to the split holding period approach. Therefore, these final regulations reflect that a share may have not only a split holding period, but also a split basis.

F. *Coordination with Section 1036*

Section 1036 provides that no gain or loss is recognized if common stock is exchanged for common stock, or preferred stock is exchanged for preferred stock, in the same corporation. Section 1031 provides rules for determining the basis of the common or preferred stock received in an exchange described in section 1036. One commentator requested clarification regarding whether the basis tracing rules of the proposed regulations apply to transactions governed by both section 1036 and section 354 or 356.

The IRS and Treasury Department believe that those same policies that support the application of a tracing regime in the context of transactions governed solely by section 354 or 356 support the application of a tracing regime in the context of transactions governed by both section 1036, on the one hand, and section 354 or 356, on the other hand. Accordingly, these final regulations provide that the tracing rules apply to determine the basis of a share of stock or security received by a shareholder or security holder in an exchange described in both section 1036, on the one hand, and section 354 or section 356, on the other hand. The IRS and Treasury

Department continue to study whether the rules of these final regulations should be adopted in regulations under section 1036 for transactions governed by section 1036, but not section 354 or 356.

G. *Application of Tracing Rules to Section 351 Transactions*

Under the proposed regulations, the tracing rules do not apply to an exchange described in section 351, unless such exchange is also described in section 354 or section 356 and certain other requirements are satisfied. One commentator urged the IRS and Treasury Department to consider expanding the tracing regime of the proposed regulations to apply more broadly to exchanges governed by section 351. That commentator suggested that having different regimes apply to the determination of the basis of stock received in a tax-free exchange for stock is undesirable.

The IRS and Treasury Department are continuing to study the possible application of a tracing approach more broadly to exchanges described in section 351. In the meantime, these final regulations retain those limitations on the application of the basis tracing regime to exchanges described in section 351 that were included in the proposed regulations.

H. *Excess Loss Accounts*

Section 1.1502–19(d) provides that if a member (P) of a consolidated group has an excess loss account in shares of a class of another member's (S's) stock at the time of a basis adjustment or determination under the Internal Revenue Code with respect to other shares of the same class of S's stock owned by the member, the adjustment or determination is allocated first to equalize and eliminate that member's excess loss account. The rule reflects a policy of permitting the elimination of excess loss accounts. The application of the rule, however, is sensitive to the form of the transaction. For example, if P owns all of the stock of S with an excess loss account of $100 and all of the stock of T with a basis of $150, and T merges into S in a reorganization under section 368(a)(1)(D) in which P receives additional shares of S stock, under §1.1502–19(d), P's excess loss account in its original shares of S stock is first eliminated. Therefore, P's original S shares will have an aggregate basis of $0 and P's new S shares will have an aggregate basis of $50. If, instead, however, S merges into T in a reorganization under section 368(a)(1)(D) in which P receives additional shares of T stock, because P does not already have T shares that have an excess loss account, §1.1502–19(d) does not apply. Therefore, P's original T shares will have a basis of $150 and P's new T shares will have an excess loss account of $100.

The limitation on the application of §1.1502–19(d) to cases in which a basis adjustment or determination is made with respect to shares of a class of stock of the corporation in which the member holds other shares with an excess loss account effectively makes the rule elective. That is, if the transaction occurs in one direction (in the example above, T merges into S), the rule applies. If the transaction occurs in the other direction (in the example above, S merges into T), the rule does not apply. The IRS and Treasury Department believe that this electivity is undesirable. Therefore, the IRS and Treasury Department believe that it is appropriate to expand the scope of the application of the rule of §1.1502–19(d). Accordingly, the temporary regulations included in this Treasury decision add an additional rule to §1.1502–19 that provides that if a member would otherwise determine shares of a class of S's stock (a new share) to have an excess loss account and such member owns one or more other shares of the same class of S's stock, the basis of such other shares is allocated to eliminate and equalize any excess loss account that would otherwise be in the new shares. Therefore, in the example above where S merges into T in a reorganization under section 368(a)(1)(D) in which P receives additional shares of T stock, the basis of P's original T shares will first be applied to eliminate the excess loss account that P would otherwise have in its new T shares. Therefore, P will have an aggregate basis of $50 in its original T shares and an aggregate basis of $0 in its new T shares.

Effective Date

The final and temporary regulations apply to exchanges and distributions of stock or securities and determinations of stock basis occurring on or after the date these regulations are filed as final regulations in the **Federal Register**.

Effect on Other Documents

The following publication is obsolete as of January 23, 2006:

Revenue Ruling 55–355, 1955–1 C.B. 418.

Special Analyses

It has been determined that the final regulations issued with respect to section 358 and section 1502 are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

It has been determined that the temporary regulations issued with respect to section 1502 are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. These temporary regulations are necessary to provide taxpayers with immediate guidance regarding the application of section 358 when a member of a consolidated group has an excess loss account in the stock of another member and consequences of such application. Accordingly, good cause is found for dispensing with notice and public procedure pursuant to 5 U.S.C. 553(b)(B) and with a delayed effective date pursuant to 5 U.S.C. 553(d)(3). For applicability of the Regulatory Flexibility Act, please refer to the cross-reference notice of proposed rulemaking published elsewhere in the Bulletin. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these regulations are Emidio J. Forlini, Jr. and Theresa M. Kolish of the Office of the Associate Chief Counsel (Corporate), IRS. However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1— INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read, in part, as follows:

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

Section 1.358–2 also issued under 26 U.S.C. 358. * * *

Section 1.1502–19T also issued under 26 U.S.C. 1502. * * *

Section 1.1502–32 also issued under 26 U.S.C. 1502. * * *

Par. 2. Section 1.356–1 is revised to read as follows:

§1.356–1 Receipt of additional consideration in connection with an exchange.

(a) If in any exchange to which the provisions of section 354 or section 355 would apply except for the fact that there is received by the shareholders or security holders other property (in addition to property permitted to be received without recognition of gain by such sections) or money, then—

(1) The gain, if any, to the taxpayer shall be recognized in an amount not in excess of the sum of the money and the fair market value of the other property, but,

(2) The loss, if any, to the taxpayer from the exchange or distribution shall not be recognized to any extent.

(b) For purposes of computing the gain, if any, recognized pursuant to section 356 and paragraph (a)(1) of this section, to the extent the terms of the exchange specify the other property or money that is received in exchange for a particular share of stock or security surrendered or a particular class of stock or securities surrendered, such terms shall control provided that such terms are economically reasonable. To the extent the terms of the exchange do not specify the other property or money that is received in exchange for a particular share of stock or security surrendered or a particular class of stock or securities surrendered, a *pro rata* portion of the other property and money received shall be treated as received in exchange for each share of stock and security surrendered, based on the fair market value of such surrendered share of stock or security.

(c) If the distribution of such other property or money by or on behalf of a corporation has the effect of the distribution of a dividend, then there shall be chargeable to each distributee (either an individual or a corporation)—

(1) As a dividend, such an amount of the gain recognized as is not in excess of the distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and

(2) As a gain from the exchange of property, the remainder of the gain so recognized.

(d) The rules of this section may be illustrated by the following examples:

Example 1. In an exchange to which the provisions of section 356 apply and to which section 354 would apply but for the receipt of property not permitted to be received without the recognition of gain or loss, A (either an individual or a corporation), received the following in exchange for a share of stock having an adjusted basis to A of $85:

One share of stock worth	$100
Cash	25
Other property (basis $25) fair market value	50
Total fair market value of consideration received	$175
Adjusted basis of stock surrendered in exchange	$85
Total gain	90
Gain to be recognized, limited to cash and other property received	$75
A's *pro rata* share of earnings and profits accumulated after February 28, 1913 (taxable dividend)	$30
Remainder to be treated as a gain from the exchange of property	45

Example 2. If, in *Example 1*, A's stock had an adjusted basis to A of $200, A would have realized a loss of $25 on the exchange, which loss would not be recognized.

Example 3. (i) *Facts.* J, an individual, acquired 10 shares of Class A stock of Corporation X on Date 1 for $3 each and 10 shares of Class B stock of Corporation X on Date 2 for $9 each. On Date 3, Corporation Y acquires the assets of Corporation X in a reorganization under section 368(a)(1)(A). Pursuant to the terms of the plan of reorganization, J surrenders all of J's shares of Corporation X stock for 10 shares of Corporation Y stock and $100 of cash. On the date of the exchange, the fair market value of each share of Class A stock of Corporation X is $10, the fair market value of each share of Class B stock of Corporation X is $10, and the fair market value of each share of Corporation Y stock is $10. The terms of the exchange do not specify that shares of Corporation Y stock or cash are received in exchange for particular shares of Class A stock or Class B stock of Corporation X.

(ii) *Analysis.* Under paragraph (b) of this section, because the terms of the exchange do not specify that the cash is received in exchange for shares of Class A or Class B stock of Corporation X, a *pro rata* portion of the cash received is treated as received in exchange for each share of Class A stock of Corporation X and each share of Class B stock of Corporation X based on the fair market value of the surrendered shares. Therefore, J is treated as receiving shares of Corporation Y stock with a fair market value of $50 and $50 of cash in exchange for its shares of Class A stock

of Corporation X and shares of Corporation Y stock with a fair market value of $50 and $50 of cash in exchange for its shares of Class B stock of Corporation X. J realizes a gain of $70 on the exchange of shares of Class A stock, $50 of which is recognized under section 356 and paragraph (a) of this section, and J realizes a gain of $10 on the exchange of shares of Class B stock of Corporation X, all of which is recognized under section 356 and paragraph (a) of this section. Assuming that J's gain recognized is not treated as a dividend under section 356(a)(2), such gain shall be treated as gain from the exchange of property.

Example 4. (i) *Facts*. The facts are the same as in Example 3, except that the terms of the plan of reorganization specify that J receives 10 shares of stock of Corporation Y in exchange for J's shares of Class A stock of Corporation X and $100 of cash in exchange for J's shares of Class B stock of Corporation X.

(ii) *Analysis*. Under paragraph (b) of this section, because the terms of the exchange specify that J receives 10 shares of stock of Corporation Y in exchange for J's shares of Class A stock of Corporation X and $100 of cash in exchange for J's shares of Class B stock of Corporation X and such terms are economically reasonable, such terms control. J realizes a gain of $70 on the exchange of shares of Class A stock, none of which is recognized under section 356 and paragraph (a) of this section, and J realizes a gain of $10 on the exchange of shares of Class B stock of Corporation X, all of which is recognized under section 356 and paragraph (a) of this section.

(e) Section 301(b)(1)(B) and section 301(d)(2) do not apply to a distribution of "other property" to a corporate shareholder if such distribution is within the provisions of section 356.

(f) See paragraph (l) of §1.301–1 for certain transactions which are not within the scope of section 356.

(g) This section applies to exchanges and distributions of stock and securities occurring on or after January 23, 2006.

Par. 3. Section 1.358–1 is revised to read as follows:

§1.358–1 Basis to distributees.

(a) In the case of an exchange to which section 354 or 355 applies in which, under the law applicable to the year in which the exchange is made, only nonrecognition property is received, immediately after the transaction, the sum of the basis of all of the stock and securities received in the transaction shall be the same as the basis of all the stock and securities in such corporation surrendered in the transaction, allocated in the manner described in §1.358–2. In the case of a distribution to which section 355 applies in which, under the law applicable to the year in which the distribution is made, only nonrecognition property is received, immediately after the transaction, the sum of the basis of all of the stock and securities with respect to which the distribution is made plus the basis of all stock and securities received in the distribution with respect to such stock and securities shall be the same as the basis of the stock and securities with respect to which the distribution is made immediately before the transaction, allocated in the manner described in §1.358–2. In the case of an exchange to which section 351 or 361 applies in which, under the law applicable to the year in which the exchange was made, only nonrecognition property is received, the basis of all the stock and securities received in the exchange shall be the same as the basis of all property exchanged therefor. If in an exchange or distribution to which section 351, 356, or 361 applies both nonrecognition property and "other property" are received, the basis of all the property except "other property" held after the transaction shall be determined as described in the preceding three sentences decreased by the sum of the money and the fair market value of the "other property" (as of the date of the transaction) and increased by the sum of the amount treated as a dividend (if any) and the amount of the gain recognized on the exchange, but the term gain as here used does not include any portion of the recognized gain that was treated as a dividend. In any case in which a taxpayer transfers property with respect to which loss is recognized, such loss shall be reflected in determining the basis of the property received in the exchange. The basis of the "other property" is its fair market value as of the date of the transaction. See §1.460–4(k)(3)(iv)(A) for rules relating to stock basis adjustments required where a contract accounted for using a long-term contract method of accounting is transferred in a transaction described in section 351 or a reorganization described in section 368(a)(1)(D) with respect to which the requirements of section 355 (or so much of section 356 as relates to section 355) are met.

(b) The application of paragraph (a) of this section may be illustrated by the following example:

Example. A purchased a share of stock in Corporation X in 1935 for $150. Since that date A has received distributions out of other than earnings and profits (as defined in section 316) totaling $60, so that A's adjusted basis for the stock is $90. In a transaction qualifying under section 356, A exchanged this share for one share in Corporation Y, worth $100, cash in the amount of $10, and other property with a fair market value of $30. The exchange had the effect of the distribution of a dividend. A's ratable share of the earnings and profits of Corporation X accumulated after February 28, 1913, was $5. A realized a gain of $50 on the exchange, but the amount recognized is limited to $40, the sum of the cash received and the fair market value of the other property. Of the gain recognized, $5 is taxable as a dividend, and $35 is taxable as a gain from the exchange of property. The basis to A of the one share of stock of Corporation Y is $90, that is, the adjusted basis of the one share of stock of Corporation X ($90), decreased by the sum of the cash received ($10) and the fair market value of the other property received ($30) and increased by the sum of the amount treated as a dividend ($5) and the amount treated as a gain from the exchange of property ($35). The basis of the other property received is $30.

(c) This section applies to exchanges and distributions of stock and securities occurring on or after January 23, 2006.

Par. 4. Section 1.358–2 is amended by:

1. Revising paragraphs (a)(1) and (a)(2).

2. Removing paragraphs (a)(3), (a)(4), and (a)(5).

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

4. Adding paragraph (d).

The revisions and addition read as follows:

§1.358–2 Allocation of basis among nonrecognition property.

(a) *Allocation of basis in exchanges or distributions to which section 354, 355, or 356 applies*. (1) As used in this paragraph the term *stock* means stock which is not "other property" under section 356. The term *securities* means securities (including, where appropriate, fractional parts of securities) which are not "other property" under section 356. Stock, or securities, as the case may be, which differ either because they are in different corporations or because the rights attributable to them differ (although they are in the same corporation) are considered different classes of stock or securities, as the case may be, for purposes of this section.

(2)(i) If a shareholder or security holder surrenders a share of stock or a security in an exchange under the terms of section 354, 355, or 356, the basis of each share of stock or security received in the exchange shall be the same as the basis of the share or shares of stock or security or securities (or allocable portions thereof) exchanged therefor (as adjusted under §1.358–1). If more than one share of stock or security is

received in exchange for one share of stock or one security, the basis of the share of stock or security surrendered shall be allocated to the shares of stock or securities received in the exchange in proportion to the fair market value of the shares of stock or securities received. If one share of stock or security is received in exchange for more than one share of stock or security or if a fraction of a share of stock or security is received, then the basis of the shares of stock or securities surrendered must be allocated to the shares of stock or securities (or allocable portions thereof) received in a manner that reflects, to the greatest extent possible, that a share of stock or security received is received in respect of shares of stock or securities that were acquired on the same date and at the same price. To the extent it is not possible to allocate basis in this manner, the basis of the shares of stock or securities surrendered must be allocated to the shares of stock or securities (or allocable portions thereof) received in a manner that minimizes the disparity in the holding periods of the surrendered shares of stock or securities whose basis is allocated to any particular share of stock or security received.

(ii) If a shareholder or security holder surrenders a share of stock or a security in an exchange under the terms of section 354, 355, or 356, and receives shares of stock or securities of more than one class, or receives "other property" or money in addition to shares of stock or securities, then, to the extent the terms of the exchange specify that shares of stock or securities of a particular class or "other property" or money is received in exchange for a particular share of stock or security or a particular class of stock or securities, for purposes of applying the rules of this section, such terms shall control provided such terms are economically reasonable. To the extent the terms of the exchange do not specify that shares of stock or securities of a particular class or "other property" or money is received in exchange for a particular share of stock or security or a particular class of stock or securities, then, for purposes of applying the rules of paragraph (a)(2)(i) of this section, a *pro rata* portion of the shares of stock and securities of each class received and a *pro rata* portion of the "other property" and money received shall be treated as received in exchange for each share of stock and security surrendered, based on the fair market value of the stock and securities surrendered.

(iii) For purposes of this section, if a shareholder or security holder surrenders a share of stock or a security in a transaction under the terms of section 354 (or so much of section 356 as relates to section 354) in which such shareholder or security holder receives no property or property (including property permitted by section 354 to be received without the recognition of gain or "other property" or money) with a fair market value less than that of the stock or securities surrendered in the transaction, such shareholder or security holder shall be treated as follows. First, the shareholder or security holder shall be treated as receiving the stock, securities, other property, and money actually received by the shareholder or security holder in the transaction and an amount of stock of the issuing corporation (as defined in §1.368–1(b)) that has a value equal to the excess of the value of the stock or securities the shareholder or security holder surrendered in the transaction over the value of the stock, securities, other property, and money the shareholder or security holder actually received in the transaction. If the shareholder owns only one class of stock of the issuing corporation the receipt of which would be consistent with the economic rights associated with each class of stock of the issuing corporation, the stock deemed received by the shareholder pursuant to the previous sentence shall be stock of such class. If the shareholder owns multiple classes of stock of the issuing corporation the receipt of which would be consistent with the economic rights associated with each class of stock of the issuing corporation, the stock deemed received by the shareholder shall be stock of each such class owned by the shareholder immediately prior to the transaction, in proportion to the value of the stock of each such class owned by the shareholder immediately prior to the transaction. The basis of each share of stock or security deemed received and actually received shall be determined under the rules of this section. Second, the shareholder or security holder shall then be treated as surrendering all of its shares of stock and securities in the issuing corporation, including those shares of stock or securities held immediately prior to the transaction, those shares of stock or securities actually received in the transaction, and those shares of stock deemed received pursuant to the previous sentence, in a reorganization under section 368(a)(1)(E) in exchange for the shares of stock and securities of the issuing corporation that the shareholder or security holder actually holds immediately after the transaction. The basis of each share of stock and security deemed received in the reorganization under section 368(a)(1)(E) shall be determined under the rules of this section.

(iv) If a shareholder or security holder receives one or more shares of stock or one or more securities in a distribution under the terms of section 355 (or so much of section 356 as relates to section 355), the basis of each share of stock or security of the distributing corporation (as defined in §1.355–1(b)), as adjusted under §1.358–1, shall be allocated between the share of stock or security of the distributing corporation with respect to which the distribution is made and the share or shares of stock or security or securities (or allocable portions thereof) received with respect to the share of stock or security of the distributing corporation in proportion to their fair market values. If one share of stock or security is received with respect to more than one share of stock or security or if a fraction of a share of stock or security is received, then the basis of each share of stock or security of the distributing corporation must be allocated to the shares of stock or securities (or allocable portions thereof) received in a manner that reflects that, to the greatest extent possible, a share of stock or security received is received with respect to shares of stock or securities acquired on the same date and at the same price. To the extent it is not possible to allocate basis in this manner, the basis of each share of stock or security of the distributing corporation must be allocated to the shares of stock or securities (or allocable portions thereof) received in a manner that minimizes the disparity in the holding periods of the shares of stock or securities with respect to which such shares of stock or securities are received.

(v) If a shareholder or security holder receives shares of stock or securities of more than one class, or receives "other property" or money in addition to stock or securities in a distribution under the terms of section 355 (or so much of section 356 as relates to section 355), then, to the ex-

tent the terms of the distribution specify that shares of stock or securities of a particular class or "other property" or money is received with respect to a particular share of stock or security of the distributing corporation or a particular class of stock or securities of the distributing corporation, for purposes of applying the rules of this section, such terms shall control provided that such terms are economically reasonable. To the extent the terms of the distribution do not specify that shares of stock or securities of a particular class or "other property" or money is received with respect to a particular share of stock or security of the distributing corporation or a particular class of stock or securities of the distributing corporation, then, for purposes of applying the rules of this section, a *pro rata* portion of the shares of stock and securities of each class received and a *pro rata* portion of the "other property" and money received shall be treated as received with respect to each share of stock and security of the distributing corporation with respect to which the distribution is made, based on the fair market value of each such share of stock or security.

(vi) If a share of stock or a security is received in exchange for, or with respect to, more than one share of stock or security and such shares or securities were acquired on different dates or at different prices, the share of stock or security received shall be divided into segments based on the relative fair market values of the shares of stock or securities surrendered in exchange for such share or security or the relative fair market values of the shares of stock or securities with respect to which the share of stock or security is received in a distribution under the terms of section 355 (or so much of section 356 as relates to section 355). Each segment shall have a basis determined under the rules of paragraph (a)(2) of this section and a corresponding holding period.

(vii) If a shareholder or security holder that purchased or acquired shares of stock or securities in a corporation on different dates or at different prices exchanges such shares of stock or securities under the terms of section 354, 355, or 356, or receives a distribution of shares of stock or securities under the terms of section 355 (or so much of section 356 as relates to section 355), and the shareholder or security holder is not able to identify which particular share of stock or security (or allocable portion of a share of stock or security) is received (or deemed received) in exchange for, or with respect to, a particular share of stock or security, the shareholder or security holder may designate which share of stock or security is received in exchange for, or with respect to, a particular share of stock or security, provided that such designation is consistent with the terms of the exchange or distribution (or an exchange deemed to have occurred pursuant to paragraph (a)(2)(iii) of this section), and the other rules of this section. In the case of an exchange under the terms of section 354 or 356 (including a deemed exchange as a result of the application of paragraph (a)(2)(iii) of this section), the designation must be made on or before the first date on which the basis of a share of stock or a security received (or deemed received in the reorganization under section 368(a)(1)(E) in the case of a transaction to which paragraph (a)(2)(iii) of this section applies) is relevant. In the case of an exchange or distribution under the terms of section 355 (or so much of section 356 as relates to section 355), the designation must be made on or before the first date on which the basis of a share of stock or a security of the distributing corporation or the controlled corporation (as defined in §1.355–1(b)) is relevant. The basis of the shares or securities received in an exchange under the terms of section 354 or section 356, for example, is relevant when such shares or securities are sold or otherwise transferred. The designation will be binding for purposes of determining the Federal tax consequences of any sale or transfer of, or distribution with respect to, the shares or securities received. If the shareholder fails to make a designation in a case in which the shareholder is not able to identify which share of stock is received in exchange for, or with respect to, a particular share of stock, then the shareholder will not be able to identify which shares are sold or transferred for purposes of determining the basis of property sold or transferred under section 1012 and §1.1012–1(c) and, instead, will be treated as selling or transferring the share received in respect of the earliest share purchased or acquired.

(viii) This paragraph (a)(2) shall not apply to determine the basis of a share of stock or security received by a shareholder or security holder in an exchange described in both section 351 and section 354 or section 356, if, in connection with the exchange, the shareholder or security holder exchanges property for stock or securities in an exchange to which neither section 354 nor section 356 applies or liabilities of the shareholder or security holder are assumed.

(ix) This paragraph (a)(2) shall apply to determine the basis of a share of stock or security received by a shareholder or security holder in an exchange described in both section 1036 and section 354 or section 356.

(b) *Allocation of basis in exchanges to which section 351 or 361 applies.* (1) As used in this paragraph (b), the term *stock* refers only to stock which is not "other property" under section 351 or 361 and the term *securities* refers only to securities which are not "other property" under section 351 or 361.

* * * * *

(c) *Examples.* The application of paragraphs (a) and (b) of this section is illustrated by the following examples:

Example 1. (i) *Facts.* J, an individual, acquired 20 shares of Corporation X stock on Date 1 for $3 each and 10 shares of Corporation X stock on Date 2 for $6 each. On Date 3, Corporation Y acquires the assets of Corporation X in a reorganization under section 368(a)(1)(A). Pursuant to the terms of the plan of reorganization, J receives 2 shares of Corporation Y stock in exchange for each share of Corporation X stock. Therefore, J receives 60 shares of Corporation Y stock. Pursuant to section 354, J recognizes no gain or loss on the exchange. J is not able to identify which shares of Corporation Y stock are received in exchange for each share of Corporation X stock.

(ii) *Analysis.* Under paragraph (a)(2)(i) of this section, J has 40 shares of Corporation Y stock each of which has a basis of $1.50 and is treated as having been acquired on Date 1 and 20 shares of Corporation Y stock each of which has a basis of $3 and is treated as having been acquired on Date 2. Under paragraph (a)(2)(vii) of this section, on or before the date on which the basis of a share of Corporation Y stock received becomes relevant, J may designate which of the shares of Corporation Y stock have a basis of $1.50 and which have a basis of $3.

Example 2. (i) *Facts.* The facts are the same as in *Example 1*, except that instead of receiving 2 shares of Corporation Y stock in exchange for each share of Corporation X stock, J receives $1\frac{1}{2}$ shares of Corporation Y stock in exchange for each share of Corporation X stock. Therefore, J receives 45 shares of Corporation Y stock. Again, J is not able to identify which shares (or portions of shares) of Corporation Y stock are received in exchange for each share of Corporation X stock.

(ii) *Analysis.* Under paragraph (a)(2)(i) of this section, J has 30 shares of Corporation Y stock each of which has a basis of $2 and is treated as having been acquired on Date 1 and 15 shares of Corporation

Y stock each of which has a basis of $4 and is treated as having been acquired on Date 2. Under paragraph (a)(2)(vii) of this section, on or before the date on which the basis of a share of Corporation Y stock received becomes relevant, J may designate which of the shares of Corporation Y stock received have a basis of $2 and which have a basis of $4.

Example 3. (i) *Facts*. J, an individual, acquired 10 shares of Class A stock of Corporation X on Date 1 for $3 each, 10 shares of Class A stock of Corporation X on Date 2 for $9 each, and 10 shares of Class B stock of Corporation X on Date 3 for $3 each. On Date 4, J surrenders all of J's shares of Class A stock in exchange for 20 shares of new Class C stock and 20 shares of new Class D stock in a reorganization under section 368(a)(1)(E). Pursuant to section 354, J recognizes no gain or loss on the exchange. On the date of the exchange, the fair market value of each share of Class A stock is $6, the fair market value of each share of Class C stock is $2, and the fair market value of each share of Class D stock is $4. The terms of the exchange do not specify that shares of Class C stock or shares of Class D stock of Corporation X are received in exchange for particular shares of Class A stock of Corporation X.

(ii) *Analysis*. Under paragraph (a)(2)(ii) of this section, because the terms of the exchange do not specify that shares of Class C stock or shares of Class D stock of Corporation X are received in exchange for particular shares of Class A stock of Corporation X, a *pro rata* portion of the shares of Class C stock and shares of Class D stock received will be treated as received in exchange for each share of Class A stock based on the fair market value of the surrendered shares of Class A stock. Therefore, J is treated as receiving one share of Class C stock and one share of Class D stock in exchange for each share of Class A stock. Under paragraph (a)(2)(i) of this section, J has 10 shares of Class C stock, each of which has a basis of $1 and is treated as having been acquired on Date 1 and 10 shares of Class C stock, each of which has a basis of $3 and is treated as having been acquired on Date 2. In addition, J has 10 shares of Class D stock, each of which has a basis of $2 and is treated as having been acquired on Date 1 and 10 shares of Class D stock, each of which has a basis of $6 and is treated as having been acquired on Date 2. J's basis in each share of Class B stock remains $3. Under paragraph (a)(2)(vii) of this section, on or before the date on which the basis of a share of Class C stock or Class D stock received becomes relevant, J may designate which of the shares of Class C stock have a basis of $1 and which have a basis of $3, and which of the shares of Class D stock have a basis of $2 and which have a basis of $6.

Example 4. (i) *Facts*. J, an individual, acquired 10 shares of Class A stock of Corporation X on Date 1 for $2 each, 10 shares of Class A stock of Corporation X on Date 2 for $4 each, and 20 shares of Class B stock of Corporation X on Date 3 for $6 each. On Date 4, Corporation Y acquires the assets of Corporation X in a reorganization under section 368(a)(1)(A). Pursuant to the terms of the plan of reorganization, J surrenders all of J's shares of Corporation X stock for 40 shares of Corporation Y stock and $200 of cash. On the date of the exchange, the fair market value of each share of Class A stock of Corporation X is $10, the fair market value of each share of Class B stock of Corporation X is $10, and the fair market value of each share of Corporation Y stock is $5. The terms of the exchange do not specify that shares of Corporation Y stock or cash are received in exchange for particular shares of Class A stock or Class B stock of Corporation X.

(ii) *Analysis*. Under paragraph (a)(2)(ii) of this section and under §1.356–1(b), because the terms of the exchange do not specify that shares of Corporation Y stock or cash are received in exchange for particular shares of Class A stock or Class B stock of Corporation X, a *pro rata* portion of the shares of Corporation Y stock and cash received will be treated as received in exchange for each share of Class A stock and Class B stock of Corporation X surrendered based on the fair market value of such stock. Therefore, J is treated as receiving one share of Corporation Y stock and $5 of cash in exchange for each share of Class A stock of Corporation X and one share of Corporation Y stock and $5 of cash in exchange for each share of Class B stock of Corporation X. J realizes a gain of $140 on the exchange of shares of Class A stock of Corporation X, $100 of which is recognized under §1.356–1(a). J realizes a gain of $80 on the exchange of Class B stock of Corporation X, all of which is recognized under §1.356–1(a). Under paragraph (a)(2)(i) of this section, J has 10 shares of Corporation Y stock, each of which has a basis of $2 and is treated as having been acquired on Date 1, 10 shares of Corporation Y stock, each of which has a basis of $4 and is treated as having been acquired on Date 2, and 20 shares of Corporation Y stock, each of which has a basis of $5 and is treated as having been acquired on Date 3. Under paragraph (a)(2)(vii) of this section, on or before the date on which the basis of a share of Corporation Y stock received becomes relevant, J may designate which of the shares of Corporation Y stock received have a basis of $2, which have a basis of $4, and which have a basis of $5.

Example 5. (i) *Facts*. The facts are the same as in *Example 4*, except that the terms of the plan of reorganization specify that J receives 40 shares of stock of Corporation Y in exchange for J's shares of Class A stock of Corporation X and $200 of cash in exchange for J's shares of Class B stock of Corporation X.

(ii) *Analysis*. Under paragraph (a)(2)(ii) of this section and under §1.356–1(b), because the terms of the exchange specify that J receives 40 shares of stock of Corporation Y in exchange for J's shares of Class A stock of Corporation X and $200 of cash in exchange for J's shares of Class B stock of Corporation X and such terms are economically reasonable, such terms control. J realizes a gain of $140 on the exchange of shares of Class A stock of Corporation X, none of which is recognized under §1.356–1(a). J realizes a gain of $80 on the exchange of shares of Class B stock of Corporation X, all of which is recognized under §1.356–1(a). Under paragraph (a)(2)(i) of this section, J has 20 shares of Corporation Y stock, each of which has a basis of $1 and is treated as having been acquired on Date 1, and 20 shares of Corporation Y stock, each of which has a basis of $2 and is treated as having been acquired on Date 2. Under paragraph (a)(2)(vii) of this section, on or before the date on which the basis of a share of Corporation Y stock received becomes relevant, J may designate which of the shares of Corporation Y stock received have a basis of $1 and which have a basis of $2.

Example 6. (i) *Facts*. J, an individual, acquired 10 shares of stock of Corporation X on Date 1 for $2 each, and a security issued by Corporation X to J on Date 2 with a principal amount of $100 and a basis of $100. On Date 3, Corporation Y acquires the assets of Corporation X in a reorganization under section 368(a)(1)(A). Pursuant to the terms of the plan of reorganization, J surrenders all of J's shares of Corporation X stock in exchange for 10 shares of Corporation Y stock and surrenders J's Corporation X security in exchange for a Corporation Y security. On the date of the exchange, the fair market value of each share of stock of Corporation X is $10, the fair market value of J's Corporation X security is $100, the fair market value of each share of Corporation Y stock is $10, and the fair market value and principal amount of the Corporation Y security received by J is $100.

(ii) *Analysis*. Under paragraph (a)(2)(ii) of this section and under §1.354–1(a), because the terms of the exchange specify that J receives 10 shares of stock of Corporation Y in exchange for J's shares of Class A stock of Corporation X and a Corporation Y security in exchange for its Corporation X security and such terms are economically reasonable, such terms control. Pursuant to section 354, J recognizes no gain on either exchange. Under paragraph (a)(2)(i) of this section, J has 10 shares of Corporation Y stock, each of which has a basis of $2 and is treated as having been acquired on Date 1, and a security that has a basis of $100 and is treated as having been acquired on Date 2.

Example 7. (i) *Facts*. J, an individual, acquired 10 shares of Corporation X stock on Date 1 for $2 each and 10 shares of Corporation X stock on Date 2 for $5 each. On Date 3, Corporation Y acquires the stock of Corporation X in a reorganization under section 368(a)(1)(B). Pursuant to the terms of the plan of reorganization, J receives one share of Corporation Y stock in exchange for every 2 shares of Corporation X stock. Pursuant to section 354, J recognizes no gain or loss on the exchange. J is not able to identify which portion of each share of Corporation Y stock is received in exchange for each share of Corporation X stock.

(ii) *Analysis*. Under paragraph (a)(2)(i) of this section, J has 5 shares of Corporation Y stock each of which has a basis of $4 and is treated as having been acquired on Date 1 and 5 shares of Corporation Y stock each of which has a basis of $10 and is treated as having been acquired on Date 2. Under paragraph (a)(2)(vii) of this section, on or before the date on which the basis of a share of Corporation Y stock received becomes relevant, J may designate which of the shares of Corporation Y stock received have a basis of $4 and which have a basis of $10.

Example 8. (i) *Facts*. The facts are the same as in *Example 7*, except that, in addition to transferring the stock of Corporation X to Corporation Y, J transfers land to Corporation Y. In addition, after the transaction, J owns stock of Corporation Y satisfying the requirements of section 368(c). J's transfer of the Corporation X stock to Corporation Y is an exchange described in sections 351 and 354. J's transfer of land to Corporation Y is an exchange described in section 351.

(ii) *Analysis*. Under paragraph (a)(2)(viii) of this section, because neither section 354 nor section 356 applies to the transfer of land to Corporation Y, the rules of paragraph (a)(2) of this section do not apply

to determine J's basis in the Corporation Y stock received in the transaction.

Example 9. (i) *Facts*. J, an individual, acquired 10 shares of Corporation X stock on Date 1 for $3 each and 10 shares of Corporation X stock on Date 2 for $6 each. On Date 3, Corporation Z, a newly formed, wholly owned subsidiary of Corporation Y, merges with and into Corporation X with Corporation X surviving. As part of the plan of merger, J receives one share of Corporation Y stock in exchange for each share of Corporation X stock. In connection with the transaction, Corporation Y assumes a liability of J. In addition, after the transaction, J owns stock of Corporation Y satisfying the requirements of section 368(c). J's transfer of the Corporation X stock to Corporation Y is an exchange described in sections 351 and 354.

(ii) *Analysis*. Under paragraph (a)(2)(viii) of this section, because, in connection with the transfer of the Corporation X stock to Corporation Y, Corporation Y assumed a liability of J, the rules of paragraph (a)(2) of this section do not apply to determine J's basis in the Corporation Y stock received in the transaction.

Example 10. (i) *Facts*. Each of Corporation X and Corporation Y has a single class of stock outstanding, all of which is owned by J, an individual. J acquired 100 shares of Corporation X stock on Date 1 for $1 each and 100 shares of Corporation Y stock on Date 2 for $2 each. On Date 3, Corporation Y acquires the assets of Corporation X in a reorganization under section 368(a)(1)(D). Pursuant to the terms of the plan of reorganization, J surrenders J's 100 shares of Corporation X stock but does not receive any additional Corporation Y stock. Immediately before the effective time of the reorganization, the fair market value of each share of Corporation X stock and each share of Corporation Y stock is $1. Pursuant to section 354, J recognizes no gain or loss.

(ii) *Analysis*. Under paragraph (a)(2)(iii) of this section, J is deemed to have received shares of Corporation Y stock with an aggregate fair market value of $100 in exchange for J's Corporation X shares. Given the number of outstanding shares of stock of Corporation Y and their value immediately before the effective time of the reorganization, J is deemed to have received 100 shares of stock of Corporation Y in the reorganization. Under paragraph (a)(2)(i) of this section, each of those shares has a basis of $1 and is treated as having been acquired on Date 1. Then, the stock of Corporation Y is deemed to be recapitalized in a reorganization under section 368(a)(1)(E) in which J receives 100 shares of Corporation Y stock in exchange for those shares of Corporation Y stock that J held immediately prior to the reorganization and those shares J is deemed to have received in the reorganization. Under paragraph (a)(2)(i), immediately after the reorganization, J holds 50 shares of Corporation Y stock each of which has a basis of $2 and is treated as having been acquired on Date 1 and 50 shares of Corporation Y stock each of which has a basis of $4 and is treated as having been acquired on Date 2. Under paragraph (a)(2)(vii) of this section, on or before the date on which the basis of any share of J's Corporation Y stock becomes relevant, J may designate which of the shares of Corporation Y have a basis of $2 and which have a basis of $4.

Example 11. (i) *Facts*. Corporation X has a single class of stock outstanding, all of which is owned by J, an individual. J acquired 100 shares of Corporation X stock on Date 1 for $1 each. Corporation Y has two classes of stock outstanding, common stock and nonvoting preferred stock. On Date 2, J acquired 100 shares of Corporation Y common stock for $2 each and 100 shares of Corporation Y preferred stock for $4 each. On Date 3, Corporation Y acquires the assets of Corporation X in a reorganization under section 368(a)(1)(D). Pursuant to the terms of the plan of reorganization, J surrenders J's 100 shares of Corporation X stock but does not receive any additional Corporation Y stock. Immediately before the effective time of the reorganization, the fair market value of each share of Corporation X stock is $10, the fair market value of each share of Corporation Y common stock is $10, and the fair market value of each share of Corporation Y preferred stock is $20. Pursuant to section 354, J recognizes no gain or loss.

(ii) *Analysis*. Under paragraph (a)(2)(iii) of this section, J is deemed to have received shares of Corporation Y stock with an aggregate fair market value of $1,000 in exchange for J's Corporation X shares. Consistent with the economics of the transaction and the rights associated with each class of stock of Corporation Y owned by J, J is deemed to receive additional shares of Corporation Y common stock. Because the value of the common stock indicates that the liquidation preference associated with the Corporation Y preferred stock could be satisfied even if the reorganization did not occur, it is not appropriate to deem the issuance of additional Corporation Y preferred stock. Given the number of outstanding shares of common stock of Corporation Y and their value immediately before the effective time of the reorganization, J is deemed to have received 100 shares of common stock of Corporation Y in the reorganization. Under paragraph (a)(2)(i) of this section, each of those shares has a basis of $1 and is treated as having been acquired on Date 1. Then, the common stock of Corporation Y is deemed to be recapitalized in a reorganization under section 368(a)(1)(E) in which J receives 100 shares of Corporation Y common stock in exchange for those shares of Corporation Y common stock that J held immediately prior to the reorganization and those shares of Corporation Y common stock that J is deemed to have received in the reorganization. Under paragraph (a)(2)(i), immediately after the reorganization, J holds 50 shares of Corporation Y common stock each of which has a basis of $2 and is treated as having been acquired on Date 1 and 50 shares of Corporation Y common stock each of which has a basis of $4 and is treated as having been acquired on Date 2. Under paragraph (a)(2)(vii) of this section, on or before the date on which the basis of any share of J's Corporation Y common stock becomes relevant, J may designate which of those shares have a basis of $2 and which have a basis of $4.

Example 12. (i) *Facts*. J, an individual, acquired 5 shares of Corporation X stock on Date 1 for $4 each and 5 shares of Corporation X stock on Date 2 for $8 each. Corporation X owns all of the outstanding stock of Corporation Y. The fair market value of the stock of Corporation X is $1800. The fair market value of the stock of Corporation Y is $900. In a distribution to which section 355 applies, Corporation X distributes all of the stock of Corporation Y *pro rata* to its shareholders. No stock of Corporation X is surrendered in connection with the distribution. In the distribution, J receives 2 shares of Corporation Y stock with respect to each share of Corporation X stock. Pursuant to section 355, J recognizes no gain or loss on the receipt of the shares of Corporation Y stock. J is not able to identify which share of Corporation Y stock is received in respect of each share of Corporation X stock.

(ii) *Analysis*. Under paragraph (a)(2)(iv) of this section, because J receives 2 shares of Corporation Y stock with respect to each share of Corporation X stock, the basis of each share of Corporation X stock is allocated between such share of Corporation X stock and two shares of Corporation Y stock in proportion to the fair market value of those shares. Therefore, each of the 5 shares of Corporation X stock acquired on Date 1 will have a basis of $2 and each of the 10 shares of Corporation Y stock received with respect to those shares will have a basis of $1. In addition, each of the 5 shares of Corporation X stock acquired on Date 2 will have a basis of $4 and each of the 10 shares of Corporation Y stock received with respect to those shares will have a basis of $2. Under paragraph (a)(2)(vii) of this section, on or before the date on which the basis of a share of Corporation Y stock received becomes relevant, J may designate which of the shares of Corporation Y stock have a basis of $1 and which have a basis of $2.

Example 13. (i) *Facts*. J, an individual, acquired 20 shares of Corporation X stock on Date 1 for $2 each and 20 shares of Corporation X stock on Date 2 for $4 each. Corporation X has 80 shares of stock outstanding. Corporation X owns 40 shares of stock of Corporation Y, which represents all of the outstanding stock of Corporation Y. The fair market value of the stock of Corporation X is $80. The fair market value of the stock of Corporation Y is $40. Corporation X distributes all of the stock of Corporation Y in a transaction to which section 355 applies. In the transaction, J surrenders 20 shares of stock of Corporation X in exchange for 20 shares of stock of Corporation Y. J retains 20 shares of Corporation X stock. Pursuant to section 355, J recognizes no gain or loss on the receipt of the shares of Corporation Y stock. J is not able to identify which shares of Corporation X stock are surrendered. In addition, J is not able to identify which shares of Corporation Y stock are received in exchange for each surrendered share of Corporation X stock.

(ii) *Analysis*. Under paragraph (a)(2)(i) of this section, J has 20 shares of Corporation Y stock each of which is treated as received in exchange for one share of Corporation X stock. The basis of the 20 shares of Corporation X stock that are retained by J will remain unchanged. Under paragraph (a)(2)(vii) of this section, on or before the date on which the basis of a share of Corporation X or Corporation Y stock becomes relevant, J may designate which shares of Corporation X stock J surrendered in the exchange and which share of the Corporation Y stock received is received for each share of Corporation X stock surrendered. Therefore, it is possible that a share of Corporation Y stock would have a basis of $2 and be treated as having been acquired on Date 1, or would have a basis of $4 and be treated as having been acquired on Date 2.

Example 14. (i) *Facts*. J, an individual, acquired 10 shares of Corporation X stock on Date 1 for $3 each, 10 shares of Corporation X stock on Date 2 for $18 each, 10 shares of Corporation X stock on Date 3 for $6 each, and 10 shares of Corporation X stock

on Date 4 for $9 each. On Date 5, Corporation Y acquires the assets of Corporation X in a reorganization under section 368(a)(1)(A). Pursuant to the terms of the plan of reorganization, J receives a 3/4 share of Corporation Y stock in exchange for each share of Corporation X stock. Therefore, J receives 30 shares of Corporation X stock. Pursuant to section 354, J recognizes no gain or loss on the exchange. J is not able to identify which shares of Corporation Y stock are received in exchange for each share (or portions of shares) of Corporation X stock.

(ii) *Analysis*. Under paragraph (a)(2)(i) of this section, J has 7 shares of Corporation Y stock each of which has a basis of $4 and is treated as having been acquired on Date 1, 7 shares of Corporation Y stock each of which has a basis of $24 and is treated as having been acquired on Date 2, 7 shares of Corporation Y stock each of which has a basis of $8 and is treated as having been acquired on Date 3, and 7 shares of Corporation Y stock each of which has a basis of $12 and is treated as having been acquired on Date 4. In addition, J has two shares of Corporation Y stock, each of which is divided into two equal segments under paragraph (a)(2)(vi) of this section. The first of those two shares has one segment with a basis of $2 that is treated as having been acquired on Date 1 and a second segment with a basis of $12 that is treated as having been acquired on Date 2. The second of those two shares has one segment with a basis of $4 that is treated as having been acquired on Date 3 and a second segment with a basis of $6 that is treated as having been acquired on Date 4. Under paragraph (a)(2)(vii), on or before the date on which a share of Corporation Y stock received becomes relevant, J may designate which of the shares of Corporation Y stock have a basis of $4, which have a basis of $24, which have a basis of $8, which have a basis of $12, and which share has a split basis of $2 and $12, and which share has a split basis of $4 and $6.

(d) *Effective date*. This section applies to exchanges and distributions of stock and securities occurring on or after January 23, 2006.

Par. 5. Section 1.1502–19 is amended as follows:

1. Revising paragraph (d).
2. Revising paragraph (g) *Example 2*.
3. Adding paragraph (h)(2)(iv).
4. Adding a sentence at the end of paragraph (h)(3).

The revisions and additions read as follows:

§1.1502–19 Excess loss accounts.

* * *

(d) [Reserved]. For further guidance, see §1.1502–19T(d).

* * * * *

(g) * * *

Example 2. [*Reserved*]. For further guidance, see §1.1502–19T(g) *Example 2*.

* * * * *

(h) Effective dates. * * *

(2) * * *

(iv) [Reserved]. For further guidance, see §1.1502–19T(h)(2)(iv).

(3) * * * For guidance regarding determinations of the basis of the stock of a subsidiary acquired in an intercompany reorganization before January 23, 2006, see paragraph (d) and (g) *Example 2* of §1.1502–19 as contained in the 26 CFR part 1 edition revised as of April 1, 2005.

Par. 6. Section 1.1502–19T is added to read as follows:

§1.1502–19T Excess loss accounts (temporary).

* * * * *

(a) through (c) [Reserved]. For further guidance, see §1.1502–19(a) through (c).

(d) *Special allocation of basis in connection with an adjustment or determination*—(1) *Excess loss account in original shares*. If a member has an excess loss account in shares of a class of S's stock at the time of a basis adjustment or determination under the Internal Revenue Code with respect to shares of the same class of S's stock owned by the member, the adjustment or determination is allocated first to equalize and eliminate that member's excess loss account. See §1.1502–32(c) for similar allocations of investment adjustments to prevent or eliminate excess loss accounts.

(2) *Excess loss account in new S shares*. If a member would otherwise determine shares of a class of S's stock (new shares) to have an excess loss account and such member owns one or more other shares of the same class of S's stock, the basis of such other shares is allocated to eliminate and equalize any excess loss account that would otherwise be in the new shares.

(e) through (g) *Example 1* [Reserved]. For further guidance, see §1.1502–19(e) through (g) *Example 1*.

Example 2. Basis determinations under the Internal Revenue Code in intercompany reorganizations-transfer of shares without an excess loss account. (i) *Facts*. P owns all of the stock of S and T. P has 150 shares of S stock that it acquired on Date 1. Each S share has a $1 basis and a fair market value of $1. P has 100 shares of T stock that it acquired on Date 2. Each T share has a $1.20 excess loss account and a fair market value of $1. P transfers S's stock to T without receiving additional T stock. The transfer is an exchange described in both sections 351 and 354.

(ii) *Analysis*. Under sections 351 and 354, P does not recognize gain in connection with the transfer. Under §1.358–2(a)(2)(iii), P is deemed to receive 150 shares of T stock. Without regard to the application of paragraph (d) of this section, under section 358 and §1.358–2(a)(2)(i), P would have a $1 basis in each such share. However, because the basis of the additional shares of T stock would be determined when P has an excess loss account in its original shares of T stock, under paragraph (d)(1) of this section, the basis that P would otherwise have in such additional shares would eliminate the excess loss account in P's original shares of T stock such that each original share of T stock would have a basis of $0 and each share of T stock deemed received would have a basis of $0.20. Then, under §1.358–2(a)(2)(iii), the T stock is deemed to be recapitalized in a reorganization under section 368(a)(1)(E) in which P receives 100 shares of T stock (those shares P actually owns immediately after the transfer) in exchange for those 100 shares of T stock that P held immediately prior to the transfer and those 150 shares of T stock P is deemed to receive in the transfer. Under §1.358–2(a)(2)(i), immediately after the transfer, P holds 100 shares of T stock, 60 of which each have a basis of $0.50 and 40 of which each have a basis of $0. In addition, T takes a $1 basis in each share of S stock under section 362. (If P had actually received an additional 150 shares of T stock, paragraph (d)(1) of this section would apply to shift basis from such additional T shares to P's original T shares because the basis of the additional T stock would be determined when P has an excess loss account in its original T shares. P would have a basis of $0 in each of the original T shares and a $0.20 basis in each of the additional T shares.)

(iii) *Transfer of shares with an excess loss account*. The facts are the same as in paragraph (i) of this *Example 2*, except that P transfers T's stock to S without receiving additional S stock. The transfer is an exchange described in both sections 351 and 354. Under paragraph (c) of this section, P's transfer is treated as a disposition of T's stock. Under sections 351 and 354 and paragraph (b)(2) of this section, P does not recognize gain from the disposition. Under section 358 and §1.358–2(a)(2)(iii), P is deemed to have received 100 shares of S stock. Without regard to the application of paragraph (d) of this section, P would have a $1.20 excess loss account in each such share. However, because P would have an excess loss account in such shares and P owns other shares of S stock of the same class, under paragraph (d)(2) of this section, the excess loss account that P would otherwise have in such shares would decrease P's basis in its original shares of S's stock such that each such original share would have a basis of $0.20 and each share deemed received would have a basis of $0. Then, under §1.358–2(a)(2)(iii), the S stock is deemed to be recapitalized in a reorganization under section 368(a)(1)(E) in which P receives 150 shares of S stock (those shares P actually owns immediately after the transfer) in exchange for those 150 shares of S stock that P held immediately prior to the transfer and those 100 shares of S stock that P is deemed to receive to receive in connection with the transfer. Under §1.358–2(a)(2)(i), immediately after the transfer, P holds 150 shares of S stock, 90 of which each have a basis of $0.33 and 60 of which each have a basis of $0. In addition, S takes an excess loss account of $1.20 in each share of T stock under section 362. (If P had actually received 100 additional shares of S stock, paragraph (d)(2) of this section would apply to

shift basis from P's original S stock because P would have otherwise had an excess loss account in such additional shares and P owns other shares of S stock of the same class. The excess loss account that P would have otherwise had in such additional shares would have decreased P's basis in its original shares of S's stock. P would have had a basis of $0.20 in each of the original shares and a basis of $0 in each of the additional shares.)

(iv) *Intercompany merger-shares with excess loss account retained*. The facts are the same as in paragraph (i) of this *Example 2*, except that S merges into T in a reorganization described in section 368(a)(1)(A) (and in section 368(a)(1)(D)), and P receives 150 additional shares of T stock in the reorganization. Under section 354 and paragraph (b)(2) of this section, P does not recognize gain. Without regard to the application of paragraph (d) of this section, under section 358 and §1.358–2(a)(2)(i), P would have a $1 basis in each such share. However, because the basis of the additional shares of T stock would be determined when P has an excess loss account in its original shares of T stock, under paragraph (d)(1) of this section, the basis that P would otherwise have in such additional shares eliminates the excess loss account in P's original shares of T stock such that each original share of T stock has a basis of $0 and each additional share of T stock has a basis of $0.20.

(v) *Intercompany merger-shares with excess loss account surrendered*. The facts are the same as in paragraph (i) of this *Example 2*, except that T merges into S in a reorganization described in section 368(a)(1)(A) (and in section 368(a)(1)(D)), and P receives 100 additional shares of S stock in the reorganization. Under section 354 and paragraph (b)(2) of this section, P does not recognize gain from the disposition. Without regard to the application of paragraph (d) of this section, under section 358 and §1.358–2(a)(2)(i), P would have a $1.20 excess loss account in each additional share of S stock received. However, because P would have an excess loss account in such shares and P owns other shares of S stock of the same class, under paragraph (d)(2) of this section, the excess loss account that P would otherwise have in such shares decreases P's basis in its original shares of S's stock such that each original share of S stock has a basis of $0.20 and each additional share of S stock has a basis of $0.

(g) *Example 3* through (h)(2)(iii) [Reserved]. For further guidance, see §1.1502–19(g) *Example 3* through (h)(2)(iii).

(h)(2)(iv) *Intercompany reorganizations*. For guidance regarding determinations of the basis of the stock of a subsidiary acquired in an intercompany reorganization on or after January 23, 2006, see paragraphs (d) and (g) *Example 2* of this section.

(3) [Reserved]. For further guidance, see §1.1502–19(h)(3).

Par. 7. Section 1.1502–32 is amended by:

1. Revising *Example* 6 of paragraph (b)(5)(ii).

2. Revising the first sentence of paragraph (h)(1).

3. Adding new paragraph (h)(8).

The revisions and addition read as follows:

§1.1502–32 Investment adjustments.

* * * * *

(b) * * *

(5) * * *

(ii) * * *

Example 6. Reorganization with boot. (i) *Facts*. P owns all the stock of S and T. P owns ten shares of the same class of common stock of S and ten shares of the same class of common stock of T. The fair market value of each share of S stock is $10 and the fair market value of each share of T stock is $10. On January 1 of Year 1, P has a $5 basis in each of its ten shares of S stock and a $10 basis in each of its ten shares of T stock. S and T have no items of income, gain, deduction, or loss for Year 1. S and T each have substantial earnings and profits. At the close of Year 1, T merges into S in a reorganization described in section 368(a)(1)(A) (and in section 368(a)(1)(D)). P receives no additional S stock, but does receive $10 which is treated as a dividend under section 356(a)(2).

(ii) *Analysis*. The merger of T into S is a transaction to which §1.1502–13(f)(3) applies. Under §1.1502–13(f)(3) and §1.358–2(a)(2)(iii), P is deemed to receive ten additional shares of S stock with a total fair market value of $100 (the fair market value of the T stock surrendered by P). Under §1.358–2(a)(2)(i), P will have a basis of $10 in each share of S stock deemed received in the reorganization. Under §1.358–2(a)(2)(iii), P is deemed to surrender all twenty shares of its S stock in a recapitalization under section 368(a)(1)(E) in exchange for the ten shares of S stock, the number of shares of S stock held by P immediately after the transaction. Thus, under §1.358–2(a)(2)(i), P has five shares of S stock each with a basis of $10 and five shares of S stock each with a basis of $20. The $10 P received is treated as a dividend distribution under section 301 and, under paragraph (b)(3)(v) of this section, the $10 is a distribution to which paragraph (b)(2)(iv) of this section applies. Accordingly, P's total basis in the S stock is decreased by the $10 distribution.

* * *

(h) *Effective date* —(1) *General rule*. Except as provided in paragraph (h)(8) of this section, this section applies with respect to determinations of the basis of the stock of a subsidiary (*e.g.*, for determining gain or loss from a disposition of stock), in consolidated return years beginning on or after January 1, 1995. * * *

(8) *Determination of stock basis in reorganization with boot*. Paragraph (b)(5)(ii) *Example 6* of this section applies only with respect to determinations of the basis of the stock of a subsidiary on or after January 23, 2006. For determinations of the basis of the stock of a subsidiary before January 23, 2006, see §1.1502–32(b)(5)(ii) *Example 6* as contained in the 26 CFR part 1 edition revised as of April 1, 2005.

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved January 17, 2006.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on January 23, 2006, 11:43 a.m., and published in the issue of the Federal Register for January 26, 2006, 71 F.R. 4264)

Section 367.—Foreign Corporations

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

T.D. 9243

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Revision of Income Tax Regulations Under Sections 367, 884, and 6038B Dealing With Statutory Mergers or Consolidations Under Section 368(a)(1)(A) Involving One or More Foreign Corporations, and Guidance Necessary to Facilitate Business Electronic Filing Under Section 6038B

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations amending the income tax regulations under various provisions of the Internal Revenue Code (Code) to account for statutory mergers and consolidations under section 368(a)(1)(A) (including such reorganizations described in section 368(a)(2)(D) or (E)) involving one or more foreign corporations. These final regulations are issued concurrently

with final regulations (T.D. 9242, 2006–7 I.R.B. 422) that define a reorganization under section 368(a)(1)(A) to include certain statutory mergers or consolidations effected pursuant to foreign law. This document also contains final regulations under section 6038B which facilitate the electronic filing of Form 926 "*Return by a U.S. Transferor of Property to a Foreign Corporation.*"

DATES: *Effective Date:* These regulations are effective on January 23, 2006.

Applicability Dates: For dates of applicability, see §1.367(a)–3(e); §1.367(b)–6(a)(1); §1.367(b)–13(f); §1.884–2(g); and §1.6038B–1(b)(1)(i) and (g).

FOR FURTHER INFORMATION CONTACT: Robert W. Lorence, Jr., (202) 622–3918 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507(d)) under control numbers 1545–1478 and 1545–1617.

The collection of information in these final regulations is in §1.367(a)–3(d)(2)(vi)(B)(*1*)(*ii*) and §1.6038B–1(b)(1)(i). The information under §1.367(a)–3(d)(2)(vi)(B)(*1*)(*ii*) is required to inform the IRS of a domestic corporation (domestic acquired corporation) that is claiming an exception from the application of section 367(a) and (d) for certain transfers of property to a foreign corporation that is re-transferred by the foreign corporation to a domestic corporation controlled by the foreign corporation (domestic controlled corporation). The information is in the form of a statement attached to the domestic acquired corporation's U.S. income tax return for the year of the transfer certifying that if the foreign corporation disposes of the stock of the domestic controlled corporation with a tax avoidance purpose, the domestic acquired corporation will file an income tax return (or amended return, as the case may be) reporting gain. The collection of information is mandatory.

The information under §1.6038B–1(b)(1)(i) is required to inform the IRS of transfers described in section 6038B(a)(1)(A) or section 367(d) or (e) by filing Form 926, "*Return by a U.S. Transferor of Property to a Foreign Corporation*," and any information attached to the form with the U.S. transferor's income tax return for the taxable year of the transfer. The collection of information is mandatory.

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 or 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

On January 24, 2003, the IRS and Treasury issued proposed regulations (REG–126485–01, 2003–1 C.B. 542 [68 FR 3477]) and temporary regulations (T.D. 9038, 2003–1 C.B. 524 [68 FR 3384]), that would revise the definition of a statutory merger or consolidation under section 368(a)(1)(A). On January 5, 2005, the IRS and Treasury issued proposed regulations (REG–117969–00, 2005–7 I.R.B. 533 [70 FR 746]) that would revise the definition of a section 368(a)(1)(A) reorganization to include transactions effected pursuant to foreign law and transactions involving entities organized under foreign law. Final regulations incorporating the temporary regulations and both sets of proposed regulations, as modified to reflect comments, are being published concurrently with this document.

On January 5, 2005, the IRS and Treasury also issued proposed regulations (REG–125628–01, 2005–7 I.R.B. 536) under sections 358, 367 and 884 (the 2005 proposed regulations) that would account for section 368(a)(1)(A) reorganizations involving one or more foreign corporations. The regulations also proposed changes to other aspects of the section 367(a) and (b) regulations that would address additional issues. This document contains final regulations that incorporate the 2005 proposed regulations amending sections 358, 367, and 884.

The public hearing with respect to the 2005 proposed regulations was cancelled because no request to speak was received. However, the IRS and Treasury received several written comments, which are discussed below.

On December 19, 2003, the IRS and Treasury issued temporary and final regulations (T.D. 9100, 2004–1 C.B. 297 [68 FR 70701]) modifying regulations under section 6038B to eliminate regulatory impediments to the electronic submission of Form 926 "*Return by a U.S. Transferor of Property to a Foreign Corporation.*" In the same issue of the **Federal Register**, the IRS and Treasury issued a notice of proposed rulemaking (REG–116664–01, 2004–1 C.B. 319 [68 FR 70747]) cross-referencing the temporary regulations under section 6038B. This document contains final regulations incorporating certain provisions of the temporary regulations under section 6038B. No public hearing regarding the notice of proposed rulemaking was requested or held and no comments were received.

Summary of Comments and Explanation of Provisions

A. *Basis and Holding Period Rules*

1. *Section 354 exchanges*

On May 3, 2004, the IRS and Treasury published a notice of proposed rulemaking (REG–116564–03, 2004–1 C.B. 927) in the Federal Register (69 FR 24107) that included regulations under section 358 that would provide guidance regarding the determination of the basis of stock or securities received in either a reorganization described in section 368 (*e.g.*, in a section 354 exchange) or a distribution to which section 355 applies. The proposed section 358 regulations would adopt a tracing regime for determining the basis of each share of stock or security received in an exchange under section 354 (or section 356). Related provisions in the 2005 proposed regulations followed that general tracing regime, with modifications. See Prop. Treas. Reg. §1.367(b)–13(b). Comments were received in response to the proposed regulations under section 358. The IRS and Treasury have issued final regulations under section 358 that adopted

the section 358 proposed regulations, with modifications to reflect the comments received. See T.D. 9244, 2006–8 I.R.B. 463.

The final section 358 regulations retained the general tracing regime for determining basis in an exchange under section 354 (or section 356). This tracing regime is consistent with the policies and requirements underlying the international provisions of the Code, including those under section 1248. As a result, these final regulations do not include the rules set forth in §1.367(b)–13(b) of the 2005 proposed regulations that would determine the basis and holding period in stock as a result of certain exchanges under section 354 (or section 356) involving foreign corporations. Instead, the final regulations cross-reference the regulations under section 358 to determine the exchanging shareholder's basis in stock or securities received in an exchange under section 354 (and section 356). Special rules for certain triangular reorganizations are discussed below.

2. *Triangular asset reorganizations*

In contrast to the above, the application of the stock basis rules of §1.358–6 in certain triangular asset reorganizations involving foreign corporations does not accurately preserve a shareholder's section 1248 amount (within the meaning of §1.367(b)–2(c)). Therefore, the 2005 proposed regulations would provide special basis and holding period rules for certain triangular asset reorganizations involving foreign corporations that have section 1248 shareholders (within the meaning of §1.367(b)–2(b)). See Prop. Treas. Reg. §1.367(b)–13(c) through (e). These rules would apply to certain reorganizations described in section 368(a)(1)(A) and (a)(2)(D) (forward triangular merger), triangular reorganizations described in section 368(a)(1)(C), and reorganizations described in section 368(a)(1)(A) and (a)(2)(E) (reverse triangular merger).

The 2005 proposed regulations would provide that, in determining the stock basis of the surviving corporation in certain triangular asset reorganizations, the exchanging shareholder's basis in the stock of the target corporation will be taken into account, rather than target corporation's basis in its assets. Further, where applicable, the 2005 proposed regulations would provide for a divided basis and holding period in each share of stock in the surviving corporation to reflect the relevant section 1248 amounts, if any, in the stock of the target corporation and the surviving corporation. If there are two or more blocks of stock in the target corporation with section 1248 amounts, then each share of the surviving corporation would be further divided to account for each block of stock. If two or more blocks of stock are held by one or more shareholders that are not section 1248 shareholders, then shares in these blocks would be aggregated into one divided portion for basis purposes. If none of the shareholders is a section 1248 shareholder, then the asset basis rules of §1.358–6 would apply.

Commentators stated that the application of the special basis rules would cause unjustified complexity. One commentator stated that such complexity arises in cases where the shares of the target corporation are widely held or where section 1248 shareholders hold less than 50 percent of the target corporation. The commentator recommended that if the special basis rules are retained, §1.358–6 should continue to apply where section 1248 shareholders hold less than 50 percent of the stock of the target corporation. The commentator further recommended that the controlling corporation be allowed to elect to apply the rules under §1.358–6 in return for all exchanging section 1248 shareholders including in income the section 1248 amounts with respect to their stock. The IRS and Treasury have considered these comments. On balance, the IRS and Treasury have concluded that creating exceptions to the application of the special basis rules (*e.g.*, by election) would create significant uncertainty for the IRS and would not meaningfully reduce administrative complexity. While the IRS and Treasury recognize the complexity of the rules, the IRS and Treasury nevertheless believe it is important to preserve section 1248 amounts and avoid unnecessary income inclusions that might otherwise be required. As a result, the final regulations do not adopt this recommendation. However, the IRS and Treasury will continue to study alternative methods for preserving the section 1248 amounts in such transactions.

One commentator suggested that the IRS and Treasury consider applying the special basis rules to section 368(a) asset reorganizations followed by asset transfers to a corporation controlled (within the meaning of section 368(c)) by the acquiring corporation pursuant to the same transaction (controlled asset transfer), because these transactions are similar to triangular reorganizations under section 368(a)(1)(C) and section 368(a)(1)(A) and (a)(2)(D). If this suggestion were adopted, the basis in the stock of the controlled subsidiary would reflect the basis in the stock of the target corporation and not the basis of the contributed assets. Because the IRS and Treasury are continuing to study the application of section 358 to such transactions, and because such controlled asset transfers may involve only a portion of the acquired assets, this comment is not adopted at this time.

Finally, commentators noted that the special basis rules of §1.367(b)–13(c) of the 2005 proposed regulations would not apply, by their terms, to a forward triangular merger or a triangular section 368(a)(1)(C) reorganization where no shareholder of the target corporation is a section 1248 shareholder, but the parent of the acquiring corporation is either a domestic corporation that is a section 1248 shareholder of the acquiring corporation or a foreign corporation that has a section 1248 shareholder that is also a section 1248 shareholder of the acquiring corporation. This result was not intended, as illustrated by *Example 3* of §1.367(b)–13(e) of the 2005 proposed regulations, which applies the special basis rules of §1.367(b)–13(c) of the 2005 proposed regulations to such a transaction. As a result, the text of the final regulations has been modified to apply the special basis rules to this type of transaction.

B. *Exceptions to the Application of Section 367(a)*

1. *Exchanges of stock or securities in certain triangular asset reorganizations*

A U.S. person recognizes gain under section 367(a) on the transfer of property to a foreign corporation in an exchange described in section 351, 354, 356, or 361, unless an exception applies. Under §1.367(a)–3(a), section 367(a) does not apply if, pursuant to a section 354 exchange, a U.S. person transfers stock of a

domestic or foreign corporation "for stock of a foreign corporation" in an asset reorganization described in section 368(a)(1) that is not treated as an indirect stock transfer.

Notwithstanding the language in the current regulations, this exception is intended to apply to any section 354 (or section 356) exchange made pursuant to an asset reorganization under section 368(a)(1) that is not treated as an indirect stock transfer under §1.367(a)–3(d). However, commentators noted that in certain triangular asset reorganizations where a U.S. person transfers stock of a foreign acquired corporation to such foreign corporation in a section 354 (or section 356) exchange, but receives stock of the domestic parent of the foreign acquiring corporation pursuant to such exchange, the transfer by the U.S. person might be subject to section 367(a). This would be the case because, under §1.367(a)–3(a), the U.S. person does not receive "stock of a foreign corporation." This result was not intended. Accordingly, the final regulations clarify the application of this rule by removing the phrase "for stock of a foreign corporation." Thus, section 367(a) will not apply to any section 354 (or section 356) exchange of stock or securities of a domestic or foreign corporation pursuant to an asset reorganization under section 368(a)(1), unless the exchange is considered an indirect stock transfer pursuant to §1.367(a)–3(d). A conforming change also is made to the section 6038B reporting rules (see part J. of this preamble).

2. *Exchanges of securities in certain recapitalizations and other reorganizations*

Prior to the issuance of the 2005 proposed regulations, several commentators noted that the exception to the application of section 367(a) contained in §1.367(a)–3(a) applied to exchanges of stock, but not exchanges of securities, in section 368(a)(1)(E) reorganizations and certain asset reorganizations. In response, the IRS and Treasury issued Notice 2005–6, 2005–5 I.R.B. 448, concurrently with the 2005 proposed regulations, and announced the plan to amend §1.367(a)–3(a) to apply the exception to exchanges of stock or securities. These final regulations incorporate the rule announced in Notice 2005–6, including the dates of applicability as discussed below in part K.3. of this preamble.

Consistent with these changes, these final regulations also amend the indirect stock transfer rules of §1.367(a)–3(d) to provide that exchanges by a U.S. person of stock or securities of an acquired corporation for stock or securities of the corporation that controls the acquiring corporation in a triangular section 368(a)(1)(B) reorganization will be treated as an indirect transfer of such stock or securities subject to the rules of section 367(a). This amendment conforms the treatment of triangular section 368(a)(1)(B) reorganizations with the other indirect stock transfers described in §1.367(a)–3(d). Although this amendment has a prospective effective date, no inference is intended as to the application of current law to such exchanges.

Other provisions of the section 367 regulations also contain references to exchanges of stock but not to securities. See, *e.g.*, §1.367(a)–8(e)(1)(i). The IRS and Treasury are studying these references and intend to amend these provisions if these omissions are not appropriate.

C. *Concurrent Application of Section 367(a) and (b)*

The 2005 proposed regulations would modify the concurrent application of section 367(a) and (b) to exchanges that require the inclusion in income of the exchanging United States shareholder's all earnings and profits amount under section 367(b). The 2005 proposed regulations would provide that the rules of section 367(b), and not section 367(a), apply to such exchanges in cases where the all earnings and profits amount attributable to the stock of an exchanging shareholder is greater than the amount of gain in such stock subject to section 367(a) pursuant to the indirect stock transfer rules. In such a case, the shareholder would be required to include in income as a deemed dividend the all earnings and profits amount pursuant to §1.367(b)–3, without regard to whether the exchanging shareholder files a gain recognition agreement as provided under §§1.367(a)–3(b) and 1.367(a)–8. This change was proposed because the IRS and Treasury determined that it was contrary to the policy of section 367(b) to allow a shareholder effectively to elect to be taxed on the lesser amount of gain under section 367(a) simply by failing to file a gain recognition agreement.

Two comments were received with respect to this overlap rule. One commentator questioned, as a general matter, the application of §1.367(b)–3 and the all earnings and profits rule to inbound asset acquisitions and, more specifically, the broadening of the circumstances under the 2005 proposed regulations where a taxpayer would be required to include in income as a deemed dividend the all earnings and profits amount. The commentator suggested an alternative means to taxing the earnings and profits of the foreign acquired corporation, such as reducing the basis of assets brought into the United States to the extent of any previously untaxed earnings and profits. The IRS and Treasury, at this time, do not believe that a comprehensive revision of the all earnings and profits rule is necessary or appropriate. Alternative approaches to the all earnings and profits rule are beyond the scope of this regulation project, because, for example, any such revision would have to take into account recently enacted section 362(e). As a result, this comment is not adopted.

The second comment stated that the overlap rule adds unnecessary complexity to the section 367 regulations, because it is unlikely that a transaction will occur that would invoke the rule (*i.e.*, where a foreign acquired corporation transfers its assets to a domestic subsidiary of a foreign parent corporation in a triangular reorganization). The overlap rule in the 2005 proposed regulations was intended to address cases that are affected by this rule. The IRS and Treasury continue to believe that the rule is necessary to preserve the policies of section 367(b), and that the rule as applied in these contexts does not create undue complexity. For this reason, the comment is not adopted.

D. *Triangular Section 368(a)(1)(B) Reorganizations*

In a triangular section 368(a)(1)(B) reorganization, if a U.S. person exchanges stock of an acquired corporation for voting stock of a foreign corporation that controls (within the meaning of section 368(c)) the acquiring corporation, the U.S. person is treated as making an in-

direct transfer of stock of the acquired corporation to the foreign controlling corporation in a transfer subject to section 367(a). §1.367(a)–3(d)(1)(iii). The current regulations do not, however, treat as an indirect stock transfer a triangular section 368(a)(1)(B) reorganization where the acquiring corporation is foreign and the controlling corporation is domestic. The 2005 proposed regulations would extend the indirect stock transfer rules to include triangular section 368(a)(1)(B) reorganizations in which a U.S. person exchanges stock of the acquired corporation for voting stock of a domestic corporation that controls the foreign acquiring corporation. In such a case, the 2005 proposed regulations would provide that a gain recognition agreement filed pursuant to such transaction is triggered if the domestic controlling corporation disposes of the stock of the foreign acquiring corporation, or the foreign acquiring corporation disposes of the stock of the acquired corporation.

Commentators stated that because any built-in gain in the stock of the acquired corporation is reflected in the stock of the foreign acquiring corporation held by the domestic controlling corporation under §1.358–6(c)(3), a gain recognition agreement should not be triggered if the domestic controlling corporation disposes of the stock of the foreign acquiring corporation. The IRS and Treasury agree, in part, with this comment. Accordingly, the final regulations provide that, in certain cases, the disposition of the stock of the foreign acquiring corporation is not a triggering event. For example, the gain recognition agreement terminates in such a case if the domestic controlling corporation disposes of the stock of the foreign acquiring corporation in a taxable exchange. See §1.367(a)–8(h)(1).

E. *Identifying the Stock Transferred in Indirect Stock Transfers Involving a Change in Domestic or Foreign Status of the Acquired Corporation*

Under the current section 367(a) regulations, if a U.S. person exchanges stock or securities of an acquired corporation for stock or securities of a foreign acquiring corporation in, for example, a section 368(a)(1)(C) reorganization, and the foreign acquiring corporation transfers all or part of the assets of the acquired corporation to a corporation in a controlled asset transfer, the U.S. person is treated, for purposes of section 367(a), as transferring the stock or securities of the acquired corporation to the foreign acquiring corporation to the extent of the assets transferred to the controlled subsidiary. §1.367(a)–3(d)(1)(v); see also §1.367(a)–3(d)(3), *Example 5A*.

A commentator stated that the indirect stock transfer rules should apply to such a transaction based on the status of the controlled subsidiary, rather than the status of the acquired corporation. Under this approach, if the acquired corporation were domestic and the controlled subsidiary were foreign, U.S. persons that exchange stock or securities of the domestic acquired corporation would be treated as having made an indirect stock transfer of stock or securities of a foreign corporation to a foreign corporation subject to §1.367(a)–3(b), rather than of stock or securities of a domestic corporation that would be subject to the more restrictive rules of §1.367(a)–3(c).

The IRS and Treasury agree, in part, with this comment and believe that §1.367(a)–3(c) should not apply to certain indirect stock transfers that occur by reason of transactions involving a subsidiary member of a consolidated group to the extent that the assets of the domestic acquired corporation are ultimately transferred to a foreign corporation. Accordingly, the final regulations provide that where a subsidiary member of a consolidated group transfers its assets to a foreign corporation pursuant to an asset reorganization, and an indirect stock transfer described in §1.367(a)–3(d)(1)(i) (mergers described in section 368(a)(1)(A) and (a)(2)(D) and reorganizations described in section 368(a)(1)(G) and (a)(2)(D)), (iv) (triangular reorganizations described in section 368(a)(1)(C)), or (v) (asset reorganizations followed by a controlled asset transfer) occurs in connection with such transfer, the U.S. persons that exchange stock or securities in the domestic acquired corporation pursuant to section 354 (or section 356) will be treated for purposes of §1.367(a)–3 as having made an indirect transfer of foreign stock or securities subject to the rules of §1.367(a)–3(b) (and not domestic stock or securities subject to §1.367(a)–3(c)). In the case where the foreign acquiring corporation transfers assets in a controlled asset transfer to a foreign corporation, the exception applies only to the extent of the assets transferred to the foreign corporation. Further, the exception does not apply to the extent that the assets of the domestic acquired corporation are ultimately transferred in one or more successive controlled asset transfers to a domestic corporation. Thus, in such a case, the indirect stock transfer remains subject to §1.367(a)–3(c). The rules relating to foreign acquired corporations remain the same as under current law (that is, the indirect stock transfer rules are based on the status of the foreign acquired corporation).

The IRS and Treasury are studying in a separate project the interaction of section 7874 and §1.367(a)–3(c). In connection with this study, the IRS and Treasury will continue to examine whether the recommended change should also apply to other transactions. The results of this study may be addressed in a future regulations project. At this time, however, the final regulation will continue to apply to other transactions based on the stock that is owned and exchanged by the U.S. person in the transaction (rather than based on stock of the corporation in which the assets of the acquired corporation are ultimately transferred). Comments are requested as to whether the exception, described above, should be expanded to other ownership structures (*e.g.*, where the domestic target corporation is an affiliated but not consolidated group member).

F. *Coordination of the Indirect Stock Transfer Rules and the Asset Transfer Rules*

Under the current regulations, when an indirect stock transfer also involves a transfer of assets by a domestic corporation to a foreign corporation, section 367(a) and (d) apply to the domestic corporation's transfer of assets prior to the application of the indirect stock transfer rules. However, section 367(a) and (d) do not apply to the domestic corporation's transfer to the extent that the foreign acquiring corporation re-transfers the assets received in the asset transfer to a controlled domestic corporation, provided that the controlled domestic corporation's basis in the assets is no greater than the ba-

sis that the domestic acquired corporation had in such assets.

The 2005 proposed regulations would modify the scope of the coordination rule as it applies to asset reorganizations such that section 367(a) and (d) generally would apply to the domestic corporation's transfer of assets to the foreign corporation, even if the foreign corporation re-transfers all or part of the assets received to a domestic corporation in a controlled asset transfer. However, the 2005 proposed regulations would provide two exceptions to this general rule. The first exception generally would apply if the domestic acquired corporation is controlled (within the meaning of section 368(c)) by 5 or fewer domestic corporations, appropriate basis adjustments as provided in section 367(a)(5) are made to the stock of the foreign acquiring corporation, and any other conditions as provided in regulations under section 367(a)(5) are satisfied.

The second exception would apply if the controlled domestic corporation's basis in the assets is no greater than the domestic acquired corporation's basis in such assets and the following two conditions are satisfied: (1) the indirect transfer of stock of the domestic acquired corporation satisfies the requirements of §1.367(a)–3(c)(1)(i), (ii), and (iv), and (c)(6); and (2) the domestic acquired corporation attaches a statement to its tax return for the taxable year of the transfer. The statement must certify that the domestic acquired corporation will recognize gain (as described below) if the foreign acquiring corporation disposes of any stock of the domestic controlled corporation with a principal purpose of avoiding the U.S. tax that would have been imposed on the domestic acquired corporation had it disposed of the re-transferred assets. The 2005 proposed regulations contain a rebuttable presumption that the disposition of stock has a principal purpose of tax avoidance if the disposition occurs within 2 years of the transfer.

When applicable, under this second exception, the domestic acquired corporation would be required to recognize gain as if, immediately prior to the exchange, it had transferred the re-transferred assets, including any intangible assets, directly to a domestic corporation in an exchange qualifying under section 351, and immediately sold the stock to an unrelated party for its fair market value in a transaction in which it recognizes gain, if any (but not loss). The 2005 proposed regulations would provide that the basis that the foreign acquiring corporation has in the stock of the domestic controlled corporation is increased immediately prior to its disposition by the amount of gain recognized by the domestic acquired corporation. However, the basis of the re-transferred assets held by the domestic controlled corporation would not be increased by such gain.

Several comments were received with respect to the second exception. Commentators stated that the final regulations should provide that the amount of gain recognized by the domestic acquired corporation under the second exception should also increase the basis of the re-transferred assets held by the domestic controlled corporation. As stated in the preamble to the 2005 proposed regulations, the IRS and Treasury believe that the concerns raised by the construct that results from a controlled asset transfer to a domestic subsidiary after an outbound asset transfer are analogous to the concerns raised in other divisive transactions where gain is recognized on the stock of a corporation without a corresponding increase in the basis of the assets of such corporation. See section 355(e) and §1.367(e)–2(b)(2)(iii). The tax consequences set forth in the final regulations are intended to be consistent with the tax consequences that result in these other transactions. As a result, the final regulations do not adopt this comment.

Commentators also questioned whether the proposed modification to the coordination rule is necessary in light of the enactment of section 7874 and whether any new limitations to the rule should await an analysis of how section 7874 affects the rules of §1.367(a)–3(c). Because of the divisive concerns present in these types of transactions, the IRS and Treasury believe that the modifications to the coordination rule continue to be necessary and therefore are retained. Nevertheless, the IRS and Treasury are studying the effect of section 7874 on the coordination rule, as well as the direct and indirect transfer of domestic stock under §1.367(a)–3(c). The results of this study may be addressed in a future regulation project.

Finally, in light of the enactment of section 7874, *Example 6D* of §1.367(a)–3(d)(3) of the 2005 proposed regulations has not been retained. Compare §1.367(a)–3(d)(3) *Example 6B*.

G. *Treatment of a Controlled Asset Transfer Following a Section 368(a)(1)(F) Reorganization as an Indirect Stock Transfer*

The 2005 proposed regulations would revise §1.367(a)–3(d)(1)(v) so that any non-triangular asset reorganization followed by a controlled asset transfer will be considered an indirect stock transfer under §1.367(a)–3(d)(1).

Commentators stated, however, that a section 368(a)(1)(F) reorganization followed by a controlled asset transfer should not be treated as an indirect stock transfer. According to the commentators, because a section 368(a)(1)(F) reorganization involves only a "single" corporation, it should be treated in effect as a "non-event" for purposes of the indirect stock transfer rules. As a result, the commentators believe that the transaction should be treated as a mere section 351 transfer of assets to the controlled subsidiary and not as an indirect stock transfer.

In response to this comment, the final regulations exclude from the application of the indirect stock transfer rules *same-country 368(a)(1)(F) reorganizations* followed by controlled asset transfers. For this purpose, a same-country section 368(a)(1)(F) reorganization is a reorganization described in section 368(a)(1)(F) in which both the acquired corporation and the acquiring corporation are foreign corporations and are created or organized under the laws of the same foreign country. This would include, for example, situations where the foreign corporation changes its name, changes its location within the foreign country, or changes its form within the foreign country. The IRS and Treasury will continue to examine whether other foreign-to-foreign section 368(a)(1)(F) reorganizations followed by controlled asset transfers should be treated as indirect stock transfers, however, as the general treatment of section 368(a)(1)(F) reorganizations is further considered. Outbound reorganizations under section 368(a)(1)(F) followed by controlled asset transfers are treated as indirect stock transfers under the final regulations. See §1.367(a)–1T(f).

H. *Treatment of Reorganizations Described in Section 368(a)(1)(G) and (a)(2)(D) as Indirect Stock Transfers*

Section 368(a)(2)(D) provides that the acquisition by one corporation, in exchange for stock of a corporation which is in control of the acquiring corporation, of substantially all the properties of another corporation does not disqualify a transaction from qualifying as a reorganization under section 368(a)(1)(A) or 368(a)(1)(G), provided certain conditions are satisfied.

Section 1.367(a)–3(d)(1)(i) and (iv) of the 2005 proposed regulations would treat certain reorganizations described in section 368(a)(1)(A) and (a)(2)(D), and certain triangular reorganizations described in section 368(a)(1)(C), respectively, as indirect stock transfers. Moreover, section 1.367(a)–3(d)(1)(v) of the 2005 proposed regulations would include certain reorganizations described in section 368(a)(1)(G), followed by controlled asset transfers, as indirect stock transfers. The 2005 proposed regulations would not explicitly treat reorganizations described in section 368(a)(1)(G) and (a)(2)(D) as indirect stock transfers, even though they have the same effect as these other reorganizations. As a result, the final regulations modify §1.367(a)–3(d)(1)(i), and related provisions, to include as indirect stock transfers certain reorganizations described in section 368(a)(1)(G) and (a)(2)(D). Similar modifications are made in other sections of the final regulations to take into account reorganizations described in section 368(a)(1)(G) and (a)(2)(D).

I. *General Operation of Section 367 Regulations and the Effect of Section 7874*

Comments were received regarding the scope of certain portions of the section 367 regulations in light of the enactment of section 7874. In response to the potential overlap of these two provisions, the IRS and Treasury are considering possible changes to §1.367(a)–3(c). Comments are requested as to the interaction of section 7874 and §1.367(a)–3(c), as well as to other aspects of the section 367 regulations.

J. *Section 6038B Reporting*

Section 6038B provides for reporting by U.S. persons that transfer property to foreign corporations in an exchange described in section 332, 351, 354, 355, 356, or 361. Temporary regulations under section 6038B provide an exception from reporting for certain transactions described in §1.367(a)–3(a). Section 1.367(a)–3(a) provides an exception to section 367(a) for certain exchanges under section 354 or 356 of stock or securities in section 368(a)(1)(E) reorganizations or in asset reorganizations that are not indirect stock transfers. These exceptions from reporting under section 6038B have been amended to conform to the amendments to §1.367(a)–3(a). These exceptions are incorporated in the final regulations. See Part B. of this preamble.

Section 6038B and the regulations thereunder provide for reporting by filing Form 926, "*Return by a U.S. Transferor of Property to a Foreign Corporation*," and any attachments with the income tax return for the year of the transfer. Temporary regulations under section 6038B eliminate the requirement to sign Form 926, thus permitting the electronic filing of the form with the U.S. transferor's federal income tax return. The temporary regulations provide that Form 926 and any attachments are verified by signing the income tax return with which the form and attachments are filed. These temporary regulations are incorporated in these final regulations, except with respect to certain filings by corporations which will be addressed as part of a larger final regulation dealing with electronic filing.

K. *Effective Dates*

1. *General rule*

Except as provided below, the final regulations apply to transactions occurring on or after January 23, 2006.

2. *Retroactive application of §1.367(b)–4(b)(1)(ii) of the proposed regulations*

Under §1.367(b)–4(b), certain shareholders of a foreign acquired corporation are required to include in income as a deemed dividend the section 1248 amount with respect to the stock of the foreign acquired corporation if such exchange results in the loss of section 1248 shareholder status. This may occur, for example, if the exchanging shareholder receives domestic stock in exchange for the stock of an acquired foreign corporation in a triangular reorganization where a domestic issuing corporation controls the foreign acquiring corporation.

The current regulations consider the section 1248 shareholder status to be lost in this case because the domestic acquiring corporation's basis in the foreign acquiring corporation is generally determined by reference to the assets of the foreign acquired corporation, rather than by reference to the stock of the foreign acquired corporation. See §1.358–6. Under the 2005 proposed regulations, however, such an exchanging shareholder would not be required to include in income as a deemed dividend the section 1248 amount under §1.367(b)–4(b), provided that the domestic issuing corporation, immediately after the exchange, is a section 1248 shareholder of the acquired corporation (in the case of a triangular section 368(a)(1)(B) reorganization) or the surviving corporation (in the case of a triangular section 368(a)(1)(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 such acquired or surviving corporation is a controlled foreign corporation. This change was made in the case of triangular asset reorganizations because the special basis rules in §1.367(b)–13(c) of the 2005 proposed regulations would preserve the section 1248 amounts attributable to the stock of the foreign acquired corporation in the stock of the foreign acquiring (or surviving) corporation held by the domestic issuing corporation. The special basis rules would not apply to triangular reorganizations under section 368(a)(1)(B). The special basis rules are not needed for these transactions because section 1248 amounts are preserved under the general rules of §1.358–6.

Commentators requested that the modification to §1.367(b)–4 relating to triangular section 368(a)(1)(B) reorganizations be made retroactive to February 23, 2000, the date on which §1.367(b)–4 was promulgated, because the basis rules of §1.358–6 were in effect at that time and

the transactions never raised concerns about preserving section 1248 amounts. The IRS and Treasury agree with this comment and therefore the final regulations allow taxpayers to apply the modification to §1.367(b)–4 to a triangular section 368(a)(1)(B) reorganization occurring on or after February 23, 2000, and during any taxable year which is not closed by the period of limitations. Taxpayers applying this rule, however, must do so consistently with respect to all such transactions.

Commentators also requested that the modification to §1.367(b)–4 apply to other triangular reorganizations on a retroactive basis, on the condition that taxpayers also apply the special basis rules of §1.367(b)–13(c) of the 2005 proposed regulations retroactively to these transactions. The IRS and Treasury only intend for the §1.367(b)–13(c) basis rules to apply on a prospective basis. Elective application of these rules to prior years would be complex and difficult to administer. Accordingly, the IRS and Treasury have not adopted this comment for other triangular reorganizations.

3. *Exchanges of securities in certain recapitalizations and reorganizations*

As stated above in part B.2. of this preamble, the final regulations provide an exception to the application of section 367(a) to transfers of securities by U.S. persons in a section 354 or 356 exchange pursuant to a section 368(a)(1)(E) reorganization, or a section 368(a)(1) asset reorganization that is not treated as an indirect stock transfer. This rule applies to transfers occurring after January 5, 2005, although taxpayers may apply the rule to transfers of securities occurring on or after July 20, 1998, and on or before January 5, 2005, if done consistently to all transactions.

4. *Asset reorganizations followed by controlled asset transfers*

Commentators stated that because the 2005 proposed regulations did not provide an effective date for the rule that treats a section 368(a)(1)(F) reorganization followed by a controlled asset transfer as an indirect stock transfer, such rule could be interpreted as applying to transactions occurring on or after July 20, 1998, which is the general effective date of §1.367(a)–3(d). The final regulations clarify that a section 368(a)(1)(F) reorganization followed by a controlled asset transfer is treated as an indirect stock transfer subject to section 367(a) only if the reorganization occurs on or after January 23, 2006.

In general, section 368(a)(1)(D) reorganizations followed by controlled asset transfers are treated as indirect stock transfers subject to section 367(a) if the reorganization occurs after December 9, 2002. However, see Rev. Rul. 2002–85, 2002–2 C.B. 986, for special retroactive applicability dates.

5. *Electronic filing under section 6038B*

These final regulations provide that Form 926 and any attachments will be verified by signing the income tax return with which the form and attachments are filed, in order to facilitate the electronic filing of Form 926 with the transferor's income tax return. This rule applies to taxable years beginning after December 31, 2002. For taxable years beginning before January 1, 2003, Form 926 must be signed under penalties of perjury declaring that the information submitted is true, correct and complete to the best of the transferor's knowledge and belief.

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. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Robert W. Lorence, Jr., of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

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

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

§1.367(a)–3(b) also issued under 26 U.S.C. 367(a) * * *

§1.367(b)–13 also issued under 26 U.S.C. 367(b) * * *

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

§1.358–6 Stock basis in certain triangular reorganizations.

* * * * *

(e) * * * For certain triangular reorganizations where the surviving corporation (S or T) is foreign, see §1.367(b)–13.

* * * * *

Par. 3. Section 1.367(a)–3 is amended as follows:

1. In paragraph (a), remove the third and fourth sentences, and add five sentences in their place.

2. In paragraph (a), add a sentence at the end of the paragraph.

3. Revise paragraph (b)(2)(i).

4. Revise paragraph (c)(5)(vi).

5. Revise paragraph (d)(1), introductory text.

6. Revise paragraph (d)(1)(i).

7. In paragraph (d)(1)(ii), add a sentence at the end of the paragraph.

8. Revise paragraph (d)(1)(iii).

9. In paragraph (d)(1)(iv), remove the language "*Example 5*" and add "*Example 6*" in its place, remove "*Example 7*" and add "*Example 8*" in its place, and remove "*Example 11*" and add "*Example 14*" in its place.

10. Revise paragraph (d)(1)(v).

11. In paragraph (d)(1)(vi), remove the language "*Example 10* and *Example 10A*" and add "*Example 13* and *Example 13A*" in its place.

12. Revise paragraphs (d)(2)(i), (ii), and (iv).

13. Revise paragraph (d)(2)(v)(A) and (C).

14. Redesignate paragraph (d)(2)(v)(D) as paragraph (d)(2)(v)(F).

15. Add new paragraphs (d)(2)(v)(D) and (E).

16. Revise paragraph (d)(2)(vi).

17. Add new paragraph (d)(2)(vii).

18. In paragraph (d)(3), remove the first sentence, and add two sentences in its place.

19. In paragraph (d)(3), redesignate the examples as follows and add the following new examples:

Redesignate	As	Add
Example 12	*Example 16*	
		Example 15
Examples 11 and *11A*	*Examples 14* and *14A*	
Examples 10 and *10A*	*Examples 13* and *13A*	
Example 9	*Example 12*	
		Examples 10 and *11*
Example 8	*Example 9*	
Examples 7, 7A, 7B, and *7C*	*Examples 8, 8A, 8B,* and *8C*	
Examples 6 and *6A*	*Examples 7* and *7A*	
		Examples 6C
Examples 5, 5A, and *5B*	*Examples 6, 6A,* and *6B*	
		Example 5A
Example 4	*Example 5*	
Example 3	*Example 4*	
Example 2	*Example 3*	
		Example 2

20. In paragraph (d)(3), newly designated *Example 3*, the title and paragraph (i) are revised.

21. In paragraph (d)(3), newly designated *Example 5*, paragraph (i), remove the language "paragraph (d)(1)(iii)" and add "paragraph (d)(1)(iii)(A)" in its place.

22. In paragraph (d)(3), newly designated *Example 5*, paragraph (ii), last sentence, remove the language ", or if S sold all or a portion of the stock of Y".

23. In paragraph (d)(3), newly designated *Example 6A*, paragraph (i), the first and last sentences, and paragraph (ii), the first, fourth, and fifth sentences are revised.

24. In paragraph (d)(3), newly designated *Example 6B* is revised.

25. In paragraph (d)(3), newly designated *Example 8*, paragraph (ii), the fourth sentence is revised.

26. In paragraph (d)(3), newly designated *Example 9* is revised.

27. In paragraph (d)(3), newly designated *Example 12*, paragraph (ii), the fifth sentence is revised.

28. In paragraph (d)(3), revise newly designated *Example 16*.

29. In paragraph (d)(3), for each of the newly designated examples listed in the first column, replace the language in the second column with the language in the third column:

Redesignated Examples	Remove	Add
Example 7, paragraph (i)	*Example 5*	*Example 6*
Example 7A, paragraph (i) and paragraph (ii), penultimate sentence	*Example 6*	*Example 7*
Example 8, paragraph (i)	*Example 5*	*Example 6*
Example 8A, paragraph (i)	*Example 7*	*Example 8*
Example 8B, paragraph (i)	*Example 7*	*Example 8*

Redesignated Examples	Remove	Add
Example 8C, paragraph (i)	*Example 7*	*Example 8*
Example 12, paragraph (i), third sentence	*Example 9*	*Example 12*
Example 13A, paragraph (i) and paragraph (ii), first sentence	*Example 10*	*Example 13*
Example 14A, paragraph (i)	*Example 11*	*Example 14*

30. Paragraph (e)(1) is revised.

The revisions and additions are as follows:

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

* * * * *

(a) * * * However, if, in an exchange described in section 354 or 356, a U.S. person exchanges stock or securities of a foreign corporation in a reorganization described in section 368(a)(1)(E), or a U.S. person exchanges stock or securities of a domestic or foreign corporation pursuant to an asset reorganization that is not treated as an indirect stock transfer under paragraph (d) of this section, such section 354 or 356 exchange is not a transfer to a foreign corporation subject to section 367(a). See paragraph (d)(3) *Example 16* of this section. For purposes of this section, an asset reorganization is defined as a reorganization described in section 368(a)(1) involving a transfer of assets under section 361. If, in a transfer described in section 361, a domestic merging corporation transfers stock of a controlling corporation to a foreign surviving corporation in a reorganization described in sections 368(a)(1)(A) and (a)(2)(E), such section 361 transfer is not subject to section 367(a) if the stock of the controlling corporation is provided to the merging corporation by the controlling corporation pursuant to the plan of reorganization; a section 361 transfer of other property, including stock of the controlling corporation not provided by the controlling corporation pursuant to the plan of reorganization, by the domestic merging corporation to the foreign surviving corporation pursuant to such a reorganization is subject to section 367(a). For special basis and holding period rules involving foreign corporations that are parties to certain triangular reorganizations under section 368(a)(1), see §1.367(b)–13. * * * For rules related to expatriated entities, see section 7874 and the regulations thereunder.

(b) * * *

(2) * * *

(i) *In general.* A transfer of foreign stock or securities described in section 367(a) or the regulations thereunder as well as in section 367(b) or the regulations thereunder shall be subject concurrently to sections 367(a) and (b) and the regulations thereunder, except as provided in paragraph (b)(2)(i)(A) or (B) of this section. See paragraph (d)(3) *Examples 11* and *14* of this section.

(A) Section 367(b) and the regulations thereunder shall not apply if a foreign corporation is not treated as a corporation under section 367(a)(1). See the example in paragraph (b)(2)(ii) of this section and paragraph (d)(3) *Example 14* of this section.

(B) If a foreign corporation transfers assets to a domestic corporation in a transaction to which §1.367(b)–3(a) and (b) and the indirect stock transfer rules of paragraph (d) of this section apply, and the all earnings and profits amount attributable to the stock of an exchanging shareholder under §1.367(b)–3(b) is greater than the amount of gain in such stock subject to section 367(a) pursuant to the indirect stock transfer rules of paragraph (d) of this section, then the rules of section 367(b), and not the rules of section 367(a), shall apply to the exchange. See paragraph (d)(3) *Example 15* of this section.

* * * * *

(c) * * *

(5) * * *

(vi) *Transferee foreign corporation.* Except as provided in paragraph (d)(2)(i)(B) of this section, a transferee foreign corporation is the foreign corporation whose stock is received in the exchange by U.S. persons.

* * * * *

(d) * * *

(1) *In general.* For purposes of this section, a U.S. person who exchanges, under section 354 (or section 356) stock or securities in a domestic or foreign corporation for stock or securities in a foreign corporation (or in a domestic corporation in control of a foreign acquiring corporation in a triangular section 368(a)(1)(B) reorganization) in connection with a transaction described in paragraphs (d)(1)(i) through (v) of this section (or who is deemed to make such an exchange under paragraph (d)(1)(vi) of this section) shall, except as provided in paragraph (d)(2)(vii) of this section, be treated as having made an indirect transfer of such stock or securities to a foreign corporation that is subject to the rules of this section, including, for example, the requirement, where applicable, that the U.S. transferor enter into a gain recognition agreement to preserve nonrecognition treatment under section 367(a). If the U.S. person exchanges stock or securities of a foreign corporation, see also section 367(b) and the regulations thereunder. For examples of the concurrent application of the indirect stock transfer rules under section 367(a) and the rules of section 367(b), see paragraph (d)(3) *Examples 14* and *15* of this section. For purposes of this paragraph (d), if a corporation acquiring assets in an asset reorganization transfers all or a portion of such assets to a corporation controlled (within the meaning of section 368(c)) by the acquiring corporation as part of the same transaction, the subsequent transfer of assets to the controlled corporation will be referred to as a controlled asset transfer. See section 368(a)(2)(C).

(i) *Mergers described in sections 368(a)(1)(A) and (a)(2)(D) and reorganizations described in sections 368(a)(1)(G) and (a)(2)(D).* A U.S. person exchanges stock or securities of a corporation (the acquired corporation) for stock or securities of a foreign corporation that controls the

acquiring corporation in a reorganization described in either sections 368(a)(1)(A) and (a)(2)(D), or in sections 368(a)(1)(G) and (a)(2)(D). See paragraph (d)(3) *Example 1* of this section for an example of a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) involving domestic acquired and acquiring corporations, and see paragraph (d)(3) *Example 10* of this section for an example involving a domestic acquired corporation and a foreign acquiring corporation.

(ii) * * * See paragraph (d)(3) *Example 2* of this section for an example of a reorganization described in sections 368(a)(1)(A) and (a)(2)(E) involving domestic acquired and acquiring corporations, and see paragraph (d)(3) *Example 11* of this section for an example involving a domestic acquired corporation and a foreign acquiring corporation.

(iii) *Triangular reorganizations described in section 368(a)(1)(B)*—(A) A U.S. person exchanges stock or securities of the acquired corporation for voting stock or securities of a foreign corporation that is in control (as defined in section 368(c)) of the acquiring corporation in a reorganization described in section 368(a)(1)(B). See paragraph (d)(3) *Example 5* of this section.

(B) A U.S. person exchanges stock or securities of the acquired corporation for voting stock or securities of a domestic corporation that is in control (as defined in section 368(c)) of a foreign acquiring corporation in a reorganization described in section 368(a)(1)(B). See paragraph (d)(3) *Example 5A* of this section.

* * * * *

(v) *Transfers of assets to subsidiaries in certain section 368(a)(1) reorganizations*. A U.S. person exchanges stock or securities of a corporation (the acquired corporation) for stock or securities of a foreign acquiring corporation in an asset reorganization (other than a triangular section 368(a)(1)(C) reorganization described in paragraph (d)(1)(iv) of this section, a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) or sections 368(a)(1)(G) and (a)(2)(D) described in paragraph (d)(1)(i) of this section, a reorganization described in sections 368(a)(1)(A) and (a)(2)(E) described in paragraph (d)(1)(ii) of this section, or a same-country section 368(a)(1)(F) reorganization) that is followed by a controlled asset transfer. For purposes of this section, a same-country section 368(a)(1)(F) reorganization is a reorganization described in section 368(a)(1)(F) in which both the acquired corporation and the acquiring corporation are foreign corporations and are created or organized under the laws of the same foreign country. In the case of a transaction described in this paragraph (d)(1)(v) in which some but not all of the assets of the acquired corporation are transferred in a controlled asset transfer, the transaction shall be considered to be an indirect transfer of stock or securities subject to this paragraph (d) only to the extent of the assets so transferred. The remaining assets shall be treated as having been transferred by the acquired corporation in an asset transfer rather than an indirect stock transfer, and, if the acquired corporation is a domestic corporation, such asset transfer shall be subject to the other provisions of section 367, including sections 367(a)(1), (3), and (5), and (d). See paragraph (d)(3) *Examples 6A* and *6B* of this section.

* * * * *

(2) * * *

(i) *Transferee foreign corporation*—(A) *General rule*. Except as provided in paragraph (d)(2)(i)(B) of this section, the transferee foreign corporation shall be the foreign corporation that issues stock or securities to the U.S. person in the exchange.

(B) *Special rule for triangular reorganizations described in paragraph (d)(1)(iii)(B) of this section*. In the case of a triangular reorganization described in paragraph (d)(1)(iii)(B) of this section, the transferee foreign corporation shall be the foreign acquiring corporation. See paragraph (d)(3) *Example 5A* of this section.

(ii) *Transferred corporation*. The transferred corporation shall be the acquiring corporation, except as provided in this paragraph (d)(2)(ii). In the case of a triangular section 368(a)(1)(B) reorganization described in paragraph (d)(1)(iii) of this section, the transferred corporation shall be the acquired corporation. In the case of an indirect stock transfer described in paragraph (d)(1)(i), (ii), or (iv) of this section followed by a controlled asset transfer, or an indirect stock transfer described in paragraph (d)(1)(v) of this section, the transferred corporation shall be the controlled corporation to which the assets are transferred. In the case of successive section 351 transfers described in paragraph (d)(1)(vi) of this section, the transferred corporation shall be the corporation to which the assets are transferred in the final section 351 transfer. The transferred property shall be the stock or securities of the transferred corporation, as appropriate under the circumstances.

* * * * *

(iv) *Gain recognition agreements involving multiple parties*. The U.S. transferor's agreement to recognize gain, as provided in §1.367(a)–8, shall include appropriate provisions consistent with the principles of these rules, including a requirement that the transferor recognize gain in the event of a direct or indirect disposition of the stock or assets of the transferred corporation. For example, in the case of a triangular section 368(a)(1)(B) reorganization described in paragraph (d)(1)(iii)(A) of this section, a disposition of the transferred stock or securities requiring the U.S. transferor to recognize gain shall include a direct or indirect disposition of such stock or securities by the transferee foreign corporation, such as a disposition of such stock or securities by a foreign acquiring corporation or a disposition of the stock of the acquiring corporation (either foreign or domestic) by the transferee foreign corporation. In the case of a triangular section 368(a)(1)(B) reorganization described in paragraph (d)(1)(iii)(B) of this section, a disposition of the transferred stock or securities requiring the U.S. transferor to recognize gain shall occur, for example, upon the disposition of such stock or securities by the acquiring corporation. Moreover, a disposition of the stock of the acquiring corporation by the domestic issuing corporation in a taxable transaction shall, for example, terminate the gain recognition agreement. See §1.367(a)–8(h)(1) and paragraph (d)(3) *Examples 5* and *5A* of this section.

(v) * * *

(A) In the case of a reorganization described in paragraph (d)(1)(i) of this section (a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) or sections 368(a)(1)(G) and (a)(2)(D)) or a reorganization described in section

(d)(1)(iv) of this section (a triangular section 368(a)(1)(C) reorganization), the assets of the acquired corporation;

* * * * *

(C) In the case of an asset reorganization followed by a controlled asset transfer, as described in paragraph (d)(1)(v) of this section, the assets of the acquired corporation that are transferred to the corporation controlled by the acquiring corporation;

(D) In the case of a triangular reorganization described in section 368(a)(1)(C) followed by a controlled asset transfer, a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) followed by a controlled asset transfer, or a reorganization described in sections 368(a)(1)(G) and (a)(2)(D) followed by a controlled asset transfer, the assets of the acquired corporation including those transferred to the corporation controlled by the acquiring corporation;

(E) In the case of a reorganization described in sections 368(a)(1)(A) and (a)(2)(E) followed by a controlled asset transfer, the assets of the acquiring corporation including those transferred to the corporation controlled by the acquiring corporation; and

* * * * *

(vi) *Coordination between asset transfer rules and indirect stock transfer rules*—(A) *General rule*. Except as otherwise provided in this paragraph (d)(2)(vi), if, pursuant to any of the transactions described in paragraph (d)(1) of this section, a U.S. person transfers (or is deemed to transfer) assets to a foreign corporation in an exchange described in section 351 or section 361, the rules of section 367, including sections 367(a)(1), (a)(3), and (a)(5), as well as section 367(d), and the regulations thereunder shall apply prior to the application of the rules of this section.

(B) *Exceptions*. (*1*) If a transaction is described in paragraph (d)(2)(vi)(A) of this section, sections 367(a) and (d) shall not apply to the extent a domestic corporation (domestic acquired corporation) transfers its 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 such assets is no greater than the basis that the domestic acquired corporation had in such assets and the conditions contained in either of the following paragraphs are satisfied:

(*i*) The domestic acquired corporation is controlled (within the meaning of section 368(c)) by 5 or fewer domestic corporations, appropriate basis adjustments as provided in section 367(a)(5) are made to the stock of the foreign acquiring corporation, 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 5 or fewer domestic corporations, all members of the same affiliated group within the meaning of section 1504 shall be treated as 1 corporation.

(*ii*) The requirements of paragraphs (c)(1)(i), (ii), and (iv), and (c)(6) of this section are satisfied with respect to the indirect transfer of stock in the domestic acquired corporation, and the domestic acquired corporation attaches a statement described in paragraph (d)(2)(vi)(C) of this section to its U.S. income tax return for the taxable year of the transfer.

(*2*) Sections 367(a) and (d) shall not apply to transfers described in paragraph (d)(1)(vi) of this section where a U.S. person transfers assets to a foreign corporation in a section 351 exchange, to the extent that such assets are transferred by such foreign corporation to a domestic corporation in another section 351 exchange, but only if the domestic transferee's basis in the assets is no greater than the basis that the U.S. transferor had in such assets.

(C) *Required statement*. The statement required by paragraph (d)(2)(vi)(B)(*1*)(*ii*) of this section shall be entitled "Required Statement under §1.367(a)–3(d) for Assets Transferred to a Domestic Corporation" and shall be signed under penalties of perjury by an authorized officer of the domestic acquired corporation and by an authorized officer of the foreign acquiring corporation. The required statement shall contain a certification that, if the foreign acquiring corporation disposes of any stock of the domestic controlled corporation in a transaction described in paragraph (d)(2)(vi)(D) of this section, the domestic acquired corporation shall recognize gain as described in paragraph (d)(2)(vi)(E) of this section. The domestic acquired corporation (or the foreign acquiring corporation on behalf of the domestic acquired corporation) shall file a U.S. income tax return (or an amended U.S. tax return, as the case may be) for the year of the transfer reporting such gain.

(D) *Gain recognition transaction*. (*1*) A transaction described in this paragraph (d)(2)(vi)(D) is one where a principal purpose of the transfer by the domestic acquired corporation is the avoidance of U.S. tax that would have been imposed on the domestic acquired corporation on the disposition of the re-transferred assets. A transfer may have a principal purpose of tax avoidance even though the tax avoidance purpose is outweighed by other purposes when taken together.

(*2*) For purposes of paragraph (d)(2)(vi)(D)(*1*) of this section, a transaction is deemed to have a principal purpose of tax avoidance if the foreign acquiring corporation disposes of any stock of the domestic controlled corporation (whether in a recognition or non-recognition transaction) within 2 years of the transfer described in paragraph (d)(2)(vi)(A) of this section. The rule in this paragraph (d)(2)(vi)(D)(*2*) shall not apply if the domestic acquired corporation (or the foreign acquiring corporation on behalf of the domestic acquired corporation) demonstrates to the satisfaction of the Commissioner that the avoidance of U.S. tax was not a principal purpose of the transaction.

(E) *Amount of gain recognized and other matters*. (*1*) In the case of a transaction described in paragraph (d)(2)(vi)(D) of this section, solely for purposes of this paragraph (d)(2)(vi)(E), the domestic acquired corporation shall be treated as if, immediately prior to the transfer described in paragraph (d)(2)(vi)(A) of this section, it transferred the re-transferred assets, including any intangible assets, directly to a domestic corporation in exchange for stock of such domestic corporation in a transaction that is treated as a section 351 exchange, and immediately sold such stock to an unrelated party for its fair market value in a sale in which it shall recognize gain, if any (but not loss). Any gain recognized by the domestic acquired corporation pursuant to this paragraph (d)(2)(vi)(E) will increase the basis that the foreign acquiring corporation has in the stock of the domestic controlled corporation immediately before the transaction described in paragraph (d)(2)(vi)(D) of

this section, but will not increase the basis of the re-transferred assets held by the domestic controlled corporation. Section 1.367(d)–1T(g)(6) shall not apply with respect to any intangible property included in the re-transferred assets described in this paragraph.

(*2*) If additional tax is required to be paid as a result of a transaction described in paragraph (d)(2)(vi)(D) 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 domestic acquired corporation's income tax return for the year of the transfer and the date on which the additional tax for that year is paid.

(F) *Examples*. For illustrations of the rules in paragraph (d)(2)(vi) of this section, see paragraph (d)(3) *Examples 6B*, *6C*, *9*, and *13A* of this section.

(vii) *Change in status of a domestic acquired corporation to a foreign corporation*. (A) A U.S. person that exchanges stock or securities of a domestic corporation for stock or securities of a foreign corporation under section 354 (or section 356) will be treated for purposes of this section as having made an indirect stock transfer of the stock or securities of a foreign corporation (and not of a domestic corporation) to a foreign corporation under paragraph (b) of this section (but not paragraph (c) of this section), if the acquired domestic corporation is a subsidiary member (within the meaning of §1.1502–1(c)) of a consolidated group (within the meaning of §1.1502–1(h)) immediately before the transaction, and if the transaction is either of the following:

(*1*) Described in paragraph (d)(1)(i) or (iv) of this section, but only if the acquiring corporation is foreign. See paragraph (d)(3) *Examples 8*, *9*, *10* and *12* of this section.

(*2*) Described in paragraph (d)(1)(v) of this section, but only to the extent the controlled asset transfer is to a foreign corporation. See paragraph (d)(3) *Example 6A* of this section.

(B) The rules of paragraph (d)(2)(vii)(A) of this section will not apply to the extent assets transferred to the foreign acquiring corporation in a transaction described in paragraph (d)(2)(vii)(A)(*1*) of this section, or assets transferred to a foreign corporation in a controlled asset transfer in a transaction described in paragraph (d)(2)(vii)(A)(*2*) of this section, are retransferred to a domestic controlled corporation in one or more successive transfers as part of the same transaction. See paragraph (d)(3) *Example 9* of this section.

(3) * * * The rules of this paragraph (d) and §1.367(a)–8 are illustrated by the following examples. For purposes of these examples, assume section 7874 does not apply.

* * * * *

Example 2. Section 368(a)(1)(A)/(a)(2)(E) reorganization—(i) *Facts*. The facts are the same as in *Example 1*, except that Newco merges into W and Newco receives stock of W which it distributes to F in a reorganization described in sections 368(a)(1)(A) and (a)(2)(E). Pursuant to the reorganization, A receives 40 percent of the stock of F in an exchange described in section 354.

(ii) *Result*. The consequences of the transfer are similar to those described in *Example 1*. Pursuant to paragraph (d)(1)(ii) of this section, A is considered to have transferred its W stock to F pursuant to the indirect stock transfer rules. F is treated as the transferee foreign corporation, and W is treated as the transferred corporation. Provided that the requirements of paragraph (c)(1) of this section are satisfied, including the requirement that A enter into a five-year gain recognition agreement as described in §1.367(a)–8, A's exchange of W stock for F stock under section 354 will not be subject to section 367(a)(1).

Example 3. Taxable transaction pursuant to indirect stock transfer rules—(i) *Facts*. The facts are the same as in *Example 1*, except that A receives 55 percent of either the total voting power or the total value of the stock of F in the transaction.

* * * * *

Example 5A. Triangular section 368(a)(1)(B) reorganization—(i) *Facts*. The facts are the same as in *Example 5*, except that F is a domestic corporation and S is a foreign corporation.

(ii) *Result*. U's exchange of Y stock for stock of F, a domestic corporation in control of S, the foreign acquiring corporation, is treated as an indirect transfer of Y stock to a foreign corporation under paragraph (d)(1)(iii)(B) of this section. U's exchange of Y stock for F stock will not be subject to section 367(a)(1) provided that all of the requirements of paragraph (c)(1) of this section are satisfied, including the requirement that U enter into a five-year gain recognition agreement. In satisfying the 50 percent or less ownership requirements of paragraphs (c)(1)(i) and (ii) of this section, U's indirect ownership of S stock (through its direct ownership of F) will determine whether the requirement of paragraph (c)(1)(i) of this section is satisfied and will be taken into account in determining whether the requirement of paragraph (c)(1)(ii) of this section is satisfied. See paragraph (c)(4)(iv) of this section. For purposes of this section, S is treated as the transferee foreign corporation (see paragraph (d)(2)(i)(B) of this section). The gain recognition agreement would be triggered, for example, if S sold all or a portion of the stock of Y, or if Y sold substantially all of its assets (within the meaning of section 368(a)(1)(C)). In addition, if F disposed of the stock of S in a taxable transaction the gain recognition agreement would be terminated.

* * * * *

Example 6A. Section 368(a)(1)(C) reorganization followed by a controlled asset transfer—(i) *Facts*. The facts are the same as in *Example 6*, except that the transaction is structured as a section 368(a)(1)(C) reorganization with Z transferring its assets to F, followed by a controlled asset transfer, and R is a foreign corporation. * * * F then contributes Businesses B and C to R in a controlled asset transfer.

(ii) *Result*. 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 section 367(a)(5), the Business A assets qualify for the section 367(a)(3) active trade or business exception and are not subject to section 367(a). * * * Subject to section 367(a)(5), the Business B assets may qualify for the exception under section 367(a)(3) and §1.367(a)–2T(c)(2) for assets that will be used by R in an active trade or business outside the United States. Pursuant to paragraphs (d)(1) and (d)(2)(vii)(A)(*2*) of this section, V is deemed to transfer the stock of a foreign corporation to F in a section 354 exchange subject to the rules of paragraphs (b) and (d) of this section. * * *

* * * * *

Example 6B. Section 368(a)(1)(C) reorganization followed by a controlled asset transfer to a domestic controlled corporation—(i) *Facts*. The facts are the same as in *Example 6A*, except that R is a domestic corporation.

(ii) *Result*. As in *Example 6A*, the outbound transfer of the Business A assets to F is not affected by the rules of this paragraph (d) and is subject to the general rules under section 367. However, subject to section 367(a)(5), the Business A assets qualify for the section 367(a)(3) active trade or business exception and are not subject to section 367(a). The Business B and C assets are part of an indirect stock transfer under this paragraph (d) but must first be tested under section 367(a) and (d). The Business B assets qualify for the active trade or business exception under section 367(a)(3); the Business C assets do not. However, pursuant to paragraph (d)(2)(vi)(B) of this section, 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, and appropriate basis adjustments are made pursuant to section 367(a)(5) to the stock of F held by V. V also is deemed to make an indirect transfer of Z stock under the rules of paragraph (d) of this section to the extent the assets are transferred to R. To preserve non-recognition treatment under section 367(a), and assuming the other requirements of paragraph (c) of this section are satisfied, V must enter into a 5-year gain recognition agreement in the amount of $50, the amount of the appreciation in the Business B and C assets, as the transfer of such assets by Z was not taxable under section 367(a)(1) and constituted an indirect stock transfer.

Example 6C. Section 368(a)(1)(C) reorganization followed by a controlled asset transfer to a domestic controlled corporation—(i) *Facts*. The facts are the same as in *Example 6B*, except that Z is owned by U.S. individuals, none of whom qualify as five-percent target shareholders with respect to Z within the

meaning of paragraph (c)(5)(iii) of this section. The following additional facts are present. No U.S. persons that are either officers or directors of Z own any stock of F immediately after the transfer. F is engaged in an active trade or business outside the United States that satisfies the test set forth in paragraph (c)(3) of this section.

(ii) *Result*. The Business A assets transferred to F are not re-transferred to R and therefore Z's transfer of these assets is not subject to the rules of paragraph (d) of this section. However, the transfer of such assets is subject to gain recognition under section 367(a)(1), because the section 367(a)(3) active trade or business exception is inapplicable pursuant to section 367(a)(5). The Business B and C assets are part of an indirect stock transfer under this paragraph (d) but must first be tested with respect to Z under section 367(a) and (d), as provided in paragraph (d)(2)(vi) of this section. 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). The transfer of the Business C assets generally is subject to section 367(a)(1) because these assets do not qualify for the active trade or business exception under section 367(a)(3). However, pursuant to paragraph (d)(2)(vi)(B) of this section, the transfer of the Business B and C assets is not subject to sections 367(a)(1) and (d), provided the basis of the Business B and C assets in the hands of R is no greater than the basis in the hands of Z and certain other requirements are satisfied. Even though Z is not controlled within the meaning of section 368(c) by 5 or fewer domestic corporations, Z may avoid immediate gain recognition under section 367(a) and (d) on the transfers of the Business B and Business C assets to F if, pursuant to paragraph (d)(3)(vi)(B) of this section, the indirect transfer of Z stock satisfies the requirements of paragraphs (c)(1)(i), (ii), and (iv), and (c)(6) of this section, and Z attaches a statement described in paragraph (d)(2)(vi)(C) of this section to its U.S. income tax return for the taxable year of the transfer. In general, the statement must contain a certification that, if F disposes of the stock of R (in a recognition or nonrecognition transaction) and a principal purpose of the transfer is the avoidance of U.S. tax that would have been imposed on Z on the disposition of the Business B and C assets transferred to R, then Z (or F on behalf of Z) will file a return (or amended return as the case may be) recognizing gain ($50), as if, immediately prior to the reorganization, Z transferred the Business B and C assets to a domestic corporation in exchange for stock in a transaction treated as a section 351 exchange and immediately sold such stock to an unrelated party for its fair market value. A transaction is deemed to have a principal purpose of U.S. tax avoidance if F disposes of R stock within two years of the transfer, unless Z (or F on behalf of Z) can rebut the presumption to the satisfaction of the Commissioner. See paragraph (d)(2)(vi)(D)(*2*) of this section. With respect to the indirect transfer of Z stock, assume the requirements of paragraphs (c)(1)(i), (ii), and (iv) of this section are satisfied. Thus, assuming Z attaches the statement described in paragraph (d)(2)(vi)(C) of this section to its U.S. income tax return and satisfies the reporting requirements of (c)(6) of this section, the transfer of Business B and C assets is not subject to immediate gain recognition under section 367(a) or (d).

* * * * *

Example 8. Concurrent application of asset transfer and indirect stock transfer rules in consolidated return setting—(i) *Facts*. * * *

(ii) * * * Pursuant to paragraphs (d)(1) and (d)(2)(vii)(A)(*1*) of this section, V is deemed to transfer the stock of a foreign corporation to F in a section 354 exchange subject to the rules of paragraphs (b) and (d) of this section, and therefore must enter into a gain recognition agreement in the amount of $60 (the gain realized but not recognized by V in the stock of Z after the $40 basis adjustment).

* * * * *

Example 9. Indirect stock transfer by reason of a controlled asset transfer—(i) *Facts*. The facts are the same as in *Example 8*, except that R transfers the Business A assets to M, a wholly owned domestic subsidiary of R, in a controlled asset transfer. In addition, V's basis in its Z stock is $90.

(ii) *Result*. Pursuant to paragraph (d)(2)(vi)(B) of this section, sections 367(a) and (d) do not apply to Z's transfer of the Business A assets to R, because such assets are re-transferred to M, a domestic corporation, provided that the basis of the Business A assets in the hands of M is no greater than the basis of the assets in the hands of Z, and certain other requirements are satisfied. Because Z is controlled (within the meaning of section 368(c)) by V, a domestic corporation, appropriate basis adjustments must be made pursuant to section 367(a)(5) to the stock of F held by V. Section 367(a)(1) does not apply to Z's transfer of its Business B assets to R (which are not re-transferred to M) because such assets qualify for an exception to gain recognition under section 367(a)(3), subject to section 367(a)(5). Pursuant to paragraphs (d)(1) and (d)(2)(vii)(A)(*1*) of this section, V is generally deemed to transfer the stock of a foreign corporation to F in a section 354 exchange subject to the rules of paragraphs (b) and (d) of this section, including the requirement that V enter into a 5-year gain recognition agreement and comply with the requirements of §1.367(a)–8. However, pursuant to paragraph (d)(2)(vii)(B) of this section, paragraph (d)(2)(vii)(A)(*1*) of this section does not apply to the extent of the transfer of business A assets by R to M, a domestic corporation. As a result, to the extent of the business A assets transferred by R to M, V is deemed to transfer the stock of Z (a domestic corporation) to F in a section 354 exchange subject to the rules of paragraphs (c) and (d) of this section. Thus, with respect to V's indirect transfer of Z stock to F, such transfer is not subject to gain recognition under section 367(a)(1) if the requirements of paragraph (c) of this section are satisfied, including the requirement that V enter into a 5-year gain recognition agreement and comply with the requirements of §1.367(a)–8. Under paragraphs (d)(2)(i) and (ii) of this section, the transferee foreign corporation is F and the transferred corporation is M. Pursuant to paragraph (d)(2)(iv) of this section, a disposition by F of the stock of R, or a disposition by R of the stock of M, will trigger the gain recognition agreement. To determine whether an asset disposition constitutes a deemed disposition of the transferred corporation's stock under the rules of §1.367(a)–8(e)(3)(i), both the Business A assets in M and the Business B assets in R must be considered.

Example 10. Concurrent application of direct stock transfer and indirect stock transfer rules in section 368(a)(1)(A)/(a)(2)(D) reorganization—(i) *Facts*. The facts are the same as in *Example 8*, except that R acquires all of the assets of Z in a reorganization described in sections 368(a)(1)(A) and (a)(2)(D). Pursuant to the reorganization, V receives 30 percent of the stock of F in a section 354 exchange.

(ii) *Result*. The consequences of the transaction are similar to those in *Example 8*. The assets of Businesses A and B that are transferred to R must be tested under section 367(a) and (d) prior to the consideration of the indirect stock transfer rules of this paragraph (d). The Business B assets qualify for the active trade or business exception under section 367(a)(3), subject to section 367(a)(5). Because the Business A assets do not qualify for the exception, Z must recognize $40 of gain under section 367(a) on the transfer of Business A assets to R. Further, because V and Z file a consolidated return, V's basis in the stock of Z is increased from $100 to $140 as a result of Z's $40 gain. Pursuant to paragraphs (d)(1) and (d)(2)(vii)(A)(*1*) of this section, V is deemed to transfer the stock of a foreign corporation to F in a section 354 exchange subject to the rules of paragraph (b) and (d) of this section. V's indirect transfer of foreign stock will be taxable under section 367(a) unless V enters into a gain recognition agreement in the amount of $60 ($200 value of Z stock less $140 adjusted basis).

Example 11. Concurrent application of section 367(a) and (b) in section 368(a)(1)(A)/(a)(2)(E) reorganization—(i) *Facts*. F, a foreign corporation, owns all the stock of D, a domestic corporation. V, a domestic corporation, owns all the stock of Z, a foreign corporation. V has a basis of $100 in the stock of Z which has a fair market value of $200. D is an operating corporation with assets valued at $100 with a basis of $60. In a reorganization described in sections 368(a)(1)(A) and (a)(2)(E), D merges into Z, and V exchanges its Z stock for 55 percent of the outstanding F stock.

(ii) *Result*. Under paragraph (d)(1)(ii) of this section, V is treated as making an indirect transfer of Z stock to F. V's exchange of Z stock for F stock will be taxable under section 367(a) (and section 1248 will be applicable) if V fails to enter into a 5-year gain recognition agreement in accordance with the requirements of §1.367(a)–8. Under paragraph (b)(2) of this section, if V enters into a gain recognition agreement, the exchange will be subject to the provisions of section 367(b) and the regulations thereunder as well as section 367(a). Under §1.367(b)–4(b), however, no income inclusion is required because both F and Z are controlled foreign corporations with respect to which V is a section 1248 shareholder immediately after the exchange. Under paragraphs (d)(2)(i) and (ii) of this section, the transferee foreign corporation is F, and the transferred corporation is Z (the acquiring corporation). If F disposes (within the meaning of §1.367(a)–8(e)) of all (or a portion) of Z stock within the 5-year term of the agreement (and V has not made a valid election under §1.367(a)–8(b)(1)(vii)), V is required to file an amended return for the year of the transfer and include in income, with interest, the gain realized but not recognized on the initial section 354 exchange. To determine whether Z (the transferred corporation) disposes of substantially all of its assets, only the assets of Z immediately prior to the transaction are taken into account, pursuant to paragraph (d)(2)(v)(B) of this section. Because D is owned by F, a foreign corporation, section 367(a)(5) precludes any assets of D from qualifying for nonrecognition

under section 367(a)(3). Thus, D recognizes $40 of gain on the transfer of its assets to Z under section 367(a)(1).

Example 12. Concurrent application of direct and indirect stock transfer rules—(i) *Facts*. * * *

(ii) * * * Pursuant to paragraphs (d)(1) and (d)(2)(vii)(A)(*1*) of this section, D is deemed to transfer the stock of a foreign corporation to F in a section 354 exchange subject to the rules of paragraphs (b) and (d) of this section, and therefore may enter into a gain recognition agreement for such indirect stock transfer as provided in paragraph (b) of this section and §1.367(a)–8. * * *

* * * * *

Example 15. Concurrent application of indirect stock transfer rules and section 367(b)— (i) *Facts*. F, a foreign corporation, owns all of the stock of Newco, a domestic corporation. P, a domestic corporation, owns all of the stock of FC, a foreign corporation. P's basis in the stock of FC is $50 and the value of FC stock is $100. The all earnings and profits amount with respect to the FC stock held by P is $60. See §1.367(b)–2(d). In a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) (and paragraph (d)(1)(i) of this section), Newco acquires all of the properties of FC, and P exchanges its stock in FC for 20 percent of the stock in F.

(ii) *Result*. P's section 354 exchange is considered an indirect stock transfer under paragraph (d)(1)(i) of this section. Further, because the assets of FC were acquired by Newco, a domestic corporation, in an asset reorganization, the transaction is within §1.367(b)–3(a) and (b). Because the transaction is subject to §1.367(b)–3 and the indirect stock rules of paragraph (d) of this section, and because the all earnings and profits amount with respect to the FC stock exchanged by P ($60) is greater than the gain in such stock subject to section 367(a) ($50), the section 367(b) rules (and not the section 367(a) rules) apply to the exchange. See §1.367(a)–3(b)(2)(i)(B). Under the rules of section 367(b), P must include in income the all earnings and profits amount of $60 with respect to its FC stock. See §1.367(b)–3. Alternatively, if P's all earnings and profits amount with respect to its FC stock were $30 (which is less than the gain in such stock subject to section 367(a) ($50)), section 367(b) and the regulations thereunder would not apply if there is gain recognition under section 367(a). Thus, if P failed to enter into a 5-year gain recognition agreement in accordance with §1.367(a)–8, then P would recognize $50 of gain under section 367(a) and there would be no income inclusion under section 367(b). If, instead, P enters into a 5-year gain recognition agreement under §1.367(a)–8, thereby avoiding immediate gain recognition on the entire $50 of section 367(a) gain, P is required to include in income the all earnings and profits amount of $30. In such a case, P will adjust its basis in the FC stock pursuant to §1.367(b)–2(e)(3)(ii) and enter into a gain recognition agreement in the amount of $20.

Example 16. Direct asset reorganization not subject to stock transfer rules—(i) *Facts*. D is a domestic corporation that owns all the stock of F1 and F2, both foreign corporations. In a reorganization described in section 368(a)(1)(D), F2 acquires all of the assets of F1, and D receives 30 percent of the stock of F2 in an exchange described in section 354.

(ii) *Result*. The section 368(a)(1)(D) reorganization is not an indirect stock transfer described in paragraph (d) of this section. Moreover, the section 354 exchange by D of F1 stock for F2 stock is not an exchange described under section 367(a). See paragraph (a) of this section.

(e) * * *

(1) *Rules of applicability*—(A) Except as otherwise provided in this paragraph (e), the rules in paragraphs (a), (b), and (d) of this section apply to transfers occurring on or after July 20, 1998.

(B) The following rules apply to transactions occurring on or after January 23, 2006. —

(*1*) The rules in paragraphs (a) and (d) of this section, as they apply to section 368(a)(1)(A) reorganizations (including reorganizations described in section 368(a)(2)(D) or (E)) involving a foreign acquiring or foreign acquired corporation;

(*2*) The rules in paragraph (b)(2)(i)(B) of this section;

(*3*) The rules in paragraph (d) of this section, as they apply to section 368(a)(1)(G) reorganizations (including reorganizations described in section 368(a)(2)(D));

(*4*) The rules of paragraph (d)(1) and (d)(2)(iv), as they relate to exchanges by a U.S. person of securities of an acquired corporation for voting stock or securities of a foreign corporation in control of the acquiring corporation in a triangular section 368(a)(1)(B) reorganization;

(*5*) The rules in paragraph (d)(1) and (d)(2)(iv) of this section, as they relate to exchanges by a U.S. person of stock or securities of an acquired corporation for voting stock or securities of a domestic corporation in control of the foreign acquiring corporation in a triangular section 368(a)(1)(B) reorganization; and

(*6*) The rules in paragraph (d)(2)(vii) of this section.

(C) The rules of paragraph (a) of this section that apply to transfers of securities in a section 354 or 356 exchange (pursuant to a section 368(a)(1)(E) reorganization or an asset reorganization that is not treated as an indirect stock transfer) that is not subject to section 367(a) apply only to transfers occurring after January 5, 2005 (although taxpayers may apply such provision to transfers of securities occurring on or after July 20, 1998, and on or before January 5, 2005, if done consistently to all transactions).

(D) The rules in paragraph (d)(1)(v) of this section apply to:

(*1*) A reorganization described in section 368(a)(1)(C) followed by a controlled asset transfer if such reorganization occurs on or after July 20, 1998;

(*2*) A reorganization described in section 368(a)(1)(D) followed by a controlled asset transfer if such reorganization occurs after December 9, 2002 (for additional guidance concerning such reorganizations that occur on or after July 20, 1998 and on or before December 9, 2002, see Rev. Rul. 2002–85, 2002–2 C.B. 986, and §601.601(d)(2) of this chapter); and

(*3*) A reorganization described in section 368(a)(1)(A), (F), or (G) followed by a controlled asset transfer if such reorganization occurs on or after January 23, 2006.

(E) 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.

(F) With respect to certain transfers of domestic stock or securities, the rules in paragraph (c) of this section are generally applicable for transfers occurring after January 29, 1997. See §1.367(a)–3(c)(11). For transition rules regarding certain transfers of domestic stock or securities after December 16, 1987, and before January 30, 1997, and transfers of foreign stock or securities after December 16, 1987, and before July 20, 1998, see paragraph (g) of this section.

* * * * *

Par. 4. Section 1.367(a)–8 is amended as follows:

1. In paragraphs (c)(2) and (d), remove the words "district director" and add "Director of Field Operations" in their place.

2. In paragraph (e)(1)(i), a sentence is added after the first sentence.

The addition reads as follows:

§1.367(a)–8 Gain recognition agreement requirements.

* * * * *

(e) * * *

(1) * * *

(i) * * * It also includes an indirect disposition of the stock of the transferred corporation as described in §1.367(a)–3(d)(2)(iv). * * *

* * * * *

Par. 5. In §1.367(b)–1(a), remove the third and fourth sentences and add a sentence in their place to read as follows:

§1.367(b)–1 Other transfers.

(a) * * * For rules coordinating the concurrent application of sections 367(a) and (b), see §1.367(a)–3(b)(2). * * *

* * * * *

Par. 6. In §1.367(b)–3(b)(3)(ii), revise paragraph (i) of *Example 5* to read as follows:

§1.367(b)–3 Repatriation of foreign corporate assets in certain nonrecognition transactions.

* * * * *

(b) * * *

(3) * * *

(ii) * * *

Example 5. (i) *Facts*. DC1, a domestic corporation, owns all of the outstanding stock of FC1, a foreign corporation. FC1 owns all of the outstanding stock of FC2, a foreign corporation. The all earnings and profits amount with respect to the FC2 stock owned by FC1 is $20. In a reorganization described in section 368(a)(1)(A), DC2, a domestic corporation unrelated to FC1 or FC2, acquires all of the assets and liabilities of FC2 pursuant to a State W merger. FC2 receives DC2 stock and distributes such stock to FC1. The FC2 stock held by FC1 is canceled, and FC2 ceases its separate legal existence.

* * * * *

Par. 7. Section 1.367(b)–4 is amended as follows:

1. Paragraph (a) is revised.
2. The title and first sentence of paragraph (b)(1)(i) are revised.
3. Paragraph (b)(1)(ii) is redesignated as paragraph (b)(1)(iii), and new paragraph (b)(1)(ii) is added.
4. In newly designated paragraph (b)(1)(iii) *Examples 3A* and *3B* are added after *Example 3*.

The revisions and additions read as follows:

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

(a) *Scope*. This section applies to an acquisition by a foreign corporation (the foreign acquiring corporation) of the stock or assets of a foreign corporation (the foreign acquired corporation) in an exchange described in section 351 or a reorganization described in section 368(a)(1). In the case of a reorganization described in sections 368(a)(1)(A) and (a)(2)(E), this section applies if stock of the foreign surviving corporation is exchanged for stock of a foreign corporation in control of the merging corporation; in such a case, the foreign surviving corporation is treated as a foreign acquired corporation for purposes of this section. A foreign corporation that undergoes a reorganization described in section 368(a)(1)(E) is treated as both the foreign acquired corporation and the foreign acquiring corporation for purposes of this section. See §1.367(a)–3(b)(2) for transactions subject to the concurrent application of this section and section 367(a).

(b) * * *

(1) * * *

(i) *General rule*. Except as provided in paragraph (b)(1)(ii) of this section, an exchange is described in this paragraph (b)(1)(i) if —

* * * * *

(ii) *Exception*. In the case of a triangular reorganization described in §1.358–6(b)(2), or a reorganization described in sections 368(a)(1)(G) and (a)(2)(D), an exchange is not described in paragraph (b)(1)(i) of this section if the stock received in the exchange is stock of a domestic corporation and, immediately after the exchange, such domestic corporation is a section 1248 shareholder of the acquired corporation (in the case of a triangular B reorganization) or the surviving corporation (in the case of a triangular C reorganization, a forward triangular merger, a reorganization described in sections 368(a)(1)(G) and (a)(2)(D), or a reverse triangular merger) and such acquired or surviving corporation is a controlled foreign corporation. See §1.367(b)–13(c) for rules regarding such domestic corporation's basis in the stock of the surviving corporation. See paragraph (b)(1)(iii) of this section, *Example 3B* for an illustration of this rule.

(iii) * * *

Example 3A. (i) *Facts*. The facts are the same as in *Example 3*, except that FC1 merges into FC2 in a reorganization described in sections 368(a)(1)(A) and (a)(2)(E). Pursuant to the reorganization, DC exchanges its FC2 stock for stock of FP.

(ii) *Result*. The result is similar to the result in *Example 3*. The transfer is an indirect stock transfer subject to section 367(a). See §1.367(a)–3(d)(1)(ii). Accordingly, DC's exchange of FC2 stock for FP stock will be taxable under section 367(a) (and section 1248 will be applicable) if DC fails to enter into a gain recognition agreement. If DC enters into a gain recognition agreement, the exchange will be subject to the provisions of section 367(b) and the regulations thereunder, as well as section 367(a). If FP and FC2 are controlled foreign corporations as to which DC is a section 1248 shareholder immediately after the reorganization, then paragraph (b)(1)(i) of this section does not apply to require DC to include in income the section 1248 amount attributable to the FC2 stock that was exchanged and the amount of the gain recognition agreement is the amount of gain realized on the indirect stock transfer. If FP or FC2 is not a controlled foreign corporation as to which DC is a section 1248 shareholder immediately after the exchange, then DC must include in income as a deemed dividend from FC2 the section 1248 amount ($20) attributable to the FC2 stock that DC exchanged. Under these circumstances, the gain recognition agreement would be the amount of gain realized on the indirect transfer, less the $20 section 1248 amount inclusion.

Example 3B. (i) *Facts*. The facts are the same as *Example 3*, except that USP, a domestic corporation, owns the controlling interest (within the meaning of section 368(c)) in FC1 stock. In addition, FC2 merges into FC1 in a reorganization described in sections 368(a)(1)(A) and (a)(2)(D). Pursuant to the reorganization, DC exchanges its FC2 stock for USP stock.

(ii) *Result*. Because DC receives stock of a domestic corporation, USP, in the section 354 exchange, the transfer is not an indirect stock transfer subject to section 367(a). Accordingly, the exchange will be subject only to the provisions of section 367(b) and the regulations thereunder. Under paragraph (b)(1)(ii) of this section, because the stock received is stock of a domestic corporation (USP) and, immediately after the exchange, USP is a section 1248 shareholder of FC1 (the surviving corporation) and FC1 is a controlled foreign corporation, the exchange is not described in paragraph (b)(1)(i) of this section and DC is not required to include in income the section 1248 amount attributable to the FC2 stock that was exchanged. See §1.367(b)–13(c) for the basis and holding period rules applicable to this transaction, which cause USP's adjusted basis and holding period in the stock of FC1 after the transaction to reflect the basis and holding period that DC had in its FC2 stock.

* * * * *

Par. 8. In §1.367(b)–6, paragraph (a)(1), add two sentences to the end to read as follows:

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

(a) * * *

(1) * * * 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. Section 1.367(b)–4(b)(1)(ii) applies to triangular B reorganizations occurring on or after February 23, 2000 and to all other triangular reorganizations and reorganizations described in section 368(a)(1)(G) and (a)(2)(D) occurring on or after January 23, 2006.

* * * * *

Par. 9. Section 1.367(b)–13 is added to read as follows:

§1.367(b)–13 Special rules for determining basis and holding period.

(a) *Scope and definitions*—(1) *Scope*. This section provides special basis and holding period rules to determine the basis and holding period of stock of certain foreign surviving corporations held by a controlling corporation whose stock is issued in an exchange under section 354 or 356 in a triangular reorganization. This section applies to transactions that are subject to section 367(b) as well as section 367(a), including transactions concurrently subject to sections 367(a) and (b).

(2) *Definitions*. For purposes of this section, the following definitions apply:

(i) A block of stock has the meaning provided in §1.1248–2(b).

(ii) A triangular reorganization is a reorganization described in §1.358–6(b)(2)(i), (ii), or (iii) or in sections 368(a)(1)(G) and (a)(2)(D) (a forward triangular merger, triangular C reorganization, reverse triangular merger, or triangular G reorganization, respectively). For purposes of triangular reorganizations—

(A) P is a corporation that is a party to a reorganization that is in control (within the meaning of section 368(c)) of another party to the reorganization and whose stock is transferred pursuant to the reorganization;

(B) S is a corporation that is a party to the reorganization and that is controlled by P; and

(C) T is a corporation that is another party to the reorganization.

(b) *Determination of basis for exchanges of foreign stock or securities under section 354 or 356*. For rules determining the basis of stock or securities in a foreign corporation received in a section 354 or 356 exchange, see §1.358–2.

(c) *Determination of basis and holding period for triangular reorganizations*—(1) *Application*. In the case of a triangular reorganization described in paragraph (a)(2)(ii) of this section, this paragraph (c) applies, if—

(i)(A) Immediately before the transaction, either P is a section 1248 shareholder with respect to S, or P is a foreign corporation and a United States person is a section 1248 shareholder with respect to both P and S; and

(B) In the case of a reverse triangular merger, P's exchange of S stock is not described in §1.367(b)–3(a) and (b) or in §1.367(b)–4(b)(1)(i), (2)(i), or (3); or

(ii)(A) Immediately before the transaction, a shareholder of T is a section 1248 shareholder with respect to T, or a shareholder of T is a foreign corporation and a United States person is a section 1248 shareholder with respect to both such foreign corporation and T; and

(B) With respect to at least one of the exchanging shareholders described in paragraph (c)(1)(ii)(A) of this section, the exchange of T stock is not described in §1.367(b)–3(a) and (b) or in §1.367(b)–4(b)(1)(i), (2)(i), or (3).

(2) *Basis and holding period rules*. In the case of a triangular reorganization described in paragraph (c)(1) of this section, each share of stock of the surviving corporation (S or T) held by P must be divided into portions attributable to the S stock and the T stock immediately before the exchange. See paragraph (e) of this section *Examples 1* through *4* for illustrations of this rule.

(i) *Portions attributable to S stock*—(A) In the case of a forward triangular merger, a triangular C reorganization, or a triangular G reorganization, the basis and holding period of the portion of each share of surviving corporation stock attributable to the S stock is the basis and holding period of such share of stock immediately before the exchange.

(B) In the case of a reverse triangular merger, the basis and holding period of the portion of each share of surviving corporation stock attributable to the S stock is the basis and the holding period immediately before the exchange of a proportionate amount of the S stock to which the portion relates. If P is a shareholder described in paragraph (c)(1)(i)(A) of this section with respect to S, and P exchanges two or more blocks of S stock pursuant to the transaction, then each share of the surviving corporation (T) attributable to the S stock must be further divided into separate portions to account for the separate blocks of stock in S.

(C) If the value of S stock immediately before the triangular reorganization is less than one percent of the value of the surviving corporation stock immediately after the triangular reorganization, then P may determine its basis in the surviving corporation stock by applying the rules of paragraph (c)(2)(ii) of this section to determine the basis and holding period of the surviving corporation stock attributable to the T stock, and then increasing the basis of each share of surviving corporation stock by the proportionate amount of P's aggregate basis in the S stock immediately before the exchange (without dividing the stock of the surviving corporation into separate portions attributable to the S stock).

(ii) *Portions attributable to T stock*—(A) If any exchanging shareholder of T stock is described in paragraph (c)(1)(ii) of this section, the basis and holding period of the portion of each share of stock in the surviving corporation attributable to the T stock is the basis and holding period immediately before the exchange of a proportionate amount of the T stock to which such portion relates. If any exchanging shareholder of T stock is described in paragraph (c)(1)(ii) of this section, and such shareholder exchanges two or more blocks of T stock pursuant to the transaction, then each share of surviving corporation stock attributable to the T stock must be further divided into separate portions to account for the separate blocks of T stock.

(B) If no exchanging shareholder of T stock is described in paragraph (c)(1)(ii) of this section, the rules of §1.358–6 apply to determine the basis of the portion of each share of the surviving corporation attributable to T immediately before the exchange.

(d) *Special rules applicable to divided shares of stock*—(1) *In general*—(i) Shares of stock in different blocks are aggregated into one divided portion for basis purposes, if such shares immediately before the exchange are owned by one or more shareholders that are—

(A) Not section 1248 shareholders with respect to the corporation; or

(B) Foreign corporate shareholders, provided that no United States persons are section 1248 shareholders with respect to

both such foreign corporate shareholders and the corporation.

(ii) For purposes of determining the amount of gain realized on the sale or exchange of stock that has a divided portion pursuant to paragraph (c) of this section, any amount realized on such sale or exchange will be allocated to each divided portion of the stock based on the relative fair market value of the stock to which the portion is attributable at the time the portions were created. See paragraph (e) *Example 5* of this section.

(iii) Shares of stock will no longer be required to be divided if section 1248 or section 964(e) would not apply to a disposition or exchange of such stock.

(2) *Pre-exchange earnings and profits*. All earnings and profits (or deficits) accumulated by a foreign corporation before the reorganization and attributable to a share (or block) of stock for purposes of section 1248 are attributable to the divided portion of stock with the basis and holding period of that share (or block). See §1.367(b)–4(d).

(3) *Post-exchange earnings and profits*. Any earnings and profits (or deficits) accumulated by the surviving corporation subsequent to the reorganization are attributed to each divided share of stock pursuant to section 1248 and the regulations thereunder. The amount of earnings and profits (or deficits) attributable to a divided share of stock is further attributed to the divided portions of such share of stock based on the relative fair market value of each divided portion of stock. See paragraph (e) *Example 5* of this section.

(e) *Examples*. The rules of this section are illustrated by the following examples:

Example 1. Blocks of stock exchanged in a triangular reorganization—(i) *Facts*. (A) US1, a domestic corporation, owns all the stock of F1, a foreign corporation. F1 owns all the stock of FT, a foreign corporation, with 100 shares of stock outstanding. Each share of FT stock is valued at $10x. Because F1 acquired the stock of FT at two different dates, F1 owns two blocks of FT stock for purposes of section 1248. The first block consists of 60 shares. The shares in the first block have a basis of $300x ($5x per share), a holding period of 10 years, and $240x ($4x per share) of earnings and profits attributable to the shares for purposes of section 1248. The second block consists of 40 shares. The shares in the second block have a basis of $600x ($15x per share), a holding period of 2 years, and $80x ($2x per share) of earnings and profits attributable to the shares for purposes of section 1248.

(B) US2, a domestic corporation, owns all of the stock of FP, a foreign corporation, which owns all of the stock of FS, a foreign corporation. FP owns two blocks of FS stock. Each block consists of 10 shares with a value of $200x ($20x per share). The shares in the first block have a basis of $50x ($5x per share), a holding period of 10 years, and $50x ($5x per share) of earnings and profits attributable to such shares for purposes of section 1248. The shares in the second block had a basis of $100x ($10x per share), a holding period of 5 years, and $20x ($2x per share) of earnings and profits attributable to such shares for purposes of section 1248.

(C) FT merges into FS, with FS surviving, and F1 receives 50 shares of FP stock with a value of $1,000x in exchange for its FT stock. The merger of FT into FS qualifies as forward triangular merger, and immediately after the exchange US1 is a section 1248 shareholder with respect to F1, the exchanging shareholder, FP and FS, all of which are controlled foreign corporations.

(ii) *Basis and holding period determination*. (*1*) US1 is a section 1248 shareholder of F1, the exchanging shareholder, and FT (both of which are controlled foreign corporations) immediately before the transaction. Moreover, F1 is not required to include amounts in income under §1.367(b)–3(b) or 1.367(b)–4(b) as described in paragraph (c)(1)(ii)(B) of this section. Accordingly, the basis and holding period of the FS stock held by FP immediately after the triangular reorganization is determined pursuant to paragraph (c) of this section.

(*2*) Pursuant to paragraph (c) of this section, each share of FS stock is divided into portions attributable to the basis and holding period of the FS stock held by FP immediately before the exchange (the FS portion) and the FT stock held by F1 immediately before the exchange (the FT portion). The basis and holding period of the FS portion is the basis and holding period of the FS stock held by FP immediately before the exchange. Thus, each share of FS stock in the first block has a portion with a basis of $5x, a value of $20x, a holding period of 10 years, and $5x of earnings and profits attributable to such portion for purposes of section 1248. Each share of FS stock in the second block has a portion with a basis of $10x, a value of $20x, a holding period of 5 years, and $2x of earnings and profits attributable to such portion for purposes of section 1248.

(*3*) Because the exchanging shareholder of FT stock (F1) has a section 1248 shareholder (US1), the holding period and basis of the FT portion is the holding period and the proportionate amount of the basis of the FT stock immediately before the exchange to which such portion relates. Further, because F1 exchanged two blocks of FT stock, the FT portion must be divided into two separate portions attributable to the two blocks of FT stock. Thus, each share of FS stock will have a second portion with a basis of $15x ($300x basis / 20 shares), a value of $30x ($600x value / 20 shares), a holding period of 10 years, and $12x of earnings and profits ($240x / 20 shares) attributable to such portion for purposes of section 1248. Each share of FS stock will have a third portion with a basis of $30x ($600x basis / 20 shares), a value of $20x ($400x value / 20 shares), a holding period of 2 years, and $4x of earnings and profits ($80x / 20 shares) attributable to such portion for purposes of section 1248.

(iii) *Subsequent disposition—first block*. Assume, immediately after the transaction, FP disposes of a share of FS stock from the first block. When FP disposes of any share of its FS stock, it is treated as disposing of each divided portion of such share. With respect to the first portion (attributable to the FS stock), FP recognizes a gain of $15x ($20x value - $5x basis), $5x of which is treated as a dividend under section 1248. With respect to the second portion (attributable to the first block of FT stock), FP recognizes a gain of $15x ($30x value - $15x basis), $12x of which is treated as a dividend under section 1248. With respect to the third portion (attributable to the second block of FT stock), FP recognizes a capital loss of $10x ($20x value - $30x basis).

(iv) *Subsequent disposition—second block*. Assume further, immediately after the transaction, FP also disposes of a share of stock from the second block of FS stock. With respect to the first portion (attributable to the FS stock), FP recognizes a gain of $10x ($20x value - $10x basis), $2x of which is treated as a dividend under section 1248. With respect to the second portion (attributable to the first block of FT stock), FP recognizes a gain of $15x ($30x value - $15x basis), $12x of which is treated as a dividend under section 1248. With respect to the third portion (attributable to the second block of FT stock), FP recognizes a capital loss of $10x ($20x value - $30x basis).

Example 2. (i) *Facts*. The facts are the same as in *Example 1*, except that FS merges into FT with FT surviving in a reverse triangular merger. Pursuant to the merger, F1 receives FP stock with a value of $1,000x in exchange for its FT stock, and FP receives 10 shares of FT stock with a value of $1,000x in exchange for its FS stock. Immediately after the exchange, US1 is a section 1248 shareholder with respect to F1, the exchanging shareholder, FP, and FT, all of which are controlled foreign corporations.

(ii) *Basis and holding period determination*—(A) The basis and holding period of the stock of the surviving corporation held by FP are the same as in *Example 1*, except that each share of the surviving corporation (FT, instead of FS) will be divided into four portions instead of three portions. Because FP exchanges two blocks of FS stock, the FS portion must be divided into two separate portions attributable to the two blocks of FS stock. Because F1 exchanges two blocks of FT stock, the FT portion must be divided into two separate portions attributable to the two blocks of FT stock.

(B) Thus, each share of the surviving corporation (FT) will have a first portion (attributable to the first block of FS stock) with a basis of $5x ($50x / 10 shares), a value of $20x ($200x / 10 shares), a holding period of 10 years, and $5x of earnings and profits ($50x / 10 shares) attributable to such portion for purposes of section 1248. Each share of FT stock will have a second portion (attributable to the second block of FS stock) with a basis of $10x ($100x / 10 shares), a value of $20x ($200x / 10 shares), a holding period of 5 years, and $2x of earnings and profits ($20x / 10 shares) attributable to such portion for purposes of section 1248. Moreover, each share of FT stock will have a third portion (attributable to the first block of FT stock) with a basis of $30x ($300x basis / 10 shares), a value of $60x ($600x value / 10 shares), a holding period of 10 years, and $24x of earnings and profits ($240x / 10 shares) attributable to such portion for purposes of section 1248. Lastly, each share of FT stock will have a fourth portion (attributable to the

second block of FT stock) with a basis of $60x ($600x basis / 10 shares), a value of $40x ($400x value / 10 shares), a holding period of 2 years, and $8x of earnings and profits ($80x / 10 shares) attributable to such portion for purposes of section 1248.

Example 3. (i) *Facts*. USP, a domestic corporation, owns all the stock of FS, a foreign corporation with 10 shares of stock outstanding. Each share of FS stock has a value of $10x, a basis of $5x, a holding period of 10 years, and $7x of earnings and profits attributable to such share for purposes of section 1248. FP, a foreign corporation, owns the stock of FT, another foreign corporation. FP and FT do not have any section 1248 shareholders. FT has assets with a value of $100x, a basis of $50x, and no liabilities. The FT stock held by FP has a value of $100x and a basis of $75x. FT merges into FS with FS surviving in a forward triangular merger. Pursuant to the reorganization, FP receives USP stock with a value of $100x in exchange for its FT stock.

(ii) *Basis and holding period determination*—(A) Because USP is a section 1248 shareholder of FS immediately before the transaction, the basis and holding period of the FS stock held by USP immediately after the triangular reorganization is determined pursuant to paragraph (c) of this section.

(B) Pursuant to paragraph (c) of this section, each share of FS stock is divided into portions attributable to the basis and holding period of the FS stock held by USP immediately before the exchange (the FS portion) and the FT portion immediately before the exchange. Because FT does not have a section 1248 shareholder immediately before the transaction, the rules of §1.358–6 apply to determine the basis of the FT portion of each share of FS stock. Those rules determine the basis of FS stock held by USP by reference to the basis of FT's net assets. The basis and holding period of the FS portion is the basis and holding period of the FS stock held by USP immediately before the exchange. Thus, each share of FS stock has a portion with a basis of $5x, a value of $10x, a holding period of 10 years, and $7x of earnings and profits attributable to such portion for section 1248 purposes. The basis of the FT portion is the basis of the FT assets to which such portion relates. Thus, each share of FS stock has a second portion with a basis of $5x ($50x basis in FT's assets / 10 shares) and a value of $10x ($100x value of FT's assets / 10 shares). All of FS's earnings and profits prior to the transaction ($70x) is attributed solely to the FS portion in each share of FS stock. As a result of each share of stock being divided into portions, the basis of the FS stock is not averaged with the basis of the FT assets to increase the section 1248 amount with respect to the stock of the surviving corporation (FS).

Example 4. (i) *Facts*. US, a domestic corporation, owns all of the stock of FT, a foreign corporation. The FT stock held by US constitutes a single block of stock with a value of $1,000x, a basis of $600x, and holding period of 5 years. USP, a domestic corporation, forms FS, a foreign corporation, pursuant to the plan of reorganization and capitalizes it with $10x of cash. FS merges into FT with FT surviving in a reverse triangular merger and a reorganization described in section 368(a)(1)(B). Pursuant to the reorganization, US receives USP stock with a value of $1,000x in exchange for its FT stock, and USP receives 10 shares of FT stock with a value of $1,010x in exchange for its FS stock.

(ii) *Basis and holding period determination*. (A) US and USP are section 1248 shareholders of FT and FS, respectively, immediately before the transaction. Neither US nor USP is required to include amounts in income under §1.367(b)–3(b) or 1.367(b)–4(b) as described in paragraph (c)(1)(i)(B) or (c)(1)(ii)(B) of this section. The basis and holding period of the FT stock held by USP is determined pursuant to paragraph (c) of this section.

(B) Pursuant to paragraph (c) of this section, because the exchanging shareholder of FT stock (US) is a section 1248 shareholder of FT, each share of the surviving corporation (FT) has a proportionate amount of the basis and holding period of the FT stock immediately before the exchange to which such share relates. Thus, the portion of each share of FT stock attributable to the FT stock has a basis of $60x ($600x basis / 10 shares), a value of $100x ($1,000x value / 10 shares), and a holding period of 5 years. Because the value of FS stock immediately before the triangular reorganization ($10x) is less than one percent of the value of the surviving corporation (FT) immediately after the triangular reorganization ($1,010x), USP may determine its basis in the stock of the surviving corporation (FT) attributable to its FS stock basis held prior to the reorganization by increasing the basis of each share of FT stock by the proportionate amount of USP's aggregate basis in the FS stock immediately before the exchange (without dividing each share of FT stock into separate portions to account for FS and FT). If USP so elects, USP's basis in each share of FT stock is increased by $1x ($10x basis in FS stock / 10 shares). As a result, each share of FT stock has a basis of $61x, a value of $101x, and a holding period of 5 years.

Example 5. (i) *Facts*. US, a domestic corporation, owns all of the stock of F1, a foreign corporation, which owns all the stock of FT, a foreign corporation. The FT stock held by F1 constitutes one block of stock with a basis of $170x, a value of $200x, a holding period of 5 years, and $10x of earnings and profits attributable to such stock for purposes of section 1248. FP, a foreign corporation, owns all the stock of FS, a foreign corporation. FS has 10 shares of stock outstanding. No United States person is a section 1248 shareholder with respect to FP or FS. The FS stock held by FP has a value of $100x and a basis of $50x ($5x per share). FT merges into FS with FS surviving in a forward triangular merger. Pursuant to the merger, F1 receives FP stock with a value of $200x for its FT stock in an exchange that qualifies for non-recognition under section 354. US is a section 1248 shareholder with respect to F1, the exchanging shareholder, FP, and FS (all of which are controlled foreign corporations) immediately after the exchange.

(ii) *Basis and holding period determination*. (A) Because US is a section 1248 shareholder of F1, the exchanging shareholder, and FT immediately before the transaction, and US is a section 1248 shareholder of F1, FP, and FS immediately after the transactions, F1 is not required to include amounts in income under §§1.367(b)–3(b) and 1.367(b)–4(b) as described in paragraph (c)(1)(ii)(B) of this section. Thus, the basis and holding period of the FS stock held by FP immediately after the triangular reorganization is determined pursuant to paragraph (c) of this section.

(B) Pursuant to paragraph (c) of this section, each share of FS stock is divided into portions attributable to the basis and holding period of the FS stock held by FP immediately before the exchange (the FS portion) and the FT stock held by F1 immediately before the exchange (the FT portion). The basis and holding period of the FS portion is the basis and holding period of the FS stock held by FP immediately before the exchange. Thus, each share of FS stock has a portion with a basis of $5x and a value of $10x. Because the exchanging shareholder of FT stock (F1) has a section 1248 shareholder of both F1 and FT, the basis and holding period of the FT portion is the proportionate amount of the basis and the holding period of the FT stock immediately before the exchange to which such portion relates. Thus, each share of FS stock will have a second portion with a basis of $17x ($170x basis / 10 shares), a value of $20x ($200x value / 10 shares), a holding period of 5 years, and $1x of earnings and profits ($10x earnings and profits / 10 shares) attributable to such portion for purposes of section 1248.

(iii) *Subsequent disposition*. (A) Several years after the merger, FP disposes of all of its FS stock in a transaction governed by section 964(e). At the time of the disposition, FS stock has decreased in value to $210x (a post-merger reduction in value of $90x), and FS has incurred a post-merger deficit in earnings and profits of $30x.

(B) Pursuant to paragraph (d)(1)(ii) of this section, for purposes of determining the amount of gain realized on the sale or exchange of stock that has a divided portion, any amount realized on such sale or exchange is allocated to each divided portion of the stock based on the relative fair market value of the stock to which the portion is attributable at the time the portions were created. Immediately before the merger, the value of the FS stock in relation to the value of both the FS stock and the FT stock was one-third ($100x / ($100x plus $200x)). Likewise, immediately before the merger, the value of the FT stock in relation to the value of both the FT stock and the FS stock was two-thirds ($200x / $100x plus $200x). Accordingly, one-third of the $210x amount realized is allocated to the FS portion of each share and two-thirds to the FT portion of each share. Thus, the amount realized allocated to the FS portion of each share is $7x (one-third of $210x divided by 10 shares). The amount realized allocated to the FT portion of each share is $14x (two-thirds of $210x divided by 10 shares).

(C) Pursuant to paragraph (d)(3) of this section, any earnings and profits (or deficits) accumulated by the surviving corporation subsequent to the reorganization are attributed to the divided portions of shares of stock based on the relative fair market value of each divided portion of stock. Accordingly, one-third of the post-merger earnings and profits deficit of $30x is allocated to the FS portion of each share and two-thirds to the FT portion of each share. Thus, the deficit in earnings and profits allocated to the FS portion of each share is $1x (one-third of $30x divided by 10 shares). The deficit in earnings and profits allocated to the FT portion of each share is $2x (two-thirds of $30x divided by 10 shares).

(D) When FP disposes of its FS stock, FP is treated as disposing of each divided portion of a share of stock. With respect to the FS portion of each share of stock, FP recognizes a gain of $2x ($7x value - $5x basis), which is not recharacterized as a dividend because a deficit in earnings and profits

of $1x is attributable to such portion for purposes of section 1248. With respect to the FT portion of each share of stock, FP recognizes a loss of $3x ($14x value - $17x basis).

(f) *Effective date*. This section applies to exchanges occurring on or after January 23, 2006.

Par. 10. Section 1.884–2 is amended as follows:

1. Paragraphs (c)(3) through (c)(6)(i)(A) are revised.

2. Paragraphs (c)(6)(i)(B), (C), and (D) are added.

3. Paragraphs (c)(6)(ii) through (f) are revised.

4. Paragraph (g) is amended by adding a sentence at the end.

The revisions and additions read as follows:

§1.884–2 Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary.

* * * * *

(c)(3) through (c)(6)(i)(A) [Reserved]. For further guidance, see §1.884–2T(c)(3) through (c)(6)(i)(A).

(B) Shareholders of the transferee (or of the transferee's parent in the case of a triangular reorganization described in section 368(a)(1)(C) or a reorganization described in sections 368(a)(1)(A) and 368(a)(2)(D) or (E)) who in the aggregate owned more than 25 percent of the value of the stock of the transferor at any time within the 12-month period preceding the close of the year in which the section 381(a) transaction occurs sell, exchange or otherwise dispose of their stock or securities in the transferee at any time during a period of three years from the close of the taxable year in which the section 381(a) transaction occurs.

(C) In the case of a triangular reorganization described in section 368(a)(1)(C) or a reorganization described in sections 368(a)(1)(A) and 368(a)(2)(D) or (E), the transferee's parent sells, exchanges, or otherwise disposes of its stock or securities in the transferee at any time during a period of three years from the close of the taxable year in which the section 381(a) transaction occurs.

(D) A corporation related to any such shareholder or the shareholder itself if it is a corporation (subsequent to an event described in paragraph (c)(6)(i)(A) or (B) of this section) or the transferee's parent (subsequent to an event described in paragraph (c)(6)(i)(C) of this section), uses, directly or indirectly, the proceeds or property received in such sale, exchange or disposition, or property attributable thereto, in the conduct of a trade or business in the United States at any time during a period of three years from the date of sale in the case of a disposition of stock in the transferor, or from the close of the taxable year in which the section 381(a) transaction occurs in the case of a disposition of the stock or securities in the transferee (or the transferee's parent in the case of a triangular reorganization described in section 368(a)(1)(C) or a reorganization described in sections 368(a)(1)(A) and (a)(2)(D) or (E)). Where this paragraph (c)(6)(i) applies, the transferor's branch profits tax liability for the taxable year in which the section 381(a) transaction occurs shall be determined under §1.884–1, taking into account all the adjustments in U.S. net equity that result from the transfer of U.S. assets and liabilities to the transferee pursuant to the section 381(a) transaction, without regard to any provisions in this paragraph (c). If an event described in paragraph (c)(6)(i)(A), (B), or (C) of this section occurs after the close of the taxable year in which the section 381(a) transaction occurs, and if additional branch profits tax is required to be paid by reason of the application of this paragraph (c)(6)(i), then interest must be paid on that amount at the underpayment rates determined under section 6621(a)(2), with respect to the period between the date that was prescribed for filing the transferor's income tax return for the year in which the section 381(a) transaction occurs and the date on which the additional tax for that year is paid. Any such additional tax liability together with interest thereon shall be the liability of the transferee within the meaning of section 6901 pursuant to section 6901 and the regulations there under.

(c)(6)(ii) through (f) [Reserved]. For further guidance, see §1.884–2T(c)(6)(ii) through (f).

(g) * * * Paragraphs (c)(6)(i)(B), (C), and (D), are applicable for tax years beginning after December 31, 1986, except that such paragraphs are applicable to transactions occurring on or after January 23, 2006 in the case of reorganizations described in sections 368(a)(1)(A) and 368(a)(2)(D) or (E).

Par. 11. In §1.884–2T, paragraphs (c)(6)(i)(B), (C), and (D) are revised to read as follows:

§1.884–2T Special rules for termination or incorporation of a U.S. trade or business or liquidation or reorganization of a foreign corporation or its domestic subsidiary (Temporary).

* * * * *

(c) * * *

(6) * * *

(i) * * *

(B), (C), and (D) [Reserved]. For further guidance, see §1.884–2(c)(6)(i)(B), (C), and (D).

Par. 12. Section §1.6038B–1 is amended as follows:

1. Paragraphs (b)(1)(i) and (b)(1)(ii) are revised.

2. The text of paragraph (g) is redesignated as paragraph (g)(1) and the first sentence is revised.

3. Paragraphs (g)(2), (g)(3), and (g)(4) are added.

The revisions and addition are as follows:

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

* * * * *

(b) *Time and manner of reporting*—(1) *In general*—(i) *Reporting procedure*. Except for stock or securities qualifying under the special reporting rule of §1.6038B–1(b)(2), and certain exchanges described in section 354 or 356 (listed below), any U.S. person that makes a transfer described in section 6038B(a)(1)(A), 367(d) or (e), is required to report pursuant to section 6038B and the rules of §1.6038B–1 and must attach the required information to Form 926, "*Return by a U.S. Transferor of Property to a Foreign Corporation.*" For special rules regarding cash transfers made in tax years beginning after February 5, 1999, see paragraphs (b)(3) and (g) of this section. For purposes of determining a U.S. transferor that is subject to section 6038B, the rules of §§1.367(a)–1T(c) and 1.367(a)–3(d) shall apply with respect to a transfer described in section 367(a), and the rules of §1.367(a)–1T(c) shall apply with respect to a transfer described in section

367(d). Additionally, if in an exchange described in section 354 or 356, a U.S. person exchanges stock or securities of a foreign corporation in a reorganization described in section 368(a)(1)(E), or a U.S. person exchanges stock or securities of a domestic or foreign corporation pursuant to an asset reorganization described in section 368(a)(1) (involving a transfer of assets under section 361) that is not treated as an indirect stock transfer under §1.367(a)–3(d), then the U.S. person exchanging stock or securities is not required to report under section 6038B. Notwithstanding any statement to the contrary on Form 926, the form and attachments must be attached to, and filed by the due date (including extensions) of the transferor's income tax return for the taxable year that includes the date of the transfer (as defined in §1.6038B–1T(b)(4)). For taxable years beginning before January 1, 2003, any attachment to Form 926 required under the rules of this section is filed subject to the transferor's declaration under penalties of perjury on Form 926 that the information submitted is true, correct and complete to the best of the transferor's knowledge and belief. For taxable years beginning after December 31, 2002, Form 926 and any attachments shall be verified by signing the income tax return with which the form and attachments are filed.

(ii) [Reserved]. For further guidance, see §1.6038B–1T(b)(ii).

* * * * *

(g) *Effective dates*—(1) 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), except for transfers described in paragraphs (g)(2) through (4) of this section, 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). * * *

(2) The rules of paragraph (b)(1)(i) of this section as they apply to section 368(a)(1)(A) reorganizations (including reorganizations described in section 368(a)(2)(D) or (E)) apply to transfers occurring on or after January 23, 2006.

(3) The rules of paragraph (b)(1)(i) of this section that provide an exception from reporting under section 6038B for transfers of stock or securities in a section 354 or 356 exchange, pursuant to a section 368(a)(1)(G) reorganization that is not treated as an indirect stock transfer under §1.367(a)–3(d), apply to transfers occurring on or after January 23, 2006.

(4) The rules of paragraph (b)(1)(i) of this section that provide an exception from reporting under section 6038B for transfers of stock in a section 354 or 356 exchange, pursuant to a section 368(a)(1)(E) reorganization or an asset reorganization under section 368(a)(1) that is not treated as an indirect stock transfer under §1.367(a)–3(d), apply to transfers occurring on or after January 23, 2006. The rules of paragraph (b)(1)(i) of this section that provide an exception from reporting under section 6038B for transfers of securities in a section 354 or 356 exchange, pursuant to a section 368(a)(1)(E) reorganization or an asset reorganization under section 368(a)(1) that is not treated as an indirect stock transfer under §1.367(a)–3(d), apply only to transfers occurring after January 5, 2005 (although taxpayers may apply such provision to transfers of securities occurring on or after July 20, 1998 and on or before January 5, 2005, if done consistently to all transactions). See §1.6038–1T(b)(i), as contained in 26 CFR Part 1 revised as of April 1, 2005, for transfers occurring prior to the effective dates described in paragraphs (g)(2) through (4) of this section.

Par. 13. In §1.6038B–1T, paragraph (b)(1)(i) is revised to read as follows:

§1.6038B–1T Reporting of certain transactions to foreign corporations (temporary).

* * * * *

(b) *Time and manner of reporting*—(1) *In general*—(i) [Reserved]. For further guidance, see §1.6038B–1(b)(1)(i).

* * * * *

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved January 17, 2006.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury (Tax Policy).

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Section 664.—Charitable Remainder Trusts

26 CFR 1.664–1: Charitable remainder trusts.

Extension of the June 28, 2005 grandfather date in Rev. Proc. 2005–24 until further guidance is issued by the IRS. See Notice 2006-15, page 501.

Section 1503.—Computation and Payment of Tax

A notice announces the adoption of a reasonable cause standard for curing late filings under section 1503(d). See Notice 2006-13, page 496.

Part III. Administrative, Procedural, and Miscellaneous

Announcement of Rules Adopting a Reasonable Cause Standard for Section 1503(d) Filings

Notice 2006–13

PURPOSE

This notice announces that the Internal Revenue Service (IRS) and Treasury intend to issue regulations under section 1503(d) of the Internal Revenue Code providing that taxpayers who fail to file any agreements, statements, rebuttals, requests or other information required under section 1503(d) in a timely manner may seek relief for such failure under a reasonable cause standard similar to Prop. Treas. Reg. § 1.1503(d)–1(c)(1). Prior to the issuance of those regulations, and except as provided below, taxpayers may rely on the guidance contained in Prop. Treas. Reg. § 1.1503(d)–1(c)(1), as modified by this notice, to cure such late filings. During that time, taxpayers may continue, in lieu of using the reasonable cause procedure contained in this notice, to apply the provisions of Treas. Reg. §§ 301.9100–1 through –3. The IRS and Treasury intend that the reasonable cause procedure set forth in final regulations will be consistent with the reasonable cause standard set forth in Prop. Treas. Reg. § 1.1503(d)–1(c)(1) and this notice, and such final regulations will prospectively supersede relief under Treas. Reg. §§ 301.9100–1 through –3 for purposes of curing all late filings required under section 1503(d).

BACKGROUND

Section 1503(d) provides that a dual consolidated loss of a dual resident corporation is not allowed to reduce the taxable income of any other member of the corporation's affiliated group for any taxable year. The term dual resident corporation includes a domestic corporation that is subject to the income tax of a foreign country on its worldwide income or on a residence basis and a separate unit of a domestic corporation. Sections 1503(d)(2)(A) and (d)(3).

The IRS and Treasury issued temporary regulations under section 1503(d) in 1989 (T.D. 8261, 1989–2 C.B. 220) and final regulations in 1992 (T.D. 8434, 1992–2 C.B. 240). The temporary regulations were initially designated as Treas. Reg. § 1.1503–2T, but were re-designated as Treas. Reg. § 1.1503–2A by the final regulations. The temporary regulations in Treas. Reg. § 1.1503–2A are effective for taxable years beginning after December 31, 1986 and before October 1, 1992. The final regulations in Treas. Reg. § 1.1503–2 are generally effective for taxable years beginning on or after October 1, 1992. In 2002, the IRS and Treasury issued proposed regulations, which were finalized in 2003 (T.D. 9084, 2003–2 C.B. 742) and are effective with respect to transactions constituting triggering events occurring on or after January 1, 2002. These regulations provide that certain events will not trigger the recapture of a dual consolidated loss or payment of the associated interest charge and identify transactions for which a closing agreement is no longer required. In addition, in 2003 the IRS and Treasury issued temporary regulations under section 1503(d) (T.D. 9100, 2004–1 C.B. 297) that modified the final regulations to facilitate electronic filings. These 2003 temporary regulations generally are effective for taxable years beginning after December 31, 2002.

Treasury Reg. §§ 1.1503–2(g)(2) and 1.1503–2T(g)(2) provide an exception to the general limitation on the use of dual consolidated losses if an election is made to be bound by the provisions of Treas. Reg. §§ 1.1503–2(g)(2) and 1.1503–2T(g)(2) by attaching to a timely filed U.S. income tax return for the taxable year in which the dual consolidated loss is incurred an agreement ((g)(2) agreement) which includes a certification that no portion of the dual consolidated loss has been or will be used to offset the income of another person under the laws of a foreign country. In addition to the (g)(2) agreement, taxpayers may be required to attach to their timely filed income tax return other agreements, statements, rebuttals, or information. Similar requirements are contained in Treas. Reg. § 1.1503–2A. Taxpayers who fail to file such agreements, statements, rebuttals, requests or other information in a timely manner must request an extension of time under Treas. Reg. §§ 301.9100–1 through –3.

In order to avoid the recapture of a dual consolidated loss with respect to which a (g)(2) agreement has been filed, taxpayers may, in certain circumstances, enter into a closing agreement with the IRS. Treas. Reg. § 1.1503–2(g)(2)(iv)(B)(*3*). Under Rev. Proc. 2000–42, 2000–2 C.B. 394, the request to enter into a closing agreement must be submitted by the due date of the return (including extensions) for the year in which the triggering event occurred. Before requesting a closing agreement, a taxpayer is required to have complied with the regulations under section 1503(d), including the requirement that all the requisite agreements, elections, and certifications have been filed. To the extent the taxpayer has failed to file any agreement, election or certification required under section 1503(d), the taxpayer must request and secure (or at least simultaneously request) relief under § 301.9100–1 through –3.

On May 24, 2005, Treasury and the IRS issued proposed regulations under section 1503(d) regarding dual consolidated losses to address certain fundamental concerns which arise under the current regulations. These proposed regulations would revise the procedures for taxpayers who fail to file any statements, rebuttals, requests, or other information required under section 1503(d) in a timely manner, by replacing the requirement that a taxpayer obtain relief pursuant to Treas. Reg. §§ 301.9100–1 through –3 with a reasonable cause standard. Under Prop. Treas. Reg. § 1.1503(d)–1(c)(1), if a taxpayer that is permitted or required to file an election, agreement, statement, rebuttal, computation, or other information fails to make such filing in a timely manner, the taxpayer shall be considered to have satisfied the timeliness requirement with respect to such filing if the taxpayer is able to demonstrate to the Director of Field Operations having jurisdiction of the taxpayer's tax return for the taxable year, that such failure was due to reasonable cause and not willful neglect. This rule applies only if, once the taxpayer becomes aware

of the failure, the taxpayer attaches all documentation that should have been filed previously, as well as a written statement setting forth the reasons for the failure to comply timely, to an amended income tax return that amends the return to which the documents should have been attached. In determining whether the taxpayer has reasonable cause, the Director of Field Operations shall consider whether the taxpayer acted reasonably and in good faith after considering all the facts and circumstances. The Director of Field Operations shall notify the taxpayer in writing within 120 days of the filing if it is determined that the failure to comply was not due to reasonable cause, or if additional time is needed to make such determination.

DISCUSSION

The IRS and Treasury have determined that it is appropriate to allow taxpayers who fail to file any agreements, statements, rebuttals, requests, or other information required under section 1503(d) in a timely manner, to cure such late filings under procedures similar to those in Prop. Treas. Reg. § 1.1503(d)–1(c)(1) prior to its publication as a final regulation in the Federal Register. The IRS and Treasury believe that these procedures will be beneficial to both taxpayers and the IRS. Therefore, during the elective period of these procedures, taxpayers may choose to seek relief under Treas. Reg. §§ 301.9100–1 through –3 or elect to use the reasonable cause standard contained in Prop. Treas. Reg. § 1.1503(d)–1(c)(1), as modified by this notice.

In order to qualify for the relief provided in this notice, taxpayers must demonstrate to the Area Director, Field Examination, Small Business/Self Employed or the Director, Field Operations, Large and Mid-Size Business (Director) having jurisdiction of the taxpayer's return for the taxable year, that the failure to file in a timely manner was due to reasonable cause and not willful neglect. In addition to the requirements contained in Prop. Treas. Reg. § 1.1503(d)–1(c)(1), taxpayers must provide a copy of the amended return and all required attachments to the IRS as follows:

- If the taxpayer is under examination for any taxable year when the taxpayer requests relief under Prop. Treas. Reg. § 1.1503(d)–1(c)(1) and this notice, the taxpayer must provide a copy of the amended return and attachments to the IRS personnel conducting the examination.

- If the taxpayer is not under examination for any taxable year when the taxpayer requests relief under Prop. Treas. Reg. § 1.1503(d)–1(c)(1) and this notice, the taxpayer must provide a copy of the amended return and attachments to the Director having jurisdiction of the taxpayer's return.

In determining whether the taxpayer's failure to file any such election, agreement, statement, rebuttal, computation or other information in a timely manner was due to reasonable cause, the Director shall apply the same criteria applicable to reasonable cause determinations under other provisions of the Code, including sections 367(a) and 6038B. Under these provisions, in general, the taxpayer must demonstrate that it exercised ordinary care and prudence in meeting its tax obligations but nonetheless did not comply with the prescribed duty within the prescribed time. Similarly, taxpayers may appeal these determinations in the same manner as reasonable cause determinations made pursuant to other provisions are appealed. A determination that the failure to file in a timely manner was due to reasonable cause is not a determination that the taxpayer is otherwise eligible to file the election, agreement, statement, rebuttal, computation or other information. A determination that such failure to file in a timely manner was due to reasonable cause is also not a determination that any information provided or position taken by the taxpayer in the election, agreement, statement, rebuttal, computation or other information is correct.

Proposed Treas. Reg. § 1.1503(d)–1 (c)(1) provides that the Director shall notify the taxpayer within 120 days if it is determined that the failure to comply with the filing requirements of the section 1503(d) regulations was not due to reasonable cause or if additional time is needed to make such determination. For this purpose, the 120 day period will begin to run on the date the Service notifies the taxpayer in writing that the request has been received and assigned for review. Appropriate procedures will be implemented to ensure that the Service generally issues such notification within ten business days of receipt of a properly submitted request for relief.

Proposed Treas. Reg. § 1.1503(d)–3 eliminates the closing agreement requirement contained in the current regulations and provides an exception in all such cases where a closing agreement would otherwise be available if, among other things, a new domestic use agreement is entered into. This notice does not incorporate these provisions. Thus, in order to avoid the recapture of a dual consolidated loss with respect to which a (g)(2) agreement has been filed, taxpayers must continue to apply the provisions of the current regulations, including the closing agreement requirement. Because requests for closing agreements under Treas. Reg. § 1.1503–2(g)(2) must be submitted to the National Office, taxpayers requiring relief to cure a late request for a closing agreement must continue to seek extensions of time under Treas. Reg. §§ 301.9100–1 through –3 and may not use the reasonable cause procedure contained in this notice. This restriction applies only to submissions to enter into the closing agreement itself. Taxpayers seeking relief for the failure to file any election, agreement, statement, rebuttal, computation or other information required in connection with the closing agreement, in a timely manner, may cure the late filing pursuant to Prop. Treas. Reg. § 1503(d)–1(c)(1) and this notice. In those cases in which requests are submitted seeking relief under Treas. Reg. §§ 301.9100–1 through –3 for the closing agreement itself and seeking relief under this notice for other late filings in connection with the closing agreement, the National Office will coordinate with the Director to ensure that both requests are handled in a consistent and timely manner.

Until final regulations are published, taxpayers may, in lieu of using the relief provided by this notice, continue to request extensions of time under Treas. Reg. §§ 301.9100–1 through –3. Taxpayers may not, however, apply for relief pursuant to both procedures. For example, if a taxpayer is denied relief for a late filing pursuant to Treas. Reg. §§ 301.9100–1 through –3, such taxpayer may not seek relief under the reasonable cause procedures set forth in Prop. Treas. Reg.

§ 1.1503(d)–1(c)(1) and this notice. Consideration of any letter ruling request received by the National Office will continue to be coordinated with the Director having jurisdiction of the taxpayer's income tax return.

Taxpayers who have letter ruling requests under Treas. Reg. §§ 301.9100–1 through –3 pending as of March 23, 2006, and that have not yet received a determination on their request, may withdraw their request, consistent with the procedures contained in Rev. Proc. 2006–1, 2006–1 I.R.B. 1 (January 3, 2006) (or any succeeding document) and use the reasonable cause procedure set forth in Prop. Treas. Reg. § 1.1503(d)–1(c)(1) and this notice. In that event, the IRS will refund the taxpayer's user fee.

EFFECTIVE DATE

This notice is effective on March 23, 2006. Taxpayers may rely on the reasonable cause standard of Prop. Treas. Reg. § 1.1503(d)–1(c)(1) and this notice until final regulations are issued incorporating these provisions. The IRS and Treasury intend that the reasonable cause procedure set forth in final regulations will be consistent with the reasonable cause standard set forth in Prop. Treas. Reg. § 1.1503(d)–1(c)(1) and this notice and that such final regulations will prospectively supersede relief under Treas. Reg. §§ 301.9100–1 through –3 for purposes of curing all late filings required under section 1503(d).

PAPERWORK REDUCTION ACT

The collections of information contained in this notice have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. § 3507) under control number 1545–1946. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collections of information in this notice are described in the Background and Discussion paragraphs above. They are required to notify the Service that the taxpayer is asserting reasonable cause and enable it to determine whether the taxpayer is entitled to rely on the reasonable cause standard for a permitted or required filing under the current section 1503(d) regulations. The collections of information are required in order to obtain the benefit of the reasonable cause standard. The likely respondents are businesses.

The estimated total annual reporting and/or recordkeeping burden is 125 hours. The estimated annual burden hours per respondent and/or recordkeeper is 5 hours. The estimated number of respondents and/or recordkeepers is 25. The estimated frequency of response is occasional.

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

DRAFTING INFORMATION

The principal author of this notice is Margaret A. Hogan of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Gerard Traficanti at (202) 622–3619 (not a toll-free call).

Certain Distributions Treated As Sales or Exchanges

Notice 2006–14

Section 1. PURPOSE

This notice invites public comments on certain distributions treated as sales or exchanges under § 751(b) of the Internal Revenue Code.

Section 2. BACKGROUND

Section 751 was enacted to prevent the conversion of ordinary income into capital gain and the shifting of ordinary income among partners. *See* H.R. Rep. No. 1337, at 70 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4097. Section 751(a) provides for recharacterization of capital gain or loss when an interest in a partnership is sold or exchanged to the extent of the selling partner's share of unrealized receivables and inventory items of the partnership. Section 751(b) overrides the nonrecognition scheme of § 731 for certain current and liquidating partnership distributions that alter a partner's share of unrealized receivables and substantially appreciated inventory items (disproportionate distributions). Section 751(b)(1) provides:

(1) GENERAL RULE.—To the extent a partner receives in a distribution—

> (A) partnership property which is— (i) unrealized receivables, or (ii) inventory items which have appreciated substantially in value, in exchange for all or a part of his interest in other partnership property (including money), or
>
> (B) partnership property (including money) other than property described in subparagraph (A)(i) or (ii) in exchange for all or part of his interest in partnership property described in subparagraph (A)(i) or (ii), such transactions shall, under regulations prescribed by the Secretary, be considered as a sale or exchange of such property between the distributee and the partnership (as constituted after the distribution).

The legislative history of § 751 demonstrates that Congress was primarily concerned with unrealized appreciation in unrealized receivables and inventory items of a partnership.

> The provisions relating to unrealized receivables and appreciated inventory items are necessary to prevent the use of the partnership as a device for obtaining capital-gain treatment on fees or other rights to income and on appreciated inventory. Amounts attributable to such rights would be treated as ordinary income if realized in normal course by the partnership. The sale of a partnership interest or distributions to partners should not be permitted to change the character of this income. *The statutory treatment proposed, in general, regards the income rights as severable from the partnership interest and as subject to the same tax consequences which would be accorded an individual entrepreneur.*

S. Rep. No. 1622, at 99 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 4732 (emphasis added).

The current regulations under § 751(b) require the identification of two classes of assets: (1) hot assets (unrealized receivables as defined in § 751(c) and substantially appreciated inventory as defined in § 751(b)(3) and (d)); and (2) cold assets (assets other than unrealized receivables and substantially appreciated inventory).

In computing the distributee partner's income under § 751(b), the current regulations provide that the distributee partner's share of the partnership's hot assets and cold assets before and after the distribution must be compared. For purposes of this comparison, each partner's share of the partnership's hot and cold assets is determined by reference to the gross value of the assets. If the distribution results in an exchange of all or a portion of the distributee partner's share of one class of assets (relinquished assets) for assets in the other class (acquired assets), it is necessary to construct a deemed exchange by identifying which relinquished assets are treated as exchanged for which acquired assets.

For example, if a partner receives more than the partner's share of the partnership's hot assets in a distribution, that partner is treated as exchanging a portion of the partner's interest in certain cold assets of the partnership for the other partners' shares of the acquired hot assets. In order to accomplish the exchange, the distributee partner is treated as (1) receiving the relinquished assets (the cold assets) in a nonliquidating distribution and (2) engaging in a taxable exchange (with the partnership) of those assets for the acquired assets (the hot assets). Both the distributee partner and the other partners may recognize income or loss on the exchange. The distributee partner and the partnership then hold the exchanged assets (or portions thereof) with a cost basis under § 1012. The rest of the actual distribution (the part that is not subject to § 751(b)) is characterized under the general rules for partnership distributions prescribed in §§ 731 through 736.

The current regulations under § 751(b) were published in 1956 and have not been amended to reflect significant changes in subchapter K and in the operations of contemporary partnerships. Moreover, the current § 751(b) regulations have been widely criticized as being extraordinarily complex and burdensome and as not achieving the objectives of the statute. As a result, a distribution may reduce a partner's *pro rata* share of the unrealized appreciation in the partnership's hot assets without triggering § 751(b), and a distribution can trigger § 751(b) even if the partner's *pro rata* share of the unrealized appreciation is not reduced.

The Treasury Department and the Service are considering several possible methods, discussed below, for addressing the issues associated with the current § 751(b) regulations.

Section 3. DISCUSSION

(a) *Determining the partners' shares of partnership property*

The current regulations under § 751(b) provide little guidance on how each partner's share of partnership property is determined. Two economic rights are inherent in most partnership interests: a right to partnership capital, and a right to partnership profits and losses. A partner may have a different interest in each of these rights, and those interests may vary over time. Moreover, a partner's share of unrealized partnership items may be affected by both the economic arrangement of the partners and certain requirements of subchapter K, such as § 704(c).

The legislative history of § 751(b) emphasizes "income rights" of the partners and suggests that these rights may be treated as severable and subject to the same tax consequences as those of an individual entrepreneur. S. Rep. No. 1622, at 99. Consistent with this legislative history, in order to determine whether a distribution may be subject to § 751(b), commentators have suggested that new regulations could require partnerships and their partners to compare the amounts of ordinary income that would be recognized by the partners if the partnership's hot assets (including distributed assets) were sold or exchanged for fair market value in a taxable transaction both before and after the distribution (hypothetical sale approach). If the amount of ordinary income that would be allocated to any partner (including the distributee) as a result of such a sale or exchange is reduced as a result of a distribution from the partnership, an analysis under § 751(b) would be required. The hypothetical sale approach, combined with the application of § 704(c) principles, could provide rules that achieve the objective of the statute in a less burdensome manner.

Under § 704(c), if partnership property is sold or exchanged, the built-in gain or loss in contributed or revalued partnership property must be allocated to the contributing or appropriate historic partner (§ 704(c) principles). *See* § 704(c)(1)(A) and §§ 1.704–1(b)(4)(i), 1.704–3(a)(2), and 1.704–3(a)(6). As a result of the application of § 704(c) principles, there can be layers of appreciation in partnership assets (due to successive revaluations), each of which may be allocable separately. Moreover, distributed § 704(c) property and § 704(c) property with a substantial built-in loss must be analyzed separately to determine each partner's appropriate share of the unrealized gain or loss. *See, e.g.*, § 704(c)(1)(B) and (C). As a result, § 704(c) generally operates to preserve each partner's share of the built-in appreciation and depreciation in partnership assets. If the regulations under § 751(b) were amended to specify that § 704(c) principles are taken into account for purposes of determining whether a partner's share of partnership hot assets has been altered by a distribution, significantly fewer distributions would trigger § 751(b).

Example 1. Assume that *A*, *B*, and *C* each contribute $120 to partnership *ABC*. *ABC* purchases land for $210, which appreciates in value to $300. At a time when the partnership also has $90 of zero-basis unrealized receivables and cash of $150, *ABC* distributes $90 to *C*, reducing *C*'s interest in *ABC* from 1/3 to 1/5. If, immediately before the distribution, the partnership's assets are revalued and the partners' capital accounts are increased to reflect each partner's share of the unrealized appreciation in the partnership's assets, *C*'s entire pre-distribution share of the partnership's unrealized income in the accounts receivable (1/3 of $90, or $30) is preserved in *C*'s capital account after the distribution. *ABC* will have the following post-distribution balance sheet (before the application of section 751(b)):

Assets	Basis	Value	Capital	Basis	Value
Cash	$60	$60	*A*	$120	$180
Unrealized Receivables	$0	$90	*B*	$120	$180
Land	$210	$300	*C*	$ 30	$ 90
Total	$270	$450		$270	$450

If § 704(c) principles were applicable for purposes of § 751(b), the distribution to *C* would not trigger § 751(b), as *C*'s predistribution share of the unrealized income in the receivables ($30) is fully preserved in its capital account after the distribution. Section 704(c) principles would require the partnership to allocate that share of appreciation to *C* when it is recognized.

Special rules may be necessary to address distributions of hot assets to a partner where the adjusted basis of the distributed assets (and the unrealized appreciation in those assets) is different in the hands of the distributee partner than it was in the hands of the partnership. Under §§ 732(a)(2) and (b), the adjusted basis of distributed hot assets is reduced (and the unrealized appreciation in those hot assets is increased) if the distributee partner's basis in its partnership interest is insufficient to absorb the partnership's adjusted basis in the distributed hot asset. If the partnership has a § 754 election in effect at the time of the distribution, § 734(b)(1)(B) permits the partnership to increase the adjusted basis of the partnership's retained hot assets to the extent of the reduction in the basis of the distributed hot assets under § 732(a)(2) or (b). Under these circumstances, the hot asset appreciation remaining in the partnership is reduced. As such, one of the issues raised by use of a hypothetical sale to measure changes in a partner's interest in hot asset appreciation is the extent to which basis adjustments under §§ 732 and 734(b) should be taken into account.

Moreover, a hypothetical sale at any one point in time does not take into account future allocations that are planned or expected. For example, a partner's allocations with respect to a particular asset may vary over time. Measuring income or loss on a hypothetical sale of that asset at a particular time may not accurately reflect that partner's income rights with respect to that asset over the life of the partnership.

Once it is determined that a partner's share of the income rights in the partnership's hot assets has been reduced by a distribution, the tax consequences of the distribution under § 751(b) must be determined.

(b) *Determining the tax consequences of disproportionate distributions*

The current § 751(b) regulations impose a complex deemed distribution/exchange approach for determining the tax consequences of a disproportionate distribution. One possible way to simplify this determination would be to treat a disproportionate distribution as triggering a taxable sale of the partners' shares of relinquished hot assets to the partnership immediately before the distribution (hot asset sale approach). The hot asset sale approach would apply § 751(b) in a fully aggregate manner that is arguably consistent with its legislative history (under which each partner's tax treatment should be that of an individual entrepreneur).

This approach could be combined with the hypothetical sale approach. Thus, new regulations could provide that § 751(b) applies if any partner's share of the net unrealized appreciation in hot assets of the partnership is reduced as a result of a distribution from the partnership. Under the hot asset sale approach, for any partner whose share of hot assets is reduced (selling partner), whether or not the selling partner is the distributee, the selling partner would be treated as receiving the relinquished hot assets in a deemed distribution and selling to the partnership the relinquished share of the hot assets immediately before the actual distribution. The selling partner would recognize ordinary income from the deemed sale, and the partner's basis in the partnership interest and the partner's capital account would be adjusted to reflect the consideration treated as contributed to the partnership. The assets deemed sold to the partnership would have a cost basis under § 1012. Under the hot asset sale approach there would be no deemed exchange for cold assets, thereby eliminating the need to identify cold assets to be exchanged and to construct a deemed distribution of those assets.

The hot asset sale approach can be straightforward if the distributee partner's share of hot asset appreciation is reduced by the distribution. In this situation, the partnership would be treated as distributing the relinquished share of hot assets to the distributee who sells the hot assets back to the partnership, recognizing ordinary income, with appropriate adjustments to the distributee partner's basis in the partnership interest and capital account. The asset deemed sold would take a cost basis, and the distribution would be governed by §§ 731 through 736.

Example 2. Assume *A*, *B* and *C* are each 1/3 partners in a partnership that holds one hot asset and one cold asset, each with a basis of $0 and a fair market value of $150. *A*, *B*, and *C* each have an adjusted basis in the partnership interest of $0, and a $50 share of hot asset appreciation. *A* is fully redeemed by a distribution of 2/3 of the cold asset ($100). Immediately before the distribution, the partnership's assets are revalued and the partners' capital accounts are increased to $100 to reflect each partner's share of the unrealized appreciation in the partnership's assets. Because the entire $150 of hot asset appreciation remains in the partnership after the distribution, *A*'s share of that appreciation has been reduced by $50. Under the hot asset sale approach, *PRS* would be treated as distributing the relinquished share of the hot asset ($50) to *A* and then purchasing that share for $50. *A* would recognize income of $50 and would be treated as contributing the $50 to *PRS*. *A*'s basis in the partnership interest would increase to $50 and *A*'s capital account would be restored to $100. The portion of the hot asset deemed sold would take a cost basis, increasing the partnership's basis in the hot asset to $50.

In this example, because *A*'s basis in its partnership interest is $50, the basis of the distributed cold asset would be increased under § 732(b) to $50 in *A*'s hands. The cold asset remaining in the partnership has a $0 basis and would not be subject to a basis reduction under § 734(b) even if the partnership had a § 754 election in effect. In these circumstances, $50 of capital gain is potentially eliminated from the system, however.

The hot asset sale approach also raises certain complications where the distributee partner has insufficient basis in its partnership interest to absorb the partnership's adjusted basis in the distributed hot assets. This can lead to results inconsistent with the intent of § 751(b).

Example 3. Assume the same facts as *Example 2*, except that instead of distributing 2/3 of the cold asset to *A*, the partnership fully redeems *A* by a distribution of 2/3 of the hot asset ($100). Because only $50 of hot asset appreciation remains in the partnership after the distribution, *B*'s and *C*'s shares of that appreciation have been reduced by $25 each. Under the hot asset sale approach, *PRS* would be deemed to distribute the relinquished share of the hot asset ($50) equally to *B* and *C* and each would be treating as selling $25 worth of the hot asset to the partnership. *B* and *C* would each recognize $25 of ordinary income and would be treated as contributing $25 to the partnership. The portion of the hot asset deemed sold would take a cost basis, increasing the partnership's basis in the distributed portion of the distributed hot asset to $50. Because *A*'s basis in its partnership interest is $0, however, the basis of the distributed hot asset would be reduced under § 732(b) to $0 in *A*'s hands. If the partnership had a § 754 election in effect, the partnership would increase the basis of the retained hot asset under § 734(b) by $50. After the distribution, *A*'s share of unrealized income in hot assets would still be $100, and *B* and *C*, who each recognized $25 of ordinary income, would recognize no additional ordinary income.

Commentators have suggested that, in these situations, it may be appropriate to permit or require the distributee partner to recognize capital gain to the extent the adjusted basis of the distributed hot assets exceeds that partner's basis in the partnership interest. In Example 3, *A* could elect, or be required, to recognize capital gain equal to the amount by which the adjusted basis of the distributed hot assets exceeds that partner's basis in the partnership interest ($50), thereby increasing *A*'s basis to $50. The distributed hot asset would take a $50 basis in *A*'s hands under § 732(b), and no § 734(b) adjustment would be made to the retained hot asset. If *A* recognizes capital gain on the distribution, future regulations could permit an equivalent increase to the basis of the partnership's retained cold assets.

Section 4. REQUEST FOR COMMENTS

The Treasury Department and the Service are conducting a study of the current § 751(b) regulations and are considering alternative approaches to achieving the purpose of the statute that would provide greater simplicity. For example, it may be possible to provide safe harbor methods for calculating the share of ordinary income or capital gain that should be recognized as a result of a disproportionate distribution that may reduce some administrative burden but still serve the purpose of the statute. In this regard, the Treasury Department and the Service request comments on the approaches discussed in this notice (as well as other possible approaches) to determining a partner's share of hot assets and to prescribing the tax consequences of a disproportionate distribution. Comments are requested concerning the following issues:

A. For purposes of determining each partner's share of partnership assets before and after a distribution that may be subject to § 751(b),

1. Whether the hypothetical sale approach (combined with the application of § 704(c) principles) for determining each partner's share of partnership assets provides an accurate and appropriate measure for purposes of § 751(b). In particular,
   a. Whether special rules would be necessary to address situations in which the distributee partner's interest in unrealized appreciation in hot assets prior to the distribution exceeds the partner's interest in partnership capital after the distribution;
   b. Whether the hypothetical sale approach should be modified to take into account changes in allocations that are planned or may occur in the future or changes in the partner's interest in anticipated future appreciation and depreciation in partnership assets;
   c. The extent to which regulations adopting the hypothetical sale approach should take into account the distributee partner's basis in the partnership interest and basis adjustments under §§ 734(b) and 743(b), including basis adjustments resulting from the distribution;
   d. Whether the partners' shares of partnership liabilities should be considered in determining the partners' shares of partnership assets, and how the rules of § 752 should be coordinated with those of § 751(b).
2. Whether § 751(b) should be limited to transactions that change the partners' shares of unrealized appreciation in hot assets or should also apply to transactions that change the partners' shares of unrealized depreciation in hot assets.
3. Whether other approaches to determining a partner's share of partnership hot and cold assets should be considered.

B. For purposes of simplifying the tax consequences of a distribution that is subject to § 751(b), whether the hot asset sale approach is an appropriate method of applying § 751(b) or whether other approaches should be considered. Comments are specifically requested on the following:

1. Whether the regulations should provide a simple safe harbor that approximates the appropriate taxation of a disproportionate distribution and, if so, the appropriate parameters and availability of such a safe harbor.
2. Whether the current § 751(b) regulations should be generally retained or retained in combination with a safe harbor, or whether the current § 751(b) regulations should be completely revised to adopt a new paradigm such as the hot asset sale approach.
3. Whether mandatory or elective capital gain recognition should be included in the hot asset sale approach.

Comments should be submitted in writing on or before August 2, 2006, and should include a reference to Notice 2006–14. In addition to the topics on which comments are specifically requested above, comments are requested on any other matters that should be addressed in future guidance under § 751(b). Comments may be submitted to CC:PA:LPD:PR (Notice 2006–14), Room 5226, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Alternatively, comments may be submitted electronically via the following e-mail address: *Notice.Comments@irscounsel.treas.gov*. Please include "Notice 2006–14" in the subject line of any electronic communications. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to CC:PA:LPD:PR (Notice 2006–14), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224.

DRAFTING INFORMATION

The principal author of this notice is Charlotte Chyr of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this notice, contact Charlotte Chyr at (202) 622–3070 (not a toll-free call).

Extension of June 28, 2005, Safe Harbor Date

Notice 2006–15

The purpose of this notice is to extend the June 28, 2005, grandfather date in Rev. Proc. 2005–24, 2005–16, I.R.B. 909, until further guidance is issued by the Internal Revenue Service.

Rev. Proc. 2005–24 applies to any charitable remainder annuity trust (CRAT) or charitable remainder unitrust (CRUT) that is created by the grantor, *G*, if, under applicable state law, *G*'s surviving spouse, *S*, has a right of election exercisable on *G*'s death to receive an elective, statutory share of *G*'s estate, and such share could be satisfied in whole or in part from the assets of the CRAT or CRUT in violation of § 664(d)(1)(B) or (d)(2)(B) of the Internal Revenue Code. Rev. Proc. 2005–24 provides a safe harbor procedure under which the Service will disregard the right of election for purposes of determining whether the CRAT or CRUT meets the requirements of § 664(d)(1)(B) or (d)(2)(B) continuously since its creation, if *S* irrevocably waives the right of election in the manner prescribed in the revenue procedure. For trusts created before June 28, 2005, the Service will disregard the right of election, even without a waiver, but only if *S* does not exercise the right of election.

Commentators have asserted that Rev. Proc. 2005–24 places an undue burden on taxpayers and trustees seeking to comply with the safe harbor rule. Some commentators have recommended that the Service withdraw the revenue procedure. Other commentators have suggested alternative safe harbor rules. The Service and Treasury are reconsidering the approach of Rev. Proc. 2005–24, including the safe harbor rule. The Service and Treasury are also considering alternative safe harbor rules. Consequently, the Service is extending the June 28, 2005, grandfather date. Until further guidance is published regarding the effect of a spousal right of election on a trust's qualification as a CRAT or CRUT, the Service will disregard the existence of such a right of election, even without a waiver as described in Rev. Proc. 2005–24, but only if the surviving spouse does not exercise the right of election.

The principal author of this notice is Susan H. Levy of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Susan H. Levy at (202) 622–3090 (not a toll-free call).

Recomputed Differential Earnings Rate for Mutual Life Insurance Companies

Notice 2006–18

This notice publishes a tentative determination under § 809 of the Internal Revenue Code of the "recomputed differential earnings rate" for 2004. This rate is used by mutual life insurance companies to calculate their federal income tax liability for taxable years beginning in 2005.

The Job Creation and Worker Assistance Act of 2002, Pub. L. 107–147, § 611, amended § 809 by adding new paragraph (j). Section 809(j) provides that the differential earnings rate shall be treated as zero for purposes of computing both the differential earnings amount and the recomputed differential earnings amount for a mutual life insurance company's taxable years beginning in 2001, 2002, or 2003. *See* Notice 2002–33, 2002–1 C.B. 989. Subsequently, the Pension Funding Equity Act of 2004, Pub. L. 108–218, § 205, repealed § 809 of the Code for taxable years beginning after December 31, 2004. Therefore, the Internal Revenue Service is required to determine a differential earnings rate for 2004 and a recomputed differential earnings rate for 2004. The differential earnings rate for 2004 was zero. *See* Rev. Rul. 2005–58, 2005–36 I.R.B. 465.

The tentative determination of the rates is set forth in Table 1.

Notice 2006–18 Table 1

Tentative Determination of Rates To Be Used For Taxable Years Beginning in 2005	
Recomputed differential earnings rate for 2004	0
Imputed earnings rate for 2004	4.449
Base period stock earnings rate	18.221
Current stock earnings rate for 2004	4.913
Stock earnings rate for 2001	2.354
Stock earnings rate for 2002	-1.876
Stock earnings rate for 2003	14.261
Average mutual earnings rate for 2004	10.450

For additional background concerning the tentative recomputed differential earnings rate, see Notice 2002–19, 2002–1 C.B. 619.

DRAFTING INFORMATION

The principal author of this notice is Katherine A. Hossofsky of the Office of the Associate Chief Counsel (Financial Institutions and Products). For further information regarding this notice, contact Ms. Hossofsky at (202) 622–8435 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations

Treatment of Excess Loss Accounts

REG–138879–05

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9244) that provide guidance under section 1502 that governs certain basis determinations and adjustments of subsidiary stock in certain transactions involving members of a consolidated group. The text of those regulations also serves as the text of these proposed regulations.

DATES: Written or electronic comments, and a request for a public hearing, must be received by April 26, 2006.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–138879–05), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–138879–05), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the IRS internet site at *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS and REG–138879–05).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Theresa M. Kolish, (202) 622–7530, concerning submissions of comments, Treena Garrett, (202) 622–7181 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Temporary Regulations in this issue of the Bulletin amend 26 CFR Part 1 relating to section 1502. The temporary regulations add § 1.1502–19T. The text of those regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the amendments included in these proposed regulations.

Special Analysis

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. Further, it is hereby certified that these proposed regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses. Moreover, the number of taxpayers affected and the average burden are minimal. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight copies) that are submitted timely to the IRS. Alternatively, taxpayers may submit comments electronically via the IRS Internet site at *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov*. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by any person who timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place of the hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these regulations are Emidio J. Forlini, Jr. and Theresa M. Kolish of the Office of Associate Chief Counsel (Corporate). Other personnel from Treasury and the IRS participated in their development.

* * * * *

Proposed Amendments to the Regulations

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

PART 1 — INCOME TAXES

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

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

Section 1.1502–19 also issued under 26 U.S.C. 1502. * * *

Par. 2. Section 1.1502–19 is amended by:

1. Revising paragraph (d).
2. Revising paragraph (g) *Example 2*.
3. Adding paragraph (h)(2)(iv).
4. Adding a new sentence at the end of paragraph (h)(3).

The revisions and additions read as follows:

§1.1502–19 Excess loss accounts.

[The text of the proposed §1.1502–19 is the same as the text for §1502–19T published elsewhere in this issue of the Bulletin].

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on January 23, 2006, 11:43 a.m., and published in the issue of the Federal Register for January 26, 2006, 71 F.R. 4319)

Notice of Proposed Rulemaking

Designated Roth Accounts Under Section 402A

REG–146459–05

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under sections 402(g), 402A, 403(b), and 408A of the Internal Revenue Code (Code) relating to designated Roth accounts. These regulations will affect administrators of, employers maintaining, participants in, and beneficiaries of section 401(k) and section 403(b) plans, as well as owners and beneficiaries of Roth IRAs and trustees of Roth IRAs.

DATES: Written or electronic comments and requests for a public hearing must be received by April 26, 2006.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–146459–05), room 5203, Internal Revenue Service, POB 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–146459–05), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, D.C. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at *www.irs.gov/regs*, or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS-REG–146459–05).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, R. Lisa Mojiri-Azad, 202–622–6060 or Cathy A. Vohs, 202–622–6090; concerning the submission of comments or to request a public hearing, Richard Hurst at *Richard.A.Hurst@irscounsel.treas.gov* or (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has 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 collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the 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 collection of information should be received by March 27, 2006. Comments are specifically requested concerning:

Whether the proposed collection of information is 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 collection of information (see below);

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

How the burden of complying with the proposed collection of information may be minimized, including through the application of 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 collection of information in this proposed regulation is in 26 CFR §1.402A–2. This information is required to comply with the separate accounting and recordkeeping requirements of section 402A. This information will be used by the IRS and employers maintaining designated Roth accounts to insure compliance with the requirements of section 402A. The collection of information is required to obtain a benefit. The likely recordkeepers are state or local governments, businesses or other for-profit institutions, nonprofit institutions, and small businesses or organizations.

Estimated total annual recordkeeping burden: 828,000 hours.

Estimated average annual burden hours per recordkeeper: 2.3 hours.

Estimated number of recordkeepers: 357,000.

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 or 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 regulations under sections 402(g), 402A, 403(b), and 408A of the Internal Revenue Code. Section 402A, which sets forth rules for designated Roth contributions, was added to the Code by section 617(a) of the Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107–16 (115 Stat. 103) (EGTRRA), effective for taxable years beginning after December 31, 2005.

Section 401(k) sets forth rules for qualified cash or deferred arrangements under which an employee may make an election between cash and an employer contribution to a plan qualified under section 401(a) and section 403(b) permits a similar salary reduction agreement under which payments are made to a section 403(b) plan. Section 402(e)(3) provides that an amount is not includible in an employee's income merely because the employee has an election whether these contributions will be made to the trust or annuity or received by the employee in cash.

Amounts contributed pursuant to these qualified cash or deferred arrangements and salary reduction agreements are defined in section 402(g)(3) as elective deferrals and section 402(g)(1) provides a limit on the amount of elective deferrals that may be excluded from an employee's income for a taxable year. Section 402(g)(2) provides for the distribution of elective de-

ferrals that exceed the annual limit on elective deferrals (an excess deferral).

A designated Roth contribution is an elective deferral, as described in section 402(g)(3)(A) or (C), to a section 401(k) or 403(b) plan that has been designated by an employee, pursuant to section 402A, as not excludable from the employee's gross income. Under section 402A(b)(2), designated Roth contributions must be maintained by the plan in a separate account (a designated Roth account).

Under section 402(a), a distribution from a plan qualified under section 401(a) is taxable under section 72 to the distributee in the taxable year distributed. However, pursuant to section 402A(d)(1), a qualified distribution from a designated Roth account is excludable from gross income. A qualified distribution is defined in section 402A(d)(2) as a distribution that is made after completion of a specified 5-year period and the satisfaction of other specified requirements.

If the distribution is not a qualified distribution, pursuant to section 72, the distribution is included in the distributee's gross income to the extent allocable to income on the contract and excluded from gross income to the extent allocable to investment in the contract (basis). The amount of a distribution allocated to investment in the contract is determined by applying to the distribution the ratio of the investment in the contract to the account balance.

Section 402(c) provides rules under which certain distributions from a plan qualified under section 401(a) may be rolled over into another eligible retirement plan. In such a case, the distribution is not currently includible in the distributee's gross income. Under section 402(c)(2), to the extent some or all of the distribution from a plan qualified under section 401(a) would not have been includible in gross income if it were not rolled over, that portion of the distribution can only be rolled over into an individual retirement plan, or through a direct rollover to another plan qualified under section 401(a) which agrees to separately account for such rolled over amounts. Section 403(b)(8)(B) provides that the rules of section 402(c)(2) also apply for purposes of the rollover rules under section 403(b)(8).

Under section 402(c)(8) and 402A(c)(3), a distribution from a designated Roth account can be rolled over only to another designated Roth account or to a Roth IRA. Under section 408A, a Roth IRA is a type of individual retirement plan (IRA) under which contributions to the account are never deductible and qualified distributions from the account are excludable from gross income. Section 408A(d)(4) sets forth special ordering rules for the return of basis in the case of a distribution from a Roth IRA. Under these ordering rules, in the case of a nonqualified distribution from the account, basis is recovered before income is taxed.

Section 617(d) of EGTRRA amended section 6051(a)(8) to require the reporting of designated Roth contributions on Form W–2, "*Wage and Tax Statement*," and added a new subsection (f) to section 6047 to require plan administrators or other responsible persons of section 401(k) or 403(b) plans to make such returns and reports regarding designated Roth contributions to the Secretary of the Treasury and such other persons the Secretary may prescribe.

Final regulations (T.D. 9169, 2005–5 I.R.B. 381) under section 401(k) were issued on December 29, 2004 (69 FR 78144). Those final regulations reserved §1.401(k)–1(f) for special rules for designated Roth contributions. On March 2, 2005, proposed regulations (REG–152354–04, 2005–13 I.R.B. 805) to fill in that reserved paragraph and provide additional rules applicable to designated Roth contributions were issued (70 FR 10062). Final regulations (T.D. 9237, 2006–6 I.R.B. 394) adopting those proposed regulations, with certain modifications, were issued on January 3, 2006 (71 FR 6). The provisions of the final section 401(k) regulations regarding designated Roth contributions do not address the taxability of distributions from designated Roth accounts or the reporting requirements that apply to contributions of designated Roth contributions or distributions from the accounts.[1]

These proposed regulations under section 402A are intended to provide comprehensive guidance on the taxation of distributions from designated Roth accounts under section 401(k) and section 403(b) plans. The proposed regulations also provide guidance on the reporting requirements with respect to these accounts. In addition, these proposed regulations provide guidance with respect to designated Roth contributions under section 403(b) plans by amending the proposed section 403(b) regulations issued in 2004 (2004 proposed section 403(b) regulations), which were published in the **Federal Register** on November 16, 2004 (REG–155608–02, 2004–2 C.B. 924 [69 FR 67075]), to reflect the provisions of section 402A.

Finally, these proposed regulations include amendments to the regulations under section 402(g) issued in 1991 in order to reflect the enactment of section 402A (as well as other statutory changes since those regulations were issued) and to make changes to conform the regulations under section 402(g) to the final section 401(k) regulations. These proposed regulations also add a new §1.408A–10 to the existing regulations under section 408A for Roth IRAs (§1.408A–1 through 9) issued in 1999 to reflect the interaction between section 408A and section 402A.

Explanation of Provisions

Overview

These proposed regulations provide guidance on the taxation of distributions from designated Roth accounts and other related issues. A designated Roth account is a separate account under a section 401(k) plan or section 403(b) plan to which designated Roth contributions are made, and for which separate accounting of contributions, gains, and losses are maintained. These proposed regulations clarify that any transaction or accounting methodology involving an employee's designated Roth account and any other accounts under the plan or plans of an employer that has the effect of directly or indirectly transferring value from another account into the designated Roth account violates the separate accounting requirement under section 402A.

[1] The preamble to the proposed regulations under section 401(k) regarding designated Roth contributions, which were issued on March 2, 2005, requested comments on the issues for which guidance is needed with respect to the taxation of distributions from designated Roth accounts and any other issues under section 402A on which guidance is needed. A number of comments were received in response to that solicitation and those comments have been taken into account in developing these proposed regulations.

The taxation of a distribution from a designated Roth account depends on whether or not the distribution is a qualified distribution. A qualified distribution from a designated Roth account is not includible in the employee's gross income. A qualified distribution is generally a distribution that is made after a 5-taxable-year period of participation and that either (1) is made on or after the date the employee attains age 59½, (2) is made after the employee's death, or (3) is attributable to the employee's being disabled within the meaning of section 72(m)(7).

Determination of 5-year Rule for Qualified Distributions

In order for a distribution from a designated Roth account to be a qualified distribution and thus not includible in gross income, a 5-taxable-year requirement must be satisfied. These proposed regulations would reflect the rule in section 402A that the 5-taxable-year period during which a distribution is not a qualified distribution begins on the first day of the employee's taxable year for which the employee first had designated Roth contributions made to the plan and ends when 5 consecutive taxable years have been completed. However, if a direct rollover is made from a designated Roth account under another plan, the 5-taxable-year period for the recipient plan begins on the first day of the employee's taxable year for which the employee first had designated Roth contributions made to the other plan, if earlier.

Taxation of Nonqualified Distributions

Some commentators requested that the special ordering rules in section 408A(d), providing that the first distributions from a Roth IRA are a return of contributions (and thus not includible in gross income) until all contributions have been returned as basis, be applied to distributions from a designated Roth account. Although designated Roth contributions to a designated Roth account bear some similarity to contributions to a Roth IRA (*e.g.*, contributions to either type of account are after-tax contributions and qualified distributions from either type of account are excludable from gross income), there are many differences between these types of arrangements.

Section 402A does not provide that the special ordering rules of section 408A(d) apply to distributions from designated Roth accounts and, thus, these proposed regulations do not apply those special ordering rules. The only special rule under section 402A for nonqualified distributions from a designated Roth account is that the account is treated as a separate contract for purposes of section 72. Thus, these proposed regulations provide that a distribution from a designated Roth account that is not a qualified distribution is taxable to the distributee under section 402 (or section 403(b)(1)), treating the designated Roth account as a separate contract under section 72. In applying that treatment, the portion of any distribution that is includible in gross income as an amount allocable to income on the contract and the portion not includible in income as an amount allocable to investment in the contract is generally determined under section 72(e)(8). For example, if a nonqualified distribution of $5,000 is made from an employee's designated Roth account when the account consists of $9,400 of designated Roth contributions and $600 of earnings, the distribution consists of $4,700 of designated Roth contributions (that are not includible in the employee's gross income) and $300 of earnings (that are includible in the employee's gross income).

Rollover of Designated Roth Contributions

As described above in the Background section of this preamble, section 402(c)(2) provides that, if a portion of the distribution from a plan qualified under section 401(a) is not includible in income (determined without regard to the rollover), that portion of the distribution can only be rolled over by a direct rollover of the distribution to another plan qualified under section 401(a) that agrees to separately account for the amount not includible in income. (Alternatively the distribution can be rolled over to an IRA in either a 60-day rollover or direct rollover.) The rule under section 402(c)(2) requiring direct rollover is designed to insure that the portion of the rolled over distribution that is investment in the contract is properly accounted for in the recipient plan.

Section 402A(c)(3) provides that a rollover contribution of a distribution from a designated Roth account may only be made to the extent it is otherwise allowable. Section 402(c)(2) provides rules regarding when a rollover contribution of amounts not includable in gross income are allowable. The IRS and Treasury Department believe that the rules in section 402(c)(2) relating to the distribution of an amount not includable in gross income apply to a distribution from a designated Roth account.[2] Thus, these regulations would provide that if the portion of a distribution from a designated Roth account under a plan qualified under section 401(a) that is not includible in income is to be rolled over into a designated Roth account under another plan, the rollover of the distribution must be accomplished through a direct rollover (*i.e.*, a rollover to another designated Roth account is not available for the portion of the distribution not includible in gross income if the distribution is made directly to the employee) and can only be made to a plan qualified under section 401(a) which agrees to separately account for the amount not includible in income (*i.e.*, it cannot be rolled over into a section 403(b) plan). To insure that there is proper accounting in the recipient plan, as described under *Reporting and recordkeeping* the distributing plan is required to report the amount of the investment in the contract and the first year of the 5-year period to the recipient plan so that the recipient plan will not need to rely on information from the distributee.

If a distribution from a designated Roth account is made to the employee, the employee would still be able to roll over the entire amount (or any portion thereof) into a Roth IRA within a 60-day period. Under section 402(c)(2), if only a portion of the distribution is rolled over, the portion that is not rolled over is treated as consisting first of the amount of the distribution that is includible in gross income. These regulations would provide that the income limits for contributions for Roth IRAs do not apply for this purpose.

Alternatively, the employee is permitted to roll over the taxable portion of the

[2] For distributions from designated Roth accounts, there is the same need for proper accounting of investment in the contract as for distributions from other accounts that include after-tax contributions. In addition, it is necessary to track whether the employee has satisfied the 5-year rule for qualified distributions.

distribution to a designated Roth account under either a section 401(a) or 403(b) plan within a 60-day period. In such a case, additional reporting is required from the recipient plan, as described below under the heading *Reporting and recordkeeping*. In addition, the employee's period of participation under the distributing plan is not carried over to the recipient plan for purposes of determining whether the employee satisfies the 5-taxable-year requirement under the recipient plan.

Determination of 5-Taxable-year Period after a Rollover to a Roth IRA

Section 402A and section 408A each provide for a 5-taxable-year period that must be completed in order for a distribution from a designated Roth account or a Roth IRA to be a qualified distribution. However, each of these sections contains different rules for determining when the 5-taxable-year requirement is satisfied. Generally, under section 402A, satisfaction of the 5-taxable-year requirement with respect to a designated Roth account under a plan is based on the years since a designated Roth contribution was first made by the employee under that plan. In contrast, the 5-year period under section 408A begins with the first taxable year for which a contribution is made to any Roth IRA.

Commentators suggested that, if a distribution from a designated Roth account to an individual is rolled into a Roth IRA, the individual receive credit under the 5-year rule in section 408A for the years since the individual first made a contribution to a designated Roth account. The IRS and Treasury Department do not believe that the Code permits this interaction between the two 5-year rules. Instead, these proposed regulations would provide that the 5-taxable-year period described in section 402A and the 5-taxable-year period described in section 408A(d)(2)(B) are determined independently. Thus, in the case of a rollover of a distribution from a designated Roth account maintained under a section 401(k) or 403(b) plan to a Roth IRA, the period that the rolled-over funds were in the designated Roth account does not count towards the 5-taxable-year period for determining qualified distributions from the Roth IRA. However, if an individual had established a Roth IRA in a prior year, the 5-year period for determining qualified distributions from a Roth IRA that began as a result of that earlier Roth IRA contribution applies to any distributions from the Roth IRA (including a distribution of an amount attributable to a rollover contribution from a designated Roth account).

If a nonqualified distribution from a designated Roth account is rolled over into a Roth IRA, the portion of the distribution that constitutes a nontaxable return of investment in the contract is treated as basis in the Roth IRA. However, the proposed regulations would provide that, if a qualified distribution from a designated Roth account is rolled over into a Roth IRA, the entire amount of the distribution will be treated as basis in the Roth IRA. As a result, a subsequent distribution from the Roth IRA in the amount of the rollover would be treated as a tax-free return of basis regardless of whether the individual had maintained a Roth IRA for 5 years (although the investment return on that amount earned in the Roth IRA would not be excluded from income when distributed unless the distribution satisfied the requirements for a qualified distribution from a Roth IRA).

Under section 402A(c)(3)(B), only an amount rolled over from a designated Roth account is not taken into account for purposes of section 402A(c). Thus, these proposed regulations provide that a distribution from a Roth IRA cannot be rolled over into a designated Roth account.

Certain Amounts not Qualified Distributions

Section 1.402(c)–2, A–4, provides a list of amounts that are not treated as eligible rollover distributions and are instead currently includible in income. These proposed regulations would provide that these same amounts also cannot be qualified distributions. Distributions described in A–4(a) (distribution of elective deferrals in excess of the section 415 limits), (b) (corrective distribution of excess deferrals), and (c) (corrective distribution of excess contributions or excess aggregate contributions), have statutorily specified tax treatments. In the case of a deemed distribution under section 72(p) or the cost of current life insurance protection, an actual amount has not in fact been distributed. In the case of distributions of dividends deductible under section 404(k), section 72(e)(5)(D) and §1.404k–1(t) provide that these amounts are treated as paid under a separate contract providing only for payment of deductible dividends. However, if a dividend described in section 404(k) has been reinvested in accordance with section 404(k)(2)(iii)(II), then a distribution of the reinvested amount can be a qualified distribution.

Distribution of Employer Securities

The proposed regulations would also provide rules relating to the distribution of employer securities and the application of the net unrealized appreciation election of section 402(e)(4). If a qualified distribution includes employer securities, the distribution is not includible in gross income and the basis of each security in the hands of the distributee is the fair market value of the security on the date of the distribution. In such a case, the distributee will receive capital gains treatment at the time of any future disposition of the security, to the extent of any post-distribution appreciation. If a distribution with respect to employer securities is not a qualified distribution, the rules of section 402(e)(4) apply in the same manner as to any other distribution except that the designated Roth account is treated as a separate contract.

Designated Roth Accounts under Section 403(b) Plans

These proposed regulations amend the 2004 proposed section 403(b) regulations to reflect the provisions of section 402A. Generally, these proposed regulations merely incorporate basic and definitional rules for a designated Roth program in §1.401(k)–1(f) under a section 401(k) plan into the 2004 proposed section 403(b) proposed regulations under section 403(b). Further, these proposed regulations also incorporate the taxation rules in section 402A into the 2004 proposed regulations under section 403(b) and clarify the taxation rules of section 402(c)(2) as they would apply to distributions from a section 403(b) plan. Thus, these proposed regulations provide that to the extent some or all of the distribution from a section 403(b) plan (including a distribution of an amount from a designated Roth account)

would not have been includible in gross income if it were not rolled over, that portion of the distribution can only be rolled over into an individual retirement plan, or through a direct rollover to another section 403(b) plan which agrees to separately account for such rolled over amounts.

However, there is one issue that is unique to section 403(b) plans: the interaction between the right to make designated Roth contributions and the universal availability requirement in section 403(b)(12)(A)(ii). These proposed regulations provide that the universal availability requirement of section 403(b)(12) includes the right to make designated Roth contributions. Thus, if any employee is given the opportunity to designate section 403(b) elective deferrals as designated Roth contributions, then all employees must be given that right. These proposed regulations do not address what other rights with respect to section 403(b) elective deferrals under a section 403(b) plan may also be subject to the universal availability requirement.

Reporting and Recordkeeping

Under these proposed regulations, the plan administrator or other responsible party with respect to a plan with a designated Roth account would be responsible for keeping track of the 5-taxable-year period for each employee and the amount of designated Roth contributions made on behalf of such employee. In addition, the plan administrator or other responsible party of a plan directly rolling over a distribution would be required to provide the plan administrator of the recipient plan (*i.e.*, the plan accepting the eligible rollover distribution) with a statement indicating either the first year of the 5-taxable-year period for the employee and the portion of such distribution attributable to basis or that the distribution is a qualified distribution. If the distribution is not a direct rollover to a designated Roth account under another eligible plan, the plan administrator or responsible party must provide to the employee, upon request, this same information, except the statement need not indicate the first year of the 5-taxable-year period. The statement would be required to be provided within a reasonable period following the direct rollover (or employee request), but in no event later than 30 days following the direct rollover (or employee request), and the plan administrator or other responsible party for the recipient plan would be permitted to rely on these statements.

In order to give plans sufficient time to develop systems to comply with these reporting requirements, these reporting and record keeping requirements are proposed to be effective beginning with the 2007 taxable year. However, plan administrators are cautioned that it will not be possible for a plan to comply with the separate accounting requirement under section 402A and the recently published final regulations with respect to Roth 401(k) plans without keeping track of each employee's investment in the contract under the designated Roth account. Further, for any plan accepting a rollover from another designated Roth account, the proposed regulations only permit reliance for purposes of the record keeping requirement in future years on a statement from the plan administrator (or other responsible party) for the other plan. Consequently, we would anticipate that plans accepting a rollover contribution to a designated Roth account during 2006 would request representations from the other plan administrator (or responsible party) that the distribution being rolled over is from a designated Roth account and stating what portion of the distribution is investment in the contract.

As noted above, to the extent that a portion of a distribution is includible in income (determined without regard to the rollover), if any portion of that distribution is rolled over to a designated Roth account by the distributee rather than by direct rollover, the plan administrator of the recipient plan must notify the IRS of its acceptance of the rollover contribution. The notification is required to be sent to an address to be specified by the Commissioner and must include: 1) the employee's name and social security number; 2) the amount rolled over; 3) the year in which the rollover contribution was made; and 4) such other information as the Commissioner may require in future published guidance in order to determine that the amount rolled over is a valid rollover contribution.

With respect to other reporting, generally, the same reporting requirements apply to plans with designated Roth accounts as apply to other plans. A contribution to and a distribution from a designated Roth account must be reported on Form W–2 and Form 1099-R, "*Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*," respectively, in accordance with the instructions thereto. It is expected that the instructions to Form 1099-R will be changed to require that a separate Form 1099-R be used to report the amount of a distribution from a designated Roth account, the taxable amount with respect to the distribution, and the first year of the 5-taxable-year period. An employee has no reporting obligation with respect to designated Roth contributions under a section 401(k) or 403(b) plan. However, an employee rolling over a distribution from a designated Roth account to a Roth IRA should keep track of the amount rolled over in accordance with the instructions to Form 8606, "*Nondeductible IRAs*."

Designated Roth Contributions as Excess Deferrals

Even though designated Roth contributions are not excluded from income when contributed, they are treated as elective deferrals for purposes of section 402(g). Thus, to the extent total elective deferrals for the year exceed the section 402(g) limit for the year, the excess amount can be distributed by April 15th of the year following the year of the excess without adverse tax consequences. However, if such excess deferrals are not distributed by April 15th of the year following the year of the excess, these proposed regulations would provide that any distribution attributable to an excess deferral that is a designated Roth contribution is includible in gross income (with no exclusion from income for amounts attributable to basis under section 72) and is not eligible for rollover. These regulations would provide that if there are any excess deferrals that are designated Roth contributions that are not corrected prior to April 15th of the year following the excess, the first amounts distributed from the designated Roth account are treated as distributions of excess deferrals and earnings until the full amount of the excess deferrals (and attributable earnings) are distributed.

Gap Period Income

In addition, these proposed regulations conform the gap period income rules for a distribution of excess deferrals under section 402(g) to the gap period income rules in the 2004 final section 401(k) and 401(m) regulations by providing that gap period income (*i.e.*, income for the period after the taxable year) needs to be included in the distribution to the extent the employee is or would be credited with allocable gain or loss on those excess deferrals for that period, if the total account were to be distributed. This gap period income rule applies to both pre-tax excess deferrals and designated Roth contributions.

Effective Date

Section 402A applies to employees' taxable years beginning on or after January 1, 2006. The proposed regulations under section 402A are generally proposed to be applicable for taxable years beginning on or after January 1, 2007. However, certain provisions in the proposed regulations under section 402A are proposed to be applicable at the same time as section 402A. These include the clarification that the separate accounting requirement does not permit any transaction or accounting methodology that transfers value between designated Roth accounts and other accounts under a plan and the rules relating to rollovers to designated Roth accounts and Roth IRAs. Similarly, the proposed regulations under section 408A would be applicable at the same time as section 402A. These proposed regulations also address the treatment of rollover contributions to Roth IRAs and designated Roth accounts.

The proposed amendments to the regulations under section 402(g) relating to designated Roth contributions also are proposed to be applicable at the same time as section 402A. Thus, those proposed amendments would be applicable for excess deferrals for taxable years beginning on or after January 1, 2006. The rule requiring distribution of gap period income on excess deferrals applies to distributions in taxable years beginning on or after January 1, 2007, and thus will generally also apply for excess deferrals for taxable years beginning on or after January 1, 2006. As a result, this requirement generally would become applicable when the corresponding requirement under the 2004 final 401(k) and (m) regulations that distributions to correct excess contributions and excess aggregate contributions include gap period income becomes applicable.

The proposed amendments to the 2004 proposed section 403(b) regulations will not be applicable earlier than the applicability date of those regulations when they are finalized. The IRS and Treasury Department expect that the 2004 proposed section 403(b) regulations when finalized will be applicable for taxable years on or after January 1, 2007.

For the period after section 402A is applicable and before these proposed regulations are made final, taxpayers may rely on these proposed regulations. If, and to the extent, future guidance is more restrictive than the guidance in these proposed regulations, the future guidance will be applied without retroactive effect.

These regulations do not provide rules for the application of the EGTRRA sunset provision (section 901 of EGTRRA), under which the provisions of EGTRRA do not apply to taxable, plan, or limitation years beginning after December 31, 2010. Unless the EGTRRA sunset provision is repealed before it becomes effective, additional guidance will be needed to clarify its application.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that 5 U.S.C. 553(b) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that most small entities that will maintain a designated Roth account already use a third party provider to administer the plan and the collection of information in these regulations, which is required to comply with the separate accounting and recordkeeping requirements of section 402A(b), will only minimally increase the third party provider's administrative burden with respect to the plan. Therefore, an analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed regulations and how they may 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 authors of these regulations are Cathy Vohs and R. Lisa Mojiri-Azad, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in the development of these 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 to read, in part, as follows:

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

Section 1.402A–1 is also issued under 26 U.S.C. 402A * * *

Par. 2. Section 1.402(g)–1 is amended as follows:

1. Revise the second sentence and add a third sentence to paragraph (a).

2. Add new paragraphs (b)(5) and (b)(6).

3. Revise paragraph (d).

4. Revise paragraph (e)(2) introductory text.

5. Revise paragraph (e)(2)(i).

6. Revise the second sentence and add a new third sentence in paragraph (e)(3)(i)(A).

7. Revise paragraph (e)(5)(i).

8. Add a sentence after the last sentence in paragraph (e)(5)(ii).

9. Revise paragraph (e)(5)(iii).

10. Add paragraph (e)(5)(v).

11. Add paragraph (e)(8)(iv).

The additions and revisions to §1.402(g)–1 read as follows:

§1.402(g)–1 Limitation on exclusion for elective deferrals.

(a) *In general*. * * * , except to the extent the excess deferrals are comprised of designated Roth contributions, and thus, are already includible in gross income. A designated Roth contribution is treated as an excess deferral only to the extent that the total amount of designated Roth contributions for an individual exceeds the applicable limit for the taxable year or the designated Roth contributions are identified as excess deferrals and the individual receives a distribution of the excess deferrals and allocable income under paragraph (e)(2) or (e)(3) of this section.

(b) * * *

(5) Any designated Roth contributions described in section 402A (before applying the limits of section 402(g) or this section).

(6) Any elective employer contributions to a SIMPLE retirement account, on behalf of an employee pursuant to a qualified salary reduction arrangement as described in section 408(p)(2) (before applying the limits of section 402(g) or this section).

* * * * *

(d) *Applicable limit*—(1) *In general*. Except as provided under paragraph (d)(2) of this section, the applicable limit for an individual's taxable year is the applicable dollar amount set forth in section 402(g)(1)(B). This applicable dollar amount is increased for the taxable year beginning in 2007 and later years in the same manner as the dollar amount under section 415(b)(1)(A) is adjusted pursuant to section 415(d). See §1.402(g)–2 for the treatment of catch-up contributions described in section 414(v).

(2) *Special adjustment for elective deferrals with respect to section 403(b) annuity contracts for certain long-term employees*. The applicable limit for an individual who is a qualified employee (as defined in section 402(g)(7)(C)) and has elective deferrals described in paragraph (b)(3) or (5) of this section for a taxable year is adjusted by increasing the applicable limit otherwise determined under paragraph (d)(1) of this section in accordance with section 402(g)(7).

(e) * * *

(2) *Correction of excess deferrals after the taxable year*. A plan may provide that if any amount is an excess deferral under paragraph (a) of this section:

(i) Not later than the first April 15 (or such earlier date specified in the plan) following the close of the individual's taxable year, the individual may notify each plan under which deferrals were made of the amount of the excess deferrals received by the plan. If any designated Roth contributions were made to a plan, the notification must also identify the extent to which, if any, the excess deferrals are comprised of designated Roth contributions. A plan may provide that an individual is deemed to have notified the plan of excess deferrals (including the portion of excess deferrals that are comprised of designated Roth contributions) to the extent the individual has excess deferrals for the taxable year calculated by taking into account only elective deferrals under the plan and other plans of the same employer and the plan may provide the extent to which such excess deferrals are comprised of designated Roth contributions. A plan may instead provide that the employer may notify the plan on behalf of the individual under these circumstances.

* * * * *

(3) * * *

(i) * * *

(A) * * * If any designated Roth contributions were made to a plan, the notification must identify the extent to which, if any, the excess deferrals are comprised of designated Roth contributions. A plan may provide that an individual is deemed to have notified the plan of excess deferrals (including the portion of excess deferrals that are comprised of designated Roth contributions) for the taxable year calculated by taking into account only elective deferrals under the plan and other plans of the same employer and the plan may provide the extent to which such excess deferrals are comprised of designated Roth contributions. * * *

* * * * *

(5) *Income allocable to excess deferrals*—(i) *General rule*. The income allocable to excess deferrals is equal to the sum of the allocable gain or loss for the taxable year of the individual and, in the case of a distribution in a taxable year beginning on or after January 1, 2007, made to correct an excess deferral, to the extent the excess deferrals are or will be credited with gain or loss for the gap period (*i.e.*, the period after the close of the taxable year and prior to the distribution) if the total account were to be distributed, the allocable gain or loss during that period.

(ii) *Method of allocating income*. * * * A plan will not fail to use a reasonable method for computing the income allocable to excess deferrals merely because the income allocable to excess deferrals is determined on a date that is no more than 7 days before the distribution.

(iii) *Alternative method of allocating taxable year income*. A plan may determine the income allocable to excess deferrals for the taxable year by multiplying the income for the taxable year allocable to elective deferrals by a fraction. The numerator of the fraction is the excess deferrals by the employee for the taxable year. The denominator of the fraction is equal to the sum of:

(A) The total account balance of the employee attributable to elective deferrals as of the beginning of the taxable year, plus

(B) The employee's elective deferrals for the taxable year.

* * * * *

(v) *Alternative method for allocating plan year and gap period income*. A plan may determine the allocable gain or loss for the aggregate of the taxable year and the gap period by applying the alternative method provided by paragraph (e)(5)(iii) of this section to this aggregate period. This is accomplished by substituting the income for the taxable year and the gap period for the income for the taxable year and by substituting the elective deferrals

for the taxable year and the gap period for the elective deferrals for the taxable year in determining the fraction that is multiplied by that income.

* * * * *

(8) * * *

(iv) *Distributions of excess deferrals from a designated Roth account*. The rules of paragraph (e)(8)(iii) of this section generally apply to distributions of excess deferrals that are designated Roth contributions and the attributable income. Thus, if a designated Roth account described in section 402A includes any excess deferrals, any distribution of amounts attributable to those excess deferrals are includible in gross income (without adjustment for any return of investment in the contract under section 72(e)(8)). In addition, such distributions cannot be qualified distributions described in section 402A(d)(2) and are not eligible rollover distributions within the meaning of section 402(c)(4). For this purpose, if a designated Roth account includes any excess deferrals, any distributions from the account are treated as attributable to those excess deferrals until the total amount distributed from the designated Roth account equals the total of such deferrals and attributable income.

* * * * *

Par. 3. Sections 1.402A–1 and 1.402A–2 are added to read as follows:

§1.402A–1 Designated Roth Accounts

Q–1. What is a designated Roth account?

A–1. A designated Roth account is a separate account under a qualified cash or deferred arrangement under a section 401(a) plan, or under a section 403(b) plan, to which designated Roth contributions are made that satisfies the requirements of §1.401(k)–1(f) (in the case of a section 401(a) plan) or §1.403(b)–3(c) (in the case of a section 403(b) plan).

Q–2. How is a distribution from a designated Roth account taxed?

A–2. (a) The taxation of a distribution from a designated Roth account depends on whether or not the distribution is a qualified distribution. A qualified distribution from a designated Roth account is not includible in the distributee's gross income.

(b) Except as otherwise provided in paragraph (c) of this A–2, a qualified distribution is a distribution that is both—

(1) Made after the 5-taxable-year period of participation defined in A–4 of this section has been completed; and

(2) Made on or after the date the employee attains age 59½, made to a beneficiary or the estate of the employee on or after the employee's death, or attributable to the employee's being disabled within the meaning of section 72(m)(7).

(c) A distribution from a designated Roth account is not a qualified distribution to the extent it consists of a distribution of excess deferrals and attributable income described in §1.402(g)–1(e). See A–11 of this section for other amounts that are not treated as qualified distributions, including excess contributions described in section 401(k)(8), or excess aggregate contributions described in section 401(m)(8), and income on any of these excess amounts.

Q–3. How is a distribution from a designated Roth account taxed if it is not a qualified distribution?

A–3. Except as provided in A–11 of this section, a distribution from a designated Roth account that is not a qualified distribution is taxable to the distributee under section 402 in the case of a plan qualified under section 401(a) and under section 403(b)(1) in the case of a section 403(b) plan. For this purpose, a designated Roth account is treated as a separate contract under section 72. Thus, except as otherwise provided in A–5 of this section for a rollover, if a distribution is before the annuity starting date, the portion of any distribution that is includible in gross income as an amount allocable to income on the contract and the portion not includible in gross income as an amount allocable to investment in the contract is determined under section 72(e)(8), treating the designated Roth account as a separate contract. Similarly, if a distribution is on or after the annuity starting date, the portion of any annuity payment that is includible in gross income as an amount allocable to income on the contract and the portion not includible in gross income as an amount allocable to investment in the contract is determined under section 72(b), treating the designated Roth account as a separate contract. For purposes of section 72, designated Roth contributions are employer contributions described in section 72(f)(1) (contributions that are includible in gross income).

Q–4. What is the 5-taxable-year period of participation described in A–2 of this section?

A–4. (a) The 5-taxable-year period of participation described in A–2 of this section for a plan is the period of 5 consecutive taxable years that begins with the first day of the first taxable year in which the employee makes a designated Roth contribution to any designated Roth account established for the employee under the same plan and ends when 5 consecutive taxable years have been completed. For this purpose, the first taxable year in which an employee makes a designated Roth contribution is the year in which the amount is includible in the employee's gross income.

(b) Generally, an employee's 5-taxable-year period of participation is determined separately for each plan (within the meaning of section 414(l)) in which the employee participates. Thus, if an employee has elective deferrals made to designated Roth accounts under two or more plans, the employee may have two or more different 5-taxable-year periods of participation, depending on when the employee first had contributions made to a designated Roth account under each plan. However, if a direct rollover contribution of a distribution from a designated Roth account under another plan is made by the employee to the plan, the 5-taxable-year period of participation begins on the first day of the employee's taxable year in which the employee first had designated Roth contributions made to such other designated Roth account, if earlier.

(c) The beginning of the 5-taxable-year period of participation is not redetermined for any portion of an employee's designated Roth account. This is true even if the employee dies or the account is divided pursuant to a qualified domestic relations order, and thus, a portion of the account is not payable to the employee and is payable to the employee's beneficiary or an alternate payee. The same rule applies if the entire designated Roth account is distributed during the 5-taxable-year period of participation and the employee subsequently makes additional designated Roth contributions under the plan.

Q–5. How do the taxation rules apply to a distribution from a designated Roth account that is rolled over?

A–5. (a) An eligible rollover distribution from a designated Roth account is permitted to be rolled over into another designated Roth account or a Roth IRA, and the amount rolled over is not currently includable in gross income. In accordance with section 402(c)(2), to the extent that a portion of a distribution from a plan qualified under section 401(a) is not includible in income (determined without regard to the rollover), if that portion of the distribution is to be rolled over into a designated Roth account, the rollover must be accomplished through a direct rollover of the entire distribution (*i.e.*, a 60 day rollover to another designated Roth account is not available for this portion of the distribution) and can only be made to another plan qualified under section 401(a) which agrees to separately account for the amount not includible in income (*i.e.*, it cannot be rolled over into a section 403(b) plan). See § 1.403(b)–7(a) for the corresponding rule applicable to section 403(b) plans. If a distribution from a designated Roth account is instead made to the employee, the employee would still be able to roll over the entire amount (or any portion thereof) into a Roth IRA within the 60-day period described in section 402(c)(3).

(b) In the case of an eligible rollover distribution from a designated Roth account that is not a qualified distribution, if the entire amount of the distribution is not rolled over, the part that is rolled over is deemed to consist first of the portion of the distribution that is attributable to income under section 72(e)(8).

(c) If an employee receives a distribution from a designated Roth account, the portion of the distribution that would be includible in gross income is permitted to be rolled over into a designated Roth account under another plan. In such a case, §1.402A–2, A–3, provides for additional reporting by the recipient plan. In addition, the employee's period of participation under the distributing plan is not carried over to the recipient plan for purposes of satisfying the 5-taxable-year period of participation requirement under the recipient plan.

(d) The following example illustrates the application of this A–5:

Example. Employee B receives a $14,000 eligible rollover distribution that is not a qualified distribution from B's designated Roth account, consisting of $11,000 of investment in the contract and $3,000 of income. Within 60 days of receipt, Employee B rolls over $7,000 of the distribution into a Roth IRA. The $7,000 is deemed to consist of $3,000 of income and $4,000 of investment in the contract. Because the only portion of the distribution that could be includible in gross income (the income) is rolled over, none of the distribution is includible in Employee B's gross income.

(e) This A–5 applies for taxable years beginning on or after January 1, 2006.

Q–6. In the case of a rollover contribution to a designated Roth account, how is the amount that is treated as investment in the contract under section 72 determined?

A–6. If the entire amount of a distribution from a designated Roth account is rolled over to another designated Roth account, the amount of the rollover contribution allocated to investment in the contract in the recipient designated Roth account is the amount that would not have been includible in gross income (determined without regard to section 402(e)(4)) if the distribution had not been rolled over. Thus, if an amount that is a qualified distribution is rolled over, the entire amount of the rollover contribution is allocated to investment in the contract. If less than the entire amount of a distribution is rolled over, A–5(b) of this section provides a rule for determining the portion of the rollover contribution treated as investment in the contract.

Q–7. After a qualified distribution from a designated Roth account has been made, how is the remaining investment in the contract of the designated Roth account determined under section 72?

A–7. (a) The portion of any qualified distribution that is treated as a recovery of investment in the contract is determined in the same manner as if the distribution were not a qualified distribution. (See A–3 of this section) Thus, the remaining investment in the contract in a designated Roth account after a qualified distribution is determined in the same manner after a qualified distribution as it would be determined if the distribution were not a qualified distribution.

(b) The following example illustrates the application of this A–7:

Example. Employee C receives a $12,000 distribution, which is a qualified distribution that is attributable to the employee being disabled within the meaning of section 72(m)(7), from C's designated Roth account. Immediately prior to the distribution, the account consisted of $21,850 of investment in the contract (*i.e.*, designated Roth contributions) and $1,150 of income. For purposes of determining recovery of investment in the contract under section 72, the distribution is deemed to consist of $11,400 of investment in the contract [$12,000 x 21,850/(1,150 + 21,850)], and $600 of income [$12,000 x 1,150/(1,150 + 21,850)]. Immediately after the distribution, C's designated Roth account consists of $10,450 of investment in the contract and $550 of income. This determination of the remaining investment in the contract will be needed if C subsequently is no longer disabled and takes a nonqualified distribution from the designated Roth account.

Q–8. What is the relationship between the accounting for designated Roth contributions as investment in the contract for purposes of section 72 and their treatment as elective deferrals available for a hardship distribution under section 401(k)(2)(B)?

A–8. (a) There is no relationship between the accounting for designated Roth contributions as investment in the contract for purposes of section 72 and their treatment as elective deferrals available for a hardship distribution under section 401(k)(2)(B). A plan that makes a hardship distribution under section 401(k)(2)(B) from elective deferrals that includes designated Roth contributions must separately determine the amount of elective deferrals available for hardship and the amount of investment in the contract attributable to designated Roth contributions for purposes of section 72. Thus, the entire amount of a hardship distribution is treated as reducing the otherwise maximum distributable amount for purposes of applying the rule in section 401(k)(2)(B) and §1.401(k)–1(d)(3)(ii) that generally limits hardship distributions to the principal amount of elective deferrals made less the amount of elective deferrals previously distributed from the plan, even if a portion of the distribution is treated as income under section 72(e)(8).

(b) The following example illustrates the application of this A–8:

Example. Assume the same facts as in the *Example* in A–7 of this section, except that Employee C is not disabled, the distribution is a hardship distribution, and Employee C has received no previous distributions of elective deferrals from the plan. The adjustment to the investment in the contract is the same as in A–7 of this section, but for purposes of determining the amount of elective deferrals available for future hardship distribution, the entire amount of the distribution is subtracted from the maximum distributable amount. Thus, Employee C has only $9,850 ($21,850 - $12,000) available for hardship distribution from C's designated Roth account.

Q–9. Can an employee have more than one separate contract for designated Roth

contributions under a plan qualified under section 401(a) or a section 403(b) plan?

A–9. (a) Except as otherwise provided in paragraph (b) of this A–9, for purposes of section 72, there is only one separate contract for an employee with respect to the designated Roth contributions under a plan. Thus, if a plan maintains one separate account for designated Roth contributions made under the plan and another separate account for rollover contributions received from a designated Roth account under another plan (so that the rollover account is not required to be subject to the distribution restrictions otherwise applicable to the account consisting of designated Roth contributions made under the plan), both separate accounts are considered to be one contract for purposes of applying section 72 to the distributions from either account.

(b) If a separate account with respect to an employee's accrued benefit consisting of designated Roth contributions is established and maintained for an alternate payee pursuant to a qualified domestic relations order and another designated Roth account is maintained for the employee, each account is treated as a separate contract for purposes of section 72. The alternate payee's designated Roth account is also a separate contract for purposes of section 72 with respect to any other account maintained for that alternate payee. Similarly, if separate accounts are established and maintained for different beneficiaries after the death of an employee, the separate account for each beneficiary is treated as a separate contract under section 72 and is also a separate contract with respect to any other account maintained for that beneficiary under the plan that is not a designated Roth account. When the separate account is established for an alternate payee or for a beneficiary (after an employee's death), each separate account must receive a proportionate amount attributable to investment in the contract.

Q–10. What is the tax treatment of employer securities distributed from a designated Roth account?

A–10. (a) If a distribution of employer securities from a designated Roth account is not a qualified distribution, section 402(e)(4)(B) applies. Thus, in the case of a lump-sum distribution that includes employer securities, unless the taxpayer elects otherwise, net unrealized appreciation attributable to the employer securities is not includible in gross income; and such net unrealized appreciation is not included in the basis of the distributed securities and is capital gain to the extent such appreciation is realized in a subsequent taxable transaction.

(b) In the case of a qualified distribution of employer securities from a designated Roth account, the distributee's basis in the distributed securities for purposes of subsequent disposition is their fair market value at the time of distribution.

Q–11. Can an amount described in A–4 of §1.402(c)–2 with respect to a designated Roth account be a qualified distribution?

A–11. No. An amount described in A–4 of §1.402(c)–2 with respect to a designated Roth account cannot be a qualified distribution. Such an amount is taxable under the rules of §§ 1.72–16(b), 1.72(p)–1, A–11 through A–13, 1.402(g)–1(e)(8), 1.401(k)–2(b)(2)(vi), 1.401(m)–2(b)(2)(vi), or 1.404(k)–1T. Thus, for example, loans that are treated as deemed distributions pursuant to section 72(p), or dividends paid on employer securities as described in section 404(k) are not qualified distributions even if the deemed distributions occur or the dividends are paid after the employee attains age 59½ and the 5-taxable-year period of participation defined in A–4 of this section has been satisfied. However, if a dividend is reinvested in accordance with section 404(k)(2)(A)(iii)(II), the amount of such a dividend is not precluded from being a qualified distribution if later distributed.

Q–12. If any amount from a designated Roth account is included in a loan to an employee, do the plan aggregation rules of section 72(p)(2)(D) apply for purposes of determining the total amount an employee is permitted to borrow from the plan, even though the designated Roth account generally is treated as a separate contract under section 72?

A–12. Yes. If any amount from a designated Roth account is included in a loan to an employee, notwithstanding the general rule that the designated Roth account is treated as a separate contract under section 72, the plan aggregation rules of section 72(p)(2)(D) apply for purposes of determining the maximum amount the employee is permitted to borrow from the plan and such amount is based on the total of the designated Roth contributions amounts and the other amounts under the plan, regardless of whether the loan is from the designated Roth account or other accounts under the plan. However, to the extent a loan is from a designated Roth account, the repayment requirement of section 72(p)(2)(C) must be satisfied separately with respect to that portion of the loan and with respect to the portion of the loan from other accounts under the plan.

Q–13. Does a transaction or accounting methodology involving an employee's designated Roth account and any other accounts under the plan or plans of an employer that has the effect of transferring value from the other accounts into the designated Roth account violate the separate accounting requirement of section 402A?

A–13. Yes. Any transaction or accounting methodology involving an employee's designated Roth account and any other accounts under the plan or plans of an employer that has the effect of directly or indirectly transferring value from another account into the designated Roth account violates the separate accounting requirement under section 402A. However, any transaction that merely exchanges investments between accounts at fair market value will not violate the separate accounting requirement. This A–13 applies to designated Roth accounts for taxable years beginning on or after January 1, 2006.

Q–14. When is section 402A and this §1.402A–1 applicable?

A–14. Section 402A is applicable for taxable years beginning on or after January 1, 2006. Except as otherwise provided in A–5 and A–13 of this section, the rules of this §1.402A–1 apply for taxable years beginning on or after January 1, 2007.

§1.402A–2 Reporting and recordkeeping requirements with respect to designated Roth accounts.

Q–1. Who is responsible for keeping track of the 5-taxable-year period of participation and the investment in the contract, *i.e.*, the amount of unrecovered designated Roth contributions for the employee?

A–1. The plan administrator or other responsible party with respect to a plan with a designated Roth account is responsible for keeping track of the 5-taxable-year period of participation for each employee and the amount of investment in the contract (unrecovered designated Roth

contributions) on behalf of such employee. For purposes of the preceding sentence, in the absence of actual knowledge to the contrary, the plan administrator or other responsible party is permitted to assume that an employee's taxable year is the calendar year. In the case of a direct rollover from another designated Roth account, the plan administrator or other responsible party of the recipient plan can rely on reasonable representations made by the plan administrator or responsible party with respect to the plan with the other designated Roth account. See A–2 of this section for statements required in the case of rollovers.

Q–2. In the case of an eligible rollover distribution from a designated Roth account, what additional information must be provided with respect to such distribution?

A–2. (a) Pursuant to section 6047(f), if an amount is distributed from a designated Roth account, the plan administrator or other responsible party with respect to the plan must provide a statement as described below in the following situations—

(1) In the case of a direct rollover of a distribution from a designated Roth account under a plan to a designated Roth account under another plan, the plan administrator or other responsible party must provide to the plan administrator or responsible party of the recipient plan either a statement indicating the first year of the 5-taxable-year period described in A–1 of this section and the portion of the distribution that is attributable to investment in the contract under section 72, or a statement that the distribution is a qualified distribution.

(2) If the distribution is not a direct rollover to a designated Roth account under another plan, the plan administrator or responsible party must provide to the employee, upon request, the same information described in paragraph (a)(1) of this A–2, except the statement need not indicate the first year of the 5-taxable-year period described in A–1 of the section.

(b) The statement described in paragraph (a) of this A–2 must be provided within a reasonable period following the direct rollover or distributee request but in no event later than 30 days following the direct rollover or distributee request.

Q–3. If a plan qualified under section 401(a) or a section 403(b) plan accepts a 60-day rollover of earnings from a designated Roth account, what report to the IRS must be provided with respect to such rollover contribution?

A–3. A plan qualified under section 401(a), or a section 403(b) plan, accepting a rollover contribution (other than a direct rollover contribution) under section 402(c)(2), or section 403(b)(8)(B), of the portion of a distribution from a designated Roth account that would have been includable in gross income must notify the Commissioner of its acceptance of the rollover contribution no later than the due date for filing Form 1099-R, "*Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*" The notification is required to be sent to an address to be specified by the Commissioner and must include the employee's name and social security number, the amount rolled over, the year in which the rollover contribution was made, and such other information as the Commissioner, in revenue rulings, notices, or other published guidance in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter) may require in order to determine that the amount rolled over is a valid rollover contribution.

Q–4. When is this §1.402A–2 applicable?

A–4. The rules of this §1.402A–2 are applicable for taxable years beginning on or after January 1, 2007.

Par. 4. Section 1.403(b)–2 as set forth in Paragraph 5 of the 2004 section 403(b) proposed regulations (69 FR 67075) is amended by revising paragraph (a)(17) to read as follows:

§1.403(b)–2 Definitions.

(a) * * *

(17) *Section 403(b) elective deferral; designated Roth contribution*—(i) *Section 403(b) elective deferral* means an elective deferral that is an employer contribution to a section 403(b) plan for an employee. See §1.403(b)–5(b) for additional rules with respect to a section 403(b) elective deferral.

(ii) *Designated Roth contribution* under a section 403(b) plan means a section 403(b) elective deferral that satisfies §1.403(b)–3(c).

* * * * *

Par. 5. Section 1.403(b)–3, as set forth in paragraph 5 of the 2004 section 403(b) proposed regulations (69 FR 67075) is amended to read as follows:

1. A sentence is added to the end of paragraph (a) introductory text.

2. Paragraph (c) is redesignated as paragraph (d) and a new paragraph (c) is added.

§1.403(b)–3 Exclusion for contributions to purchase section 403(b) contracts.

(a) *Exclusion for section 403(b) contracts*. * * * However, the preceding two sentences do not apply to designated Roth contributions; see paragraph (c) of this section and §1.403(b)–7(e) for special taxation rules that apply with respect to designated Roth contributions under a section 403(b) plan.

* * * * *

(c) *Special rules for designated Roth contributions*. (1) The rules of §1.401(k)–1(f)(1) and (2) for designated Roth contributions under a qualified cash or deferred arrangement apply to designated Roth contributions under a section 403(b) plan. Thus, a designated Roth contribution under a section 403(b) plan is a section 403(b) elective deferral that is designated irrevocably by the employee at the time of the cash or deferred election as a designated Roth contribution that is being made in lieu of all or a portion of the section 403(b) elective deferrals the employee is otherwise eligible to make under the plan; that is treated by the employer as includible in the employee's gross income at the time the employee would have received the amount in cash if the employee had not made the cash or deferred election (*e.g.*, by treating the contributions as wages subject to applicable withholding requirements); and that is maintained in a separate account (within the meaning of §1.401(k)–1(f)(2)).

(2) A designated Roth contribution under a section 403(b) plan must satisfy the requirements applicable to section 403(b) elective deferrals. Thus, for example, designated Roth contributions under a section 403(b) plan must satisfy the requirements of §1.403(b)–6(d). Similarly, a designated Roth account under a section 403(b) plan is subject to the rules of section 401(a)(9)(A) and (B) and §1.403(b)–6(e).

* * * * *

Par. 6. Section 1.403(b)–5, as set forth in paragraph 5 of the 2004 section 403(b)

proposed regulations (69 FR 67075), is amended by adding a sentence to the end of paragraph (b)(1) to read as follows:

§1.403(b)–5 Nondiscrimination rules

(a) * * *

(b) * * * (1) * * * Further, the employee's right to make elective deferrals also includes the right to designate section 403(b) elective deferrals as designated Roth contributions.

* * * * *

Par. 7. Section 1.403(b)–7, as set forth in paragraph 5 of the 2004 section 403(b) proposed regulations (69 FR 67075), is amended as follows:

1. A sentence is added before the last sentence in paragraph (b)(1).
2. A sentence is added before the last sentence in paragraph (b)(2).
3. A paragraph (e) is added.

The additions are to read as follows:

§1.403(b)–7 Taxation of distributions and benefits

* * * * *

(b) * * * (1) * * * Thus, to the extent that a portion of a distribution (including a distribution from a designated Roth account) would be excluded from gross income if it were not rolled over, if that portion of the distribution is to be rolled over into an eligible retirement plan that is not an IRA, the rollover must be accomplished through a direct rollover of the entire distribution (*i.e.*, a 60-day rollover to another section 403(b) plan is not available for this portion of the distribution) to a section 403(b) plan that agrees to separately account for the amount not includible in income (*i.e.*, it cannot be rolled over into a plan qualified under section 401(a)). * * *

(2) * * * Thus, the special rule in §1.401(k)–1(f)(3)(ii) with respect to distributions from a designated Roth account that are expected to total less than $200 during a year applies to designated Roth accounts under a section 403(b) plan. * * *

* * * * *

(e) *Special rules relating to distributions from a designated Roth account*. If an amount is distributed from a designated Roth account under a section 403(b) plan, the amount, if any, that is includible in gross income and the amount, if any, that may be rolled over to another section 403(b) plan is determined under §1.402A–1. Thus, the designated Roth account is treated as a separate contract for purposes of section 72. For example, the rules of section 72(b) must be applied separately to annuity payments with respect to a designated Roth account under a section 403(b) plan and separately to annuity payments with respect to amounts attributable to any other contributions to the section 403(b) plan.

Par. 8. Section 1.408A–10 is added to read as follows:

§1.408A–10 Coordination between designated Roth accounts and Roth IRAs

Q–1. Can an eligible rollover distribution, within the meaning of section 402(c)(4), from a designated Roth account as defined in A–1 of §1.402A–1, be rolled over to a Roth IRA?

A–1. Yes. An eligible rollover distribution, within the meaning of section 402(c)(4), from a designated Roth account may be rolled over to a Roth IRA. For purposes of this section, designated Roth account means a designated Roth account as defined in A–1 of §1.402A–1.

Q–2. Can an eligible rollover distribution from a designated Roth account be rolled over to a Roth IRA even if the distributee is not otherwise eligible to make regular or conversion contributions to a Roth IRA?

A–2. Yes. An individual may establish a Roth IRA and roll over an eligible rollover distribution from a designated Roth account to that Roth IRA even if such individual is not eligible to make regular contributions or conversion contributions (as described in section 408A(c)(2) and (d)(3), respectively) because of the modified adjusted gross income limits in section 408A(b)(3).

Q–3. For purposes of the ordering rules on distributions from Roth IRAs, what portion of a distribution from a rollover contribution from a designated Roth account is treated as contributions?

A–3. Under section 408A(d)(4), distributions from Roth IRAs are deemed to consist first of regular contributions, then of conversion contributions, and finally, of earnings. For purposes of section 408A(d)(4), the amount of a rollover contribution that is treated as a regular contribution is the portion of the distribution that is treated as investment in the contract under A–6 of §1.402A–1, and the remainder of the rollover contribution is treated as earnings. Thus, the entire amount of any qualified distribution from a designated Roth account that is rolled over into a Roth IRA is treated as a regular contribution to the Roth IRA. Accordingly, a subsequent distribution from the Roth IRA in the amount of that rollover contribution is not includible in gross income under the rules of A–8 of §1.408A–6.

Q–4. In the case of a rollover from a designated Roth account to a Roth IRA, when does the 5-taxable-year period (described in section 408A(d)(2)(B) and A–1 of §1.408A–6) for determining qualified distributions from a Roth IRA begin?

A–4. (a) The 5-taxable-year period for determining a qualified distribution from a Roth IRA (described in section 408A(d)(2)(B) and A–1 of §1.408A–6) begins with the earlier of the taxable year described in A–2 of §1.408A–6 or the taxable year in which a rollover contribution from a designated Roth account is made to a Roth IRA. The 5-taxable-year period described in this A–4 and the 5-taxable-year period of participation described in A–4 of §1.402A–1 are determined independently.

(b) The following examples illustrate the application of this A–4:

Example 1. Employee D, who is over age 59½, takes a distribution from D's designated Roth account in 2008, prior to the end of the 5-taxable-year period of participation used to determine qualified distributions from a designated Roth account. The distribution is an eligible rollover distribution and D rolls it over in accordance with sections 402(c) and 402A(c)(3) to D's Roth IRA, which was established in 2003 (*i.e.*, established for more than 5 years). Any subsequent distribution from the Roth IRA of the amount rolled in, plus earnings thereon, would not be includible in gross income (because it would be a qualified distribution within the meaning of section 408A(d)(2)).

Example 2. Assume the facts are the same as in *Example 1* except that the Roth IRA is D's first Roth IRA and is established with the rollover in 2008, which is the only contribution made to the Roth IRA. If a distribution is made from the Roth IRA prior to the end of the 5-taxable-year period used to determine qualified distributions from a Roth IRA (which begins in 2008, the year of the rollover which established the Roth IRA) the distribution would not be a qualified distribution within the meaning of section 408A(d)(2), and any amount of the distribution that exceeded the portion of the rollover contribution that consisted of investment in the contract is includible in D's gross income.

Example 3. Assume the facts are the same as in *Example 2* except that the distribution from the designated Roth account is after the end of the 5-taxable-year period of participation used to determine qualified distributions from a designated Roth account. If a distribution is made from the Roth IRA prior to the expiration of the 5-taxable-year period used to determine qualified distributions from a Roth IRA, the distribution would not be a qualified distribution within the meaning of section 408A(d)(2), and any amount of the distribution that exceeded the amount rolled in is includible in D's gross income.

Q–5. Can amounts distributed from a Roth IRA be rolled over to a designated Roth account as defined in A–1 of §1.402A–1?

A–5. No. Amounts distributed from a Roth IRA may be rolled over or transferred only to another Roth IRA and are not permitted to be rolled over to a designated Roth account under a section 401(a) or section 403(b) plan. The same rule applies even if all the amounts in the Roth IRA are attributable to a rollover distribution from a designated Roth account in a plan.

Q–6. When is this §1.408A–10 applicable?

A–6. The rules of §1.408A–10 apply for taxable years beginning on or after January 1, 2006.

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on January 25, 2006, 8:45 a.m., and published in the issue of the Federal Register for January 26, 2006, 71 F.R. 4320)

Foundations Status of Certain Organizations

Announcement 2006–14

The following organizations have failed to establish or have been unable to maintain their status as public charities or as operating foundations. Accordingly, grantors and contributors may not, after this date, rely on previous rulings or designations in the Cumulative List of Organizations (Publication 78), or on the presumption arising from the filing of notices under section 508(b) of the Code. This listing does *not* indicate that the organizations have lost their status as organizations described in section 501(c)(3), eligible to receive deductible contributions.

Former Public Charities. The following organizations (which have been treated as organizations that are not private foundations described in section 509(a) of the Code) are now classified as private foundations:

A & G Ranch and Recreation, Houston, TX
Acclaimed Dance Company, Inc., Baton Rouge, LA
Alex Group, Inc., Middle Island, NY
American Friends of Afikei Torah, Chicago, IL
American Samoa Alternate Native Ornamental Development, Pago Pago, AS
Andrew Merritt Ministries, Inc., Detroit, MI
Ange Gardian Foundation, Naalehu, HI
Angelic Foundation, Arlington, VA
Animal Fair, Lincoln, NE
Art Ambassadors, Oakland, CA
Arts & Academic Learning Centers, Los Angeles, CA
Ashton Charities, Inc., Chester, NJ
Austins Angel Memorial Fund, Germantown, MD
Awareness Foundation for the Disabled, Inc., Cranston, RI
Battle Creek-Ida Grove School Foundation, Inc., Ida Grove, IA
BBS Charities, Inc., St. Louis, MO
Big Fun Experiential Education Trips, Inc., Bryan, TX
Birthright of Aurora, Aurora, MN
Brian D. Berlin Memorial Charitable Trust, Albertson, NY
C Heart, Chandron, NE
Care At Home, Inc., Houston, TX
Caring Hands Training Center, Mableton, GA
Center of Living Growing Gardening, Matoaka, WV
Center Street Community Development Corporation, Oakland, CA
Central Fulton Educational Foundation, McConnellsburg, PA
Charlie Hodge Youth Club, Henderson, NC
Child Friendly Foundation, San Diego, CA
Childrens Enrichment Services, Inc., Sacramento, CA
Circle Blue Productions, Malibu, CA
Cleota Youth and Women Service Center, Carson, CA
College Bound Funding, Portland, OR
Colorado Freedom of Expression Foundation, Denver, CO
Community Health Care, Inc., Greensboro, NC
Community Outreach Services, Inc., Bronx, NY
Constitutional Educational Association, Inc., Bath, OH
Corsica River Foundation, Inc., Centreville, MD
Council for Organizational Research and Evaluation, Inc., Marriotsville, MD
Country Doctor Outreach, Kahuku, HI
Crisis Institute, New Orleans, LA
DAJ Unlimited, Inc., Ft. Lauderdale, FL
Daughters of Africa in the Diaspora, Newark, NJ
Dega International, Inc., Apopka, FL
Desilu Too Foundation, Boulder City, NV
Dilworth Group, El Paso, TX
DJ Angels, Inc., Independence, MO
Donna Maria Zerbo, Morristown, NJ
Downtown Elkhart Development Corporation, Elkhart, IN
Drum Beauty, Inc., Stillwater, MN
Eastbay Works, Inc., Oakland, CA
Eben, Inc., Mesa, AZ
Education Training and Consulting, Incorporated, Sarasota, FL
Educational Solutions Unlimited, Inc., Bolton, NC
Elder Louisianians Development & Education Resource, Inc., Baton Rouge, LA
Emmett Lockley Community Development Corporation, New Orleans, LA
Empower Charitable Corporation, Wading River, NY
Ethiopian-Somali Charity Association, Inc., East Boston, MA
Fair Haven Primate Sanctuary, Inc., Loxahatchee, FL
Fair Hope Academy, Inc., Saint Albans, WV
Falconer Stamps Community Center, Marlin, TX
Fort Bayard Historic Preservation Society, Ft. Bayard, NM
Foundation Earth, Inc., Niantic, CT
Frankfort Action Committee for Tomorrow, Inc., Frankfort, NY
Frewsburg Area Youth Soccer League, Frewsburg, NY
Friends of Myers Cemetery, Berkeley, CA
Friends of the Health & Human Services Academy, Washington, DC

Friends of the Museum of Modern Art of Sao Paulo, Inc., Washington, DC
Generation's Family Tree, Tucson, AZ
George Washington Carver Primary/Wheatltey Child Parent Center, Chicago, IL
Global Institute, U.S.A., Kelowna, BC
Global Vision Ministries, Kennebunk, ME
Great Bay Regional Police Athletic League, Manahawkin, NJ
Hanul Foundation, Glendale, CA
Hawkins House, Inc., Buffalo, NY
Help and Hope AIDS Society, Blaine, WA
Herbert Wommack Ministries, Normandy, MO
Hidden People Ministries, Castro Valley, CA
Home of Grace Rehabilitation Center, Inc., Norman, OK
Homes Anew I Ltd., Old Bethpage, NY
Horizon Family Services, Inc., Citrus Heights, CA
Housing Opportunities Arizona One, Inc., Northridge, CA
Institute for Cultural Enterprise, New York, NY
Institute for Reproductive Health, Monterey, CA
International Foundation for Environmental Sustainable Development, Inc., Charleston, SC
International Muslims Organization, Inc., Albany, NY
International Society for Biomems and Biomedical Nano Technology, Dublin, OH
I T S A T Lucretia Brown Ministries, Inc., Glen Burnie, MD
It Starts With a Story, Roslyn, NY
Janiel Educational Services, Wheeling, IL
Jasmine Foundation, Inc., Woodstock, NY
J.E.F.E., Inc., Littleton, CO
Jericho Alternative Community Development Corporation, Atlanta, GA
Jesus Is The Way Out Outreach Ministries, Richmond, VA
Jubilee Center of Christ Church, Inc., East Orange, NJ
Kaiji Foundation, Inc., McLean, VA
Kids & Chocolate, Inc., Denver, CO
Kids Fighting for Kids, Goodyear, AZ
Latvian Ministries, Inc., Jewett City, CT
Learning Through Creativity and Communication, Mount Shasta, CA
Lewis Street Housing Development Fund Company, Inc., Buffalo, NY
Limecrest Tender Loving Care Community Assoc., Inc., Springfield, OH
Living in Harmony With Nature in the Church of Life, Las Vegas, NV
Long Term Care Management Representative Payee Services, Inc., Pocatello, ID
Los Amigos Baseball Association, Santa Monica, CA
Los Angeles Church Planting and Leadership Training, Redondo Beach, CA
Low Country Men, North Charleston, SC
Lyle Baker Veterinary Scholarship Board, San Anselmo, CA
Maine State Teacher of the Year Association, Sullivan, ME
Mainstreetweek.com Foundation, Inc., Orlando, FL
McCormick Sanctuary, Napa, CA
Mentor Charitable Fund, Inc., Boston, MA
Miami-Cass County Freedom Bound Wildlife Rehabilitation Center, Inc., Peru, IN
Migdal Ohr, Inc., Miami Beach, FL
Ministry of Gold Undenominational Church, Inc., Sarasota, FL
Montgomery Young Life Office, Inc., Montgomery, AL
Mountain Opportunities Corporation, Clarksburg, WV
Nantucket Homes for People, Inc., Southborough, MA
National African American Tobacco Prevention Network, Lake Mary, FL
National Association of the Children of Hope Northwest, Tacoma, WA
National Civility Center, Muscatine, IA
New Horizon Community Service, Jesup, GA
Nob Hill Group Homes for Children, Inc., Rancho Santa Margarita, CA
North Hills Jaycees Foundation Charitable Trust, Simi Valley, CA
Northern Indiana Riding for the Handicapped Association, Inc., Plymouth, IN
NW Friends of the Park Foundation, New Waterford, OH
Omentum Research Foundation, San Gabriel, CA
Orchard Park CCRC, Inc., Buffalo, NY
Pacesetter Youth Group, Inc., Canton, GA
Palmers Family Services, College Park, GA
Pardee Cancer Treatment Fund of Gratiot County, Alma, MI
Pathways to Strong Families, Lincoln, CA
Peace B Still Foundation, Inc., Lehigh Acres, FL
Pease Productions Corp., Farmington Hills, MI
Peshtigo Boxing Club, Peshtigo, WI
Piedmont Crime Control, Inc., Greensboro, NC
Planet Dog Philanthropy, Portland, ME
Prayer Line, Spanish Fork, UT
Providence Place, Defiance, MO
Recovery Research Foundation, Inc., Jacksonville, FL
Returning Home, Inc., Rialto, CA
Ritoka Foundation, Inc., Houston, TX
RR&N Ministries, Inc., Fayetteville, AR
S W Washington Development Association, Las Vegas, NV
Safe Water International, Carpinteria, CA
Samaritan Housing Foundation IV, Inc., Atlanta, GA
Sav-A-Pet, Franklin, IN
Seaside Helping Hands Services, Seaside, CA
Senior Services Foundation, Inc., Cortez, CO
Seniors Charities, Las Vegas, NV
Seventy Plus Women of Valor, Arlington, TN
Shamel Maurice Strobert & Society, Inc., Stone Mountain, GA
Shekinah Ranch, Fraser, CO
Shepherds Light Harvest Outreach Ministries, Inc., Harvest, AL
Smithville Crime Stoppers, Smithville, TX
Snead Research Institute, Georgetown, TX
Snodgrass Educational Foundation, Chico, CA
South Texas Life Resources, Inc., Falfurrias, TX
Spirit of Padre Pio-Our Lady of Grace Foundation, Califon, NJ
St. Vrain Foundation, Allenspark, CO
Syracuse Holistic Health Council, Syracuse, NY
Szczecin-America Club, Inc., New York, NY
Team Glory Baseball Ministries, Inc., Olive Branch, MS
Teens for Congress, Inc., Anniston, AL
TIPI Center, Santa Fe, NM
Tricity Community Action, Fairfield, CA
Trinity Foundation for Humanity, Rancho Cucamonga, CA
True Heart Christian Camp, Sunfield, MI
UNEED@, Milpitas, CA
United Art Spectrum, Inc., Stockton, CA

United Development Corporation, Ocoee, FL
Unity Training Group, Inc., San Jose, CA
US Friends of NCAD, Inc., Stonington, CT
Vermont Liturgical & Music Association, Inc., Woodstock, VT
Vision Unlimited, Inc., Honesdale, PA
Wauwatosa Mayfair Rotary Club Charities, Inc., Brookfield, WI
Weedy-Rough Design & Environmental Photography, Inc., Paonia, CO
Wenger Grist Mill Foundation, Ephrata, PA
West Central Common Bonds, Glenwood, MN
West High Athletic Alumni Association, Anchorage, AK
Wetohkatowak, Inc., Keshena, WI
Wild Migrations Org., Vancouver, WA
Will A. Waldrop Ministries, Inc., Jacksonville, FL
Williams Economic Development, Inc., Ocala, FL
Wishart Memorial Learning Center, Flushing, NY
Witness, Inc., Albuquerque, NM
Women Helping Women, Aloha, OR
Women of the Most High, Sacto, CA
Woodruff-Adams Foundation, Poplar Bluff, MO
Wound Biotechnology Foundation, Inc., Boston, MA
Wrangel Island Org., Ltd., Centerport, NY
Yorke Development Corporation, Inc., Wildwood, NJ
Youth Motivation Task Force, Compton, CA
Youth Visions, St. George, UT

If an organization listed above submits information that warrants the renewal of its classification as a public charity or as a private operating foundation, the Internal Revenue Service will issue a ruling or determination letter with the revised classification as to foundation status. Grantors and contributors may thereafter rely upon such ruling or determination letter as provided in section 1.509(a)–7 of the Income Tax Regulations. It is not the practice of the Service to announce such revised classification of foundation status in the Internal Revenue Bulletin.

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]

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