Internal Revenue
bulletin

Bulletin No. 2012-28
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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

Rev. Rul. 2012–19, page 16.

Dividends and dividend equivalents on restricted stock and restricted stock units. This ruling addresses whether dividends and dividend equivalents relating to restricted stock and restricted stock units that are performance-based compensation under section 162(m)(4)(C) of the Code must separately satisfy the requirements under section 162(m)(4)(C) to be treated as performance-based compensation.

T.D. 9591, page 32.

Final regulations under section 7874 of the Code provide rules for determining whether a foreign corporation is a surrogate foreign corporation. Specifically, the regulation explains when there is an indirect acquisition of a domestic corporation's properties for purposes of section 7874(a)(2)(B). In addition, the regulation includes a rule that in certain situations, a publicly traded partnership may be treated as a surrogate foreign corporation. The regulation also provides rules for the treatment of options of the surrogate foreign corporation for purposes of section 7874(a)(2)(B)(ii).

T.D. 9592, page 41.
REG–107889–12, page 53.

Temporary and proposed regulations under section 7874 of the Code provide guidance regarding whether a foreign corporation has substantial business activities in the foreign country in which, or under the law of which, the foreign corporation is created or organized.

Notice 2012–44, page 45.

This notice provides guidance regarding certain qualified conservation purposes eligible for financing with qualified energy conservation bonds under section 54D of the Code, particularly (1) how to measure reductions of energy consumption in publicly-owned buildings by at least 20 percent, and (2) what constitutes a "green community program."

Rev. Proc. 2012–29, page 49.

This procedure provides sample language that may be used (but is not required to be used) for making an election under section 83(b) of the Code. Additionally, the procedure provides examples of the income tax consequences of making such an election.

EMPLOYEE PLANS

Rev. Rul. 2012–19, page 16.

Dividends and dividend equivalents on restricted stock and restricted stock units. This ruling addresses whether dividends and dividend equivalents relating to restricted stock and restricted stock units that are performance-based compensation under section 162(m)(4)(C) of the Code must separately satisfy the requirements under section 162(m)(4)(C) to be treated as performance-based compensation.

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Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

ESTATE TAX

T.D. 9593, page 17.
REG–141832–11, page 54.
Temporary and proposed regulations under section 2010 of the Code provide rules for determining the applicable credit amount and applicable exclusion amount allowed to the estate of a decedent against the gift or estate tax. In addition, the regulations provide rules for electing portability of a deceased spousal unused exclusion amount to the surviving spouse and rules regarding the surviving spouse's use of this amount. The portability rules apply to married spouses where the death of the first spouse to die occurs on or after January 1, 2011.

GIFT TAX

T.D. 9593, page 17.
REG–141832–11, page 54.
Temporary and proposed regulations under section 2010 of the Code provide rules for determining the applicable credit amount and applicable exclusion amount allowed to the estate of a decedent against the gift or estate tax. In addition, the regulations provide rules for electing portability of a deceased spousal unused exclusion amount to the surviving spouse and rules regarding the surviving spouse's use of this amount. The portability rules apply to married spouses where the death of the first spouse to die occurs on or after January 1, 2011.

The IRS Mission

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

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

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

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

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

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

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

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

Section 83.—Property Transferred in Connection With Performance of Services

The revenue procedures contains sample language that may be used (but is not required to be used) for making an election under section 83(b) of the Internal Revenue Code. Additionally, the revenue procedure provides examples of the income tax consequences of making such an election. See Rev. Proc. 2012-29, page 49.

Section 162.—Dividends and Dividend Equivalents on Restricted Stock and Restricted Stock Units

26 CFR 1.162–27: Certain employee remuneration in excess of $1,000,000.

Dividends and dividend equivalents on restricted stock and restricted stock units. This ruling addresses whether dividends and dividend equivalents relating to restricted stock and restricted stock units that are performance-based compensation under section 162(m)(4)(C) of the Code must separately satisfy the requirements under section 162(m)(4)(C) to be treated as performance-based compensation.

Rev. Rul. 2012–19

ISSUE

Whether dividends and dividend equivalents relating to restricted stock and restricted stock units (RSUs) that are performance-based compensation under § 162(m)(4)(C) of the Internal Revenue Code must separately satisfy the requirements under § 162(m)(4)(C) to be treated as performance-based compensation.

FACTS

Corporation X and Corporation Y are publicly held corporations within the meaning of § 162(m)(2). Both corporations maintain plans under which participating employees may be granted restricted common stock of the respective corporation or RSUs based upon the common stock of the respective corporation. The restricted stock and RSUs granted under the plans of Corporations X and Y vest upon the attainment of certain preestablished, objective performance goals and otherwise meet the requirements of § 1.162–27(e). Accordingly, the compensation received due to the vesting of the restricted stock and the vesting and payment of the RSUs is qualified performance-based compensation that is excluded from the applicable employee remuneration to which the deduction limitation under § 162(m) applies.

Situation 1. Corporation X's plan provides that dividends and dividend equivalents otherwise payable to an employee during the period from grant through vesting with respect to performance-based restricted stock and RSU awards granted to the employee are accumulated and become vested and payable only if the related performance goals with respect to the restricted stock and RSUs are satisfied. All other requirements of § 1.162–27(e) are met with respect to the grant of rights to dividends and dividend equivalents.

Situation 2. Corporation Y's plan provides for payment to an employee during the period from grant to vesting of dividends and dividend equivalents with respect to performance-based restricted stock and RSU awards granted to the employee at the same time dividends are paid on common stock of Corporation Y regardless of whether the performance goals established with respect to the restricted stock and RSUs are satisfied.

LAW

Section 162(a)(1) allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.

Section 162(m)(1) provides that in the case of any publicly held corporation, no deduction is allowed for applicable employee remuneration with respect to any covered employee to the extent that the amount of the remuneration for the taxable year exceeds $1,000,000.

Section 162(m)(3) provides that the term "covered employee" means any employee of the taxpayer if (i) as of the close of the taxable year, such employee is the chief executive officer of the taxpayer or is an individual acting in such a capacity, or (ii) the total compensation of such employee for the taxable year is required to be reported to shareholders under the Securities Exchange Act of 1934 (Exchange Act) by reason of such employee being among the four highest compensated officers for the taxable year (other than the chief executive officer). See Notice 2007–49, 2007–1 C.B. 1429 (providing changes to the application of this provision based on changes in the Exchange Act compensation disclosure rules).

Section 162(m)(4)(A) defines "applicable employee remuneration," with respect to any covered employee for any taxable year, generally as the aggregate amount allowable as a deduction for the taxable year (determined without regard to § 162(m)) for remuneration for services performed by the employee (whether or not during the taxable year).

Section 162(m)(4)(C) provides that applicable employee remuneration does not include any remuneration payable solely on account of the attainment of one or more performance goals, but only if (i) the performance goals are determined by a compensation committee of the board of directors of the taxpayer which is comprised solely of two or more outside directors, (ii) the material terms under which the remuneration is to be paid, including the performance goals, are disclosed to shareholders and approved by a majority of the vote in a separate shareholder vote before payment of such remuneration, and (iii) before any payment of such remuneration, the compensation committee certifies that the performance goals and other material terms were in fact satisfied. Rules with respect to these requirements are set forth in §§ 1.162–27(e)(2) through (e)(5).

Section 1.162–27(e)(2)(i) provides that qualified performance-based compensation must be paid solely on account of the attainment of one or more preestablished, objective performance goals. Section 1.162–27–(e)(2)(ii) provides that a

preestablished performance goal must state, in terms of an objective formula or standard, the method for computing the amount of compensation payable to the employee if the goal is attained.

Section 1.162–27(e)(2)(iv) provides that the determination of whether compensation satisfies the requirements of § 1.162–27(e)(2) generally is made on a grant-by-grant basis. Section 1.162–27(e)(2)(iv) further provides that, except as provided in § 1.162–27(e)(2)(vi) (relating to stock options and stock appreciation rights), whether a grant of restricted stock or other stock-based compensation satisfies the performance goal requirements is determined without regard to whether dividends, dividend equivalents, or other similar distributions with respect to stock, on such stock-based compensation are payable prior to the attainment of the performance goal. Dividends, dividend equivalents, or other similar distributions with respect to stock that are treated as separate grants under § 1.162–27(e)(2)(iv) are not performance-based compensation unless they separately satisfy the performance goal requirements. Such performance goals may or may not be the same as the performance goals for the related stock-based compensation.

ANALYSIS

Under § 1.162–27(e)(2)(iv), the dividends and dividend equivalents under Corporation X's plan and under Corporation Y's plan are grants of compensation that are separate and apart from the related restricted stock and RSU grants. Therefore, the grants of the dividends and dividend equivalents must separately satisfy the requirements of § 1.162–27(e) to be qualified performance-based compensation.

Situation 1. Under Corporation X's plan, participants' rights to restricted stock and RSUs are subject to performance goals that meet the requirements of § 1.162–27(e) and are excluded from applicable remuneration for purposes of applying the § 162(m)(1) deduction limitation. Under the same plan, participants' rights to dividends and dividend equivalents vest and become payable only if the same performance goals that apply to the related grants of restricted stock and RSUs are satisfied. Therefore, dividends and dividend equivalents under X's plan are also excluded from applicable remuneration for purposes of applying the § 162(m)(1) deduction limitation.

Situation 2. The dividends and dividend equivalents under Corporation Y's plan fail to satisfy the requirements under § 162(m)(4)(C) and § 1.162–27(e) because the rights to these amounts do not vest and become payable solely on account of the attainment of preestablished performance goals. Thus, these amounts are not qualified performance-based compensation, regardless of whether the performance goals are met with respect to the related restricted stock and RSUs.

HOLDINGS

Situation 1. With respect to Corporation X, dividends and dividend equivalents paid under X's plan are qualified-performance based compensation and therefore are excluded from applicable employee remuneration for purposes of applying the $1,000,000 limitation on deductibility under § 162(m)(1).

Situation 2. With respect to Corporation Y, dividends and dividend equivalents paid under Y's plan are not qualified-performance based compensation and therefore are included in applicable employee remuneration for purposes of applying the $1,000,000 limitation on deductibility under § 162(m)(1).

DRAFTING INFORMATION

This revenue ruling was prepared by Dara Alderman of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt & Government Entities). For further information regarding this revenue ruling, contact Ms. Alderman at (202) 622–6030 (not a toll-free call).

Section 2010.—Unified Credit Against Estate Tax

26 CFR 20.2001–2T: Valuation of adjusted taxable gifts for purposes of determining the deceased spousal unused exclusion amount of last deceased spouse (temporary).

T.D. 9593

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 20, 25, and 602

Portability of a Deceased Spousal Unused Exclusion Amount

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations that provide guidance on the estate and gift tax applicable exclusion amount, in general, as well as on the applicable requirements for electing portability of a deceased spousal unused exclusion (DSUE) amount to the surviving spouse and on the applicable rules for the surviving spouse's use of this DSUE amount. The statutory provisions underlying the portability rules were enacted as part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. The portability rules affect married spouses where the death of the first spouse to die occurs on or after January 1, 2011. The text of the temporary regulations also serves as the text of proposed regulations (REG–141832–11) set forth in the notice of proposed rulemaking on this subject appearing elsewhere in this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective on June 15, 2012.

Applicability Dates: Sections of the temporary regulation relating to portability of a deceased spousal unused exclusion amount apply to estates of decedents dying on or after January 1, 2011. For specific dates of applicability, see §§20.2001–2T(b), 20.2010–1T(e), 20.2010–2T(e), 20.2010–3T(f), 25.2505–1T(e), and 25.2505–2T(g).

FOR FURTHER INFORMATION CONTACT: Karlene Lesho (202) 622–3090 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these regulations has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545–0015. Responses to this collection of information are voluntary to obtain the benefit of being able to elect portability or to take advantage of the special reporting requirements applicable to certain assets, and, for certain estates, to opt out of a deemed portability election.

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 control number. For further information concerning this collection of information, and the address for the submission of comments on the collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble of the cross-referencing notice of proposed rulemaking published in this issue of the Bulletin.

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

Background

On December 17, 2010, in section 303 of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Public Law 111–312 (124 Stat. 3296, 3302) (TRUIRJCA), Congress amended section 2010(c) of the Internal Revenue Code (Code) to allow portability of the applicable exclusion amount between spouses, and it made conforming amendments to sections 2505(a), 2631(c), and 6018(a)(1) of the Code. Section 303 of TRUIRJCA directs the Secretary to issue such regulations as may be necessary or appropriate to carry out section 303(a) of TRUIRJCA.

This document contains amendments to the Estate Tax Regulations (26 CFR part 20) under sections 2001 and 2010 of the Code and to the Gift Tax Regulations (26 CFR part 25) under section 2505 of the Code. The temporary regulations address not only the amendments made to section 2010(c) by TRUIRJCA and the conforming amendment to section 2505(a), but also the entirety of sections 2010 and 2505 of the Code for which there are no existing regulations. Finally, the amendment to the Estate Tax Regulations under section 2001 of the Code clarifies the application of the rule in section 2010(c)(5)(B) to section 2001 of the Code.

Section 303(a) of TRUIRJCA

Section 303(a) of TRUIRJCA amends section 2010(c) of the Code by striking paragraph (2) of section 2010(c) and adding new paragraphs (2) through (6) of section 2010(c). Section 2010(c)(2) now defines the applicable exclusion amount, used to determine the applicable credit amount, as the sum of the basic exclusion amount and, in the case of a surviving spouse, the DSUE amount. Section 2010(c)(3) provides that the basic exclusion amount is $5,000,000, to be adjusted for inflation in each year after calendar year 2011. Section 2010(c)(4) defines the DSUE amount to mean the lesser of (A) the basic exclusion amount or (B) the basic exclusion amount of the last deceased spouse of the surviving spouse, less the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse.

Section 2010(c)(5) describes special rules relating to the portability of a DSUE amount. Section 2010(c)(5)(A) provides certain requirements that must be met to allow a surviving spouse to take into account a DSUE amount of a deceased spouse. In particular, the executor of the estate of the deceased spouse must file an estate tax return, compute the DSUE amount on such return, elect portability of the DSUE amount on such return, and ensure that such return is filed within the time prescribed by law (including extensions) for filing such return. Section 2010(c)(5)(B) allows the Secretary to examine a return of the deceased spouse to determine the DSUE amount, even after the expiration of the time provided under section 6501 for assessing a tax under chapter 11 or 12.

Section 2010(c)(6) directs the Secretary to prescribe regulations as may be necessary or appropriate to carry out section 2010(c).

Notice 2011–82

On October 17, 2011, the Department of the Treasury (Treasury) and the IRS issued Notice 2011–82, 2011–42 I.R.B. 516, which can be found on *www.IRS.gov*. Notice 2011–82 alerts taxpayers to the requirements for the estate of a deceased spouse to elect portability of a DSUE amount. In addition, Notice 2011–82 announces that the estate of a deceased spouse will be deemed to elect portability of the DSUE amount by timely filing a complete and properly-prepared estate tax return, and that such return will be deemed to include a computation of the DSUE amount until such time as the IRS revises the estate tax return to expressly contain the DSUE amount computation. Notice 2011–82 also provides guidance to the estates of deceased spouses who choose not to make the portability election. Notice 2011–82 announces that Treasury and the IRS intend to issue regulations to implement section 303 of TRUIRJCA. Accordingly, Treasury and the IRS invited comments on a number of specific issues. Treasury and the IRS received comments on these issues, as well as additional issues identified by commenters. The comments are discussed in more detail in the "Explanation of Provisions" section of this preamble.

Notice 2012–21

On March 3, 2012, Treasury and the IRS issued Notice 2012–21, 2012–10 I.R.B. 450, which can be found on *www.IRS.gov*. Notice 2012–21 grants to qualifying estates a six-month extension of time for filing an estate tax return to elect portability of an unused exclusion amount provided that the qualifying estate files Form 4768, "*Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes*," within 15 months of the decedent's death. A qualifying estate is the estate of a person who died, survived by a spouse, during the first half of calendar year 2011, and whose gross estate has a fair market value that does not exceed $5 million. With the extension granted by this notice, the estate tax return must be filed within 15 months of the decedent's death.

Explanation of Provisions

1. *Rules in Section 2010(a), (b), and (d) of the Code*

The temporary regulations in §20.2010–1T(a) state the general rule of section 2010(a) that an applicable credit amount will be allowed to the estate of every decedent against the estate tax imposed by section 2001. The temporary regulations in §20.2010–1T(b) incorporate the rule in section 2010(b) relating to an adjustment to the applicable credit amount for certain gifts made before 1977. Finally, as provided in section 2010(d), the temporary regulations in §20.2010–1T(c) limit the amount of the allowable credit so that it does not exceed the amount of the estate tax imposed by section 2001.

2. *Explanation of Applicable Terms*

The temporary regulations in §20.2010–1T(d) define terms relevant to computing the credit amount allowable under section 2010. The relevant terms include *applicable credit amount*, *applicable exclusion amount*, *basic exclusion amount*, *DSUE amount*, and *last deceased spouse*.

3. *Making the Portability Election*

a. *Election Required on Estate Tax Return*

The temporary regulations in §20.2010–2T(a) require an executor electing portability to make that election on a timely-filed estate tax return. The last return filed by the due date of the return, including extensions actually granted, will supersede any previously-filed return. Thus, an executor may supersede a previously-filed portability election on a subsequent timely-filed estate tax return if the executor satisfies the requirement in §20.2010–2T(a)(3)(i). But see §20.2010–2T(a)(6) when contrary elections are made by more than one person permitted to make the election. The temporary regulations in §20.2010–2T(a)(4) provide that a portability election is irrevocable once the due date (as extended) of the return has passed.

b. *Timely Filing Required*

For a valid portability election, section 2010(c)(5) requires the executor to make the election on an estate tax return filed within the "time prescribed by law" (including extensions) for filing that return. Section 6075(a) requires the filing of an estate tax return made under section 6018(a) within 9 months of the date of the decedent's death. Section 6018(a) requires an estate tax return to be filed when the gross estate of a citizen or resident exceeds the excess (if any) of the basic exclusion amount in effect under section 2010(c) in the calendar year of the decedent's death over the sum of the decedent's adjusted taxable gifts as defined in section 2001(b) and the amount allowed to the decedent as a specific exemption under section 2521 as in effect prior to its repeal by the Tax Reform Act of 1976.

A commenter on Notice 2011–82 noted that neither section 2010(c)(5)(A) nor any other section of the Code provides a "time prescribed by law" for filing an estate tax return on behalf of a decedent's estate when the basic exclusion amount exceeds the value of the decedent's gross estate. Accordingly, the commenter requested that the regulations clarify the meaning of "time prescribed by law" as it applies in section 2010(c)(5)(A).

For executors who are required to file an estate tax return under section 6018(a), section 6075(a) requires the executor to file the estate tax return within nine months after the decedent's date of death. When an executor is not required to file an estate tax return under section 6018(a), the Code does not specify a due date for a return filed for the purpose of making the portability election. The temporary regulations in §20.2010–2T(a)(1) require every estate electing portability of a decedent's DSUE amount to file an estate tax return within 9 months of the decedent's date of death, unless an extension of time for filing has been granted. (See Notice 2012–21 providing for an extension of time to file an estate tax return for the estates of certain decedents who died in the first half of calendar year 2011.) This timing requirement for filing a return applies to all estates electing portability regardless of the size of the gross estate. The temporary regulations provide in §20.2010–2T(a)(1) that an estate choosing to elect portability will be considered for purposes of Subtitle B and Subtitle F of the Code to be required to file a return under section 6018(a).

This rule will benefit the IRS as well as taxpayers choosing the benefit of portability because the records required to compute and verify the DSUE amount are more likely to be available at the time of the death of the first deceased spouse than at the time of a subsequent transfer by the surviving spouse by gift or at death, which could occur many years later. This rule also is consistent with the "Technical Explanation of the Revenue Provisions Contained in the 'Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010' Scheduled for Consideration by the United States Senate," J. Comm. On Taxation, 111th Cong., JCX–55–10 (Dec. 10, 2010) (Technical Explanation), which suggests that estates deciding to elect portability that are not otherwise required to file an estate tax return under section 6018(a) are intended to be subject to the same timely-filing requirements applicable to estates required to file an estate tax return under section 6018(a). The Technical Explanation states that the DSUE amount is available to a surviving spouse "only if an election is made on a timely filed estate tax return (including extensions) of the predeceased spouse . . . regardless of whether the predeceased spouse otherwise is required to file an estate tax return." JCX–55–10, page 52; see also "General Explanation of Tax Legislation Enacted in the 111th Congress," J. Comm. On Taxation, 111th Cong., JCS–2–11, pages 554–555 (March 2011) (General Explanation) (incorporating the same language from the Technical Explanation).

c. *Portability Election upon Filing of "Complete and Properly-Prepared" Estate Tax Return*

Notice 2011–82 provides that the estate of a decedent dying after December 31, 2010, will be deemed to make the portability election upon the timely filing of a "complete and properly-prepared" estate tax return. The temporary regulations in §20.2010–2T(a)(2) provide that the estate of a decedent (survived by a spouse) makes the portability election by timely filing a complete and properly-prepared estate tax return for the decedent's estate.

Several commenters responding to Notice 2011–82 requested that Treasury and the IRS define what is meant by a "com-

plete and properly-prepared" estate tax return. Commenters further requested that Treasury and the IRS consider the cost and burden associated with filing an estate tax return and establishing and substantiating the values reported on such return for those estates that are not required to file a return under section 6018(a) but are filing such a return solely to elect portability of the decedent's DSUE amount.

The temporary regulations in §20.2010–2T(a)(7)(i) provide that an estate tax return prepared in accordance with all applicable requirements is considered a "complete and properly-prepared" estate tax return. The temporary regulations in §20.2010–2T(a)(7)(ii), however, provide that executors of estates that are not otherwise required to file an estate tax return under section 6018(a) do not have to report the value of certain property that qualifies for the marital or charitable deduction. If an executor chooses to make use of this special rule in filing an estate tax return, the executor must estimate the total value of the gross estate (including the values of the property that do not have to be reported on the estate tax return under this provision), based on a determination made in good faith and with due diligence regarding the value of all of the assets includible in the gross estate. The instructions issued with respect to the estate tax return ("Instructions for Form 706") will provide ranges of dollar values, and the executor must identify on the estate tax return the particular range within which falls the executor's best estimate of the total gross estate. An amount corresponding to this range will be included on line 1, part 2, of the estate tax return, along with an indication of whether the line 1 total includes an estimate under this special rule. By signing the return, the executor is certifying, under penalties of perjury, that the estimate falls within the identified range of values to the best of the executor's knowledge and belief. The inquiry required to determine the executor's best estimate is the same an executor of any estate must make under current law to determine whether the estate has a filing obligation pursuant to section 6018(a); that is, to determine whether the fair market value of the gross estate exceeds the excess of the basic exclusion amount over the sum of the decedent's adjusted taxable gifts and the amount allowed to the decedent as a specific exemption under section 2521.

d. *Opting Out of Portability Election*

If the executor of the estate of a decedent with a surviving spouse does not wish to make the portability election, the temporary regulations in §20.2010–2T(a)(3) require the executor to make an affirmative statement on the estate tax return signifying the decision to have the portability election not apply. If no estate tax return is required for that decedent's estate under section 6018(a), not filing a timely return will be considered to be an affirmative statement signifying the decision not to make a portability election.

e. *Executor Responsible For Making Portability Election*

A commenter responding to Notice 2011–82 suggested that the temporary regulations allow a surviving spouse to file an estate tax return on behalf of a decedent independently of a duly-appointed executor if the surviving spouse notifies the executor of the intention to file and the executor does not, in fact, file a return. Section 2010(c)(5), however, permits only the executor of the decedent's estate to file the estate tax return and make the portability election. Section 2203 defines the term "executor" for purposes of the estate tax to mean "the executor or administrator of the decedent, or, if there is no executor or administrator appointed, qualified, and acting within the United States, then any person in actual or constructive possession of any property of the decedent."

The temporary regulations in §20.2010–2T(a)(6)(i) provide that an executor or administrator that is appointed, qualified, and acting within the United States for the decedent's estate (an appointed executor), may file an estate tax return to elect portability or to opt to have the portability election not apply. The temporary regulations in §20.2010–2T(a)(6)(ii) provide that, if there is no appointed executor, any person in actual or constructive possession of any property of the decedent may file the estate tax return to elect portability or to opt to have the portability election not apply. The temporary regulations in §20.2010–2T(a)(6)(ii) refer to such a person as a "non-appointed executor" and provide that a portability election made by a non-appointed executor cannot be superseded by a contrary election made by another non-appointed executor of that same decedent's estate.

4. *Computing the DSUE Amount*

a. *Computation Required On Estate Tax Return to Elect Portability*

The temporary regulations in §20.2010–2T(b)(1) require that an executor include a computation of the DSUE amount on the estate tax return of the decedent to allow portability of that decedent's DSUE amount. A complete and properly-prepared return contains the information required to compute a decedent's DSUE amount. Accordingly, in a transitional rule consistent with Notice 2011–82, the temporary regulations in §20.2010–2T(b)(2) provide that the IRS will deem the required computation of the decedent's DSUE amount to have been made on an estate tax return that is considered complete and properly-prepared. The temporary regulations further clarify that, once the IRS revises the prescribed form for the estate tax return expressly to include the computation of the DSUE amount, executors that previously filed an estate tax return pursuant to the transitional rule will not be required to file a supplemental estate tax return using the revised form.

b. *Method of Computing the DSUE Amount*

Section 2010(c)(4) defines the DSUE amount as the lesser of (A) the basic exclusion amount, or (B) the excess of (i) the basic exclusion amount of the last deceased spouse of the surviving spouse, over (ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse.

The temporary regulations in §20.2010–2T(c)(1)(i) confirm that the term "basic exclusion amount" referred to in section 2010(c)(4)(A) means the basic exclusion amount in effect in the year of the death of the decedent whose DSUE amount is being computed. Generally, only the basic exclusion amount of the decedent, as in effect in the year of the decedent's death, will be known at the time the DSUE amount must be computed

and reported on the decedent's estate tax return. Because section 2010(c)(5)(A) requires the executor of an estate electing portability to compute and report the DSUE amount on a timely-filed estate tax return, and because the basic exclusion amount is integral to this computation, the term "basic exclusion amount" in section 2010(c)(4)(A) necessarily refers to such decedent's basic exclusion amount.

In responding to Notice 2011–82, several commenters also argued that the reference to "basic exclusion amount" in section 2010(c)(4)(B)(i) should be interpreted to mean "applicable exclusion amount," citing to the computation of the DSUE amount in *Example 3* on page 53 of the Technical Explanation and to footnote 1582A that was added to the General Explanation by the "ERRATA — 'General Explanation of Tax Legislation Enacted in the 111th Congress'" (ERRATA). JCX–20–11, at page 1. *Example 3* computes the DSUE amount of a deceased spouse who was preceded in death by one spouse and was survived by another spouse. The deceased spouse's DSUE amount is computed using the applicable exclusion amount rather than the basic exclusion amount of the deceased spouse (as reduced by the amount of the deceased spouse's taxable estate). *Example 3* is reproduced verbatim in the General Explanation. See JCS–2–11 at page 555. The ERRATA acknowledges that section 2010(c)(4)(B)(i) uses the term basic exclusion amount, but notes that "[a] technical correction may be necessary to replace the reference to the basic exclusion amount of the last deceased spouse of the surviving spouse with a reference to the applicable exclusion amount of such last deceased spouse, so that the statute reflects intent." JCX–20–11, at page 1, n. 1582A.

Treasury and the IRS have carefully considered this issue. Construing the language of section 2010(c)(4)(B)(i) as referring to the same number described in section 2010(c)(4)(A) would lead to an illogical result because it would effectively render the use of "basic exclusion amount" in section 2010(c)(4)(A) meaningless. Specifically, the basic exclusion amount (the amount referenced in section 2010(c)(4)(A)) cannot be less than that same number reduced by another number (the amount referenced in section 2010(c)(4)(B)). Under such an interpretation, the basic exclusion amount referenced in section 2010(c)(4)(A) could not limit or impact the DSUE amount, and thus it would serve no purpose as written. Based on the principle that a statute should not be construed in a manner that renders a provision of that statute superfluous and consistent with the indicia of legislative intent reflected in the Technical Explanation and the General Explanation, and in the exercise of the express authority granted by Congress in sections 2010(c)(6) and 7805, Treasury and the IRS have determined that the reference in section 2010(c)(4)(B)(i) to the basic exclusion amount is properly interpreted to mean the applicable exclusion amount. Thus, the temporary regulations adopt this interpretation.

c. *Effect of Gift Taxes Paid and Payable on Computing the DSUE Amount*

Several commenters on Notice 2011–82 suggested that, for purposes of computing the DSUE amount under section 2010(c)(4), the amount referred to in section 2010(c)(4)(B)(ii), which is the amount on which the decedent's tentative tax is determined under section 2001(b)(1), be construed to take into account gift tax paid by such decedent. The commenters noted that, to avoid using exclusion for amounts on which gift tax was paid, this construction should apply in computing the DSUE amount of such a decedent if (1) gift tax was paid by a decedent on transfers that caused the total of his or her taxable transfers to exceed the applicable exclusion amount at the time of the transfer, and (2) the total adjusted taxable gifts of the decedent is less than the applicable exclusion amount on the date of his or her death. The temporary regulations in §20.2010–2T(c)(2) provide that amounts on which gift taxes were paid by a decedent are excluded from adjusted taxable gifts for the purpose of computing that decedent's DSUE amount.

d. *Potential Impact of Credits in Sections 2013 — 2015 on the DSUE Amount*

Commenters on Notice 2011–82 asked for clarification as to whether the DSUE amount is determined before or after the application of other available credits, such as the credit for tax on prior transfers (section 2013), the credit for foreign death taxes (section 2014), and the credit for death taxes on remainders (section 2015). The issue of the impact of the credits in sections 2013 to 2015 on computing the DSUE amount merits further consideration. The temporary regulations reserve §20.2010–2T(c)(3) to provide future guidance on this issue. Treasury and the IRS request comments regarding appropriate rules to coordinate these credits with portability of the exclusion. For the manner of submitting these comments, see the notice of proposed rulemaking on this subject appearing elsewhere in this issue of the Bulletin.

5. *Use of the DSUE Amount by the Surviving Spouse*

a. *Date DSUE Amount May Be Taken into Consideration by Surviving Spouse*

Commenters on Notice 2011–82 asked for clarification on when the DSUE amount of a decedent is available to the surviving spouse or to the surviving spouse's estate for use in determining the surviving spouse's applicable exclusion amount. The temporary regulations in §§20.2010–3T(a) and 25.2505–2T(a) provide that, if the decedent is the last deceased spouse of the surviving spouse on the date of a transfer by the surviving spouse that is subject to gift or estate tax, the surviving spouse, or the estate of the surviving spouse, of that decedent may take into account that decedent's DSUE amount in determining the applicable exclusion amount of the surviving spouse when computing the surviving spouse's gift or estate tax liability on that transfer. This rule applies only if the decedent's executor elected portability. In addition, the temporary regulations in §§20.2010–3T(c)(1) and 25.2505–2T(d)(1) provide that a portability election made by the executor of a decedent's estate is effective as of the date of the decedent's death. Thus, the DSUE amount of a decedent survived by a spouse may be included in determining the applicable exclusion amount of the surviving spouse under section 2010(c)(2), subject to any applicable limitations, with respect to all transfers occurring after the death of the decedent, if the executor of the decedent's estate makes a portability election and the election is not superseded

by the executor of the decedent's estate before the due date of the return, including extensions.

b. *Last Deceased Spouse Limitation on DSUE Amount Available to Surviving Spouse*

Some commenters responding to Notice 2011–82 suggested that the regulations clarify the scope of the last deceased spouse limitation in section 2010(c)(4)(B)(i). The temporary regulations in §20.2010–1T(d)(5) explain that the term "last deceased spouse" referred to in section 2010(c)(4)(B)(i) means the most recently deceased individual who was married to the surviving spouse at that individual's death, except that an individual dying before calendar year 2011 cannot be considered the last deceased spouse of such surviving spouse. The temporary regulations in §§20.2010–3T(a)(3) and 25.2505–2T(a)(3) clarify that remarriage alone does not affect who will be considered the last deceased spouse and does not prevent the surviving spouse from including in the surviving spouse's applicable exclusion amount the DSUE amount of the deceased spouse who most recently preceded the surviving spouse in death. The temporary regulations further clarify that the identity of the last deceased spouse of the surviving spouse for purposes of portability is not affected by whether the estate of the last deceased spouse elects portability of the deceased spouse's DSUE amount or whether the last deceased spouse has any DSUE amount available. This is consistent with the statutory language, which refers to the "last deceased spouse of such surviving spouse" without further qualification, as well as with the Technical Explanation, which states that "[t]he last deceased spouse limitation applies whether or not the last deceased spouse has any unused exclusion or the last deceased spouse's estate makes a timely election." JCX–55–10, at page 52, n. 57; see also General Explanation, JCS–2–11, at page 554, n. 1582.

For purposes of determining the applicable credit amount under section 2505(a)(1), a commenter asked Treasury and the IRS to clarify when one determines the identity of the last deceased spouse. Although section 2505(a)(1) refers to the applicable credit amount in effect under section 2010(c) as would apply if the donor died as of the end of the calendar year, this does not mean that the identity of the last deceased spouse is subject to change for purposes of computing the surviving spouse's applicable exclusion amount if the surviving spouse is preceded in death by a subsequent spouse after the gift transfer but before the end of the calendar year. Therefore, the temporary regulations provide in §25.2505–2T(a) that for purposes of determining a surviving spouse's applicable exclusion amount when the surviving spouse makes a taxable gift, the surviving spouse's last deceased spouse is identified as of the date of the taxable gift. See §20.2010–3T(a) for a comparable rule for estate tax purposes.

c. *DSUE Amount Available in Case of Multiple Spouses and Previously-Applied DSUE Amount*

Some commenters responding to Notice 2011–82 requested that the regulations clarify the outcome when a surviving spouse is preceded in death by more than one spouse. In particular, commenters asked how the DSUE amount to be included in the applicable exclusion amount of a surviving spouse is affected when a decedent who is currently considered the last deceased spouse of such surviving spouse either has no DSUE amount or has a smaller amount of DSUE in comparison to a decedent who previously was considered the last deceased spouse of such surviving spouse. The temporary regulations clarify that, in either situation, the surviving spouse may not apply any remaining DSUE amount from a prior deceased spouse.

In addition, the temporary regulations address how to compute the DSUE amount included in the applicable exclusion amount of a surviving spouse who made gifts between the deaths of two decedents, each of whom were at separate times the last deceased spouse of such surviving spouse. First, the temporary regulations in §25.2505–2T(b) create an ordering rule by providing that, when a surviving spouse makes a taxable gift, the DSUE amount of the decedent who is the last deceased spouse of such surviving spouse will be considered to apply against the amount of the surviving spouse's taxable gifts for that calendar year before the surviving spouse's own basic exclusion amount will apply.

Second, the temporary regulations, in §§25.2505–2T(c) and 20.2010–3T(b), compute the DSUE amount available to such a surviving spouse or to his or her estate, respectively, as including both: (i) the DSUE amount of the surviving spouse's last deceased spouse, and (ii) any DSUE amount actually applied to taxable gifts pursuant to the rule in §25.2505–2T(b) to the extent the DSUE amount so applied was from a decedent who no longer is the last deceased spouse for purposes of section 2010(c)(4)(B)(i). Under the rules in §25.2505–2T, a surviving spouse may use the DSUE amount of a predeceased spouse as long as, for each transfer, such DSUE amount is from the surviving spouse's last deceased spouse at the time of that transfer. Thus, a spouse who has survived multiple spouses may use each last deceased spouse's DSUE amount before the death of that spouse's next spouse, and thereby may apply the DSUE amount of multiple deceased spouses in succession. However, this does not permit the surviving spouse to use the sum of the DSUE amounts of those deceased spouses at one time, and a surviving spouse may not use the remaining DSUE amount of a prior deceased spouse following the death of a subsequent spouse.

6. *Authority to Examine Returns of Deceased Spouses*

Section 2010(c)(5)(B) confirms the IRS's authority to examine returns of each deceased spouse of the surviving spouse to determine the allowable DSUE amount even if the period of limitations on assessment under section 6501 has expired for the tax under chapters 11 or 12 with respect to such returns.

Section 7602(a) provides that the IRS may examine any books, papers, records, or other data which may be relevant or material to an inquiry for the purpose of ascertaining the accuracy of any return or determining the liability of any person for any internal revenue tax or liability. The returns of each deceased spouse whose executor elected portability are relevant or material to the determination of the allowable DSUE amount to be applied by the surviving spouse to a taxable transfer.

Accordingly, the temporary regulations confirm in §§20.2001–2T(a), 20.2010–2T(d), 20.2010–3T(d), and 25.2505–2T(e) that, in determining the allowable DSUE amount, the IRS may examine any one or more returns of each deceased spouse of the surviving spouse whose executor elected portability. Upon examination, the IRS may adjust or eliminate the DSUE amount reported on a return; however, the IRS may make an assessment of additional tax with respect to the deceased spouse's return only within the period of limitations under section 6501. The ability of the IRS to examine returns of a deceased spouse applies to each transfer by the surviving spouse to which a DSUE amount is or has been applied. The returns and return information of a deceased spouse may be disclosed to the surviving spouse or the surviving spouse's estate as appropriate under section 6103.

A commenter to Notice 2011–82 suggested that the regulations clarify whether the IRS's authority to examine returns even after the period of limitations on assessment has expired, as confirmed in section 2010(c)(5)(B), would suspend the substantive review and examination of the estate tax return of a decedent with a surviving spouse. Except to the extent provided in section 2010(c)(5)(B) with regard to the computation of the DSUE amount, the limitation in section 6501 continues to apply to the estate tax return so examination of the estate tax return will not be suspended solely because of the possibility of future reviews to determine the decedent's DSUE amount.

7. *Applicability of Portability Rules to Nonresidents Who Are Not Citizens*

Several commenters requested that the regulations clarify the applicability of the rules in section 2010(c) to estates of nonresidents who are not citizens. In response to these comments, the temporary regulations provide in §20.2010–2T(a)(5) that an executor of the estate of a nonresident decedent who was not a citizen of the United States at the time of death may not make a portability election on behalf of that decedent. The temporary regulations in §§20.2010–3T(e) and 25.2505–2T(f) provide that a nonresident surviving spouse who was not a citizen of the United States at the time of such surviving spouse's death may not take into account the DSUE amount of any deceased spouse of such surviving spouse, except to the extent allowed under a treaty obligation of the United States.

8. *Applicability of Portability in Case of Qualified Domestic Trusts*

A commenter suggested that the regulations clarify how the portability rules apply when a qualified domestic trust (QDOT) (defined in section 2056A(a)) is created for the benefit of a surviving spouse who is a not a citizen of the United States. When property of a decedent passes to a QDOT, the decedent's estate is allowed a marital deduction under section 2056(d)(2) for the value of such property. Ultimately, however, estate tax is imposed on such property under section 2056A as distributions constituting taxable events are made from the QDOT. The estate tax imposed by section 2056A is the decedent's estate tax liability, and that tax generally equals the amount of additional estate tax that would have been imposed under section 2001 if the amount involved in the taxable event had been included in the decedent's taxable estate and had not been deductible under section 2056. See §20.2056A–5(a). The estate tax that would have been imposed under section 2001 is computed by determining the net tax under section 2001 after the allowance of any credits, including the applicable credit amount determined under section 2010(c). Consequently, when a QDOT has been created for the benefit of a decedent's surviving spouse, the executor of the decedent's estate will compute a DSUE amount, on a preliminary basis, that may decrease as distributions constituting taxable events under section 2056A are made.

Commenters made several suggestions for applying portability to this situation. One proposal is to allow a decedent's DSUE amount to be computed and available to the surviving spouse as of the date of death of the decedent, without regard to the estate tax to be imposed by section 2056A. A second suggestion is to allow an executor of such an estate to elect portability with respect to only a portion of the DSUE amount so that an executor could reserve a portion of the decedent's DSUE amount for the estate tax to be imposed by section 2056A. A third proposal is to allow the decedent's applicable exclusion amount and the initially-determined DSUE amount to be applied on a chronological, or first come, first served, basis; that is, by applying the decedent's applicable exclusion amount on the occurrence of a taxable event subject to the estate tax imposed by section 2056A and at the time of a transfer by the surviving spouse subject to the gift tax imposed by section 2501, in each case, to the extent applicable exclusion amount or DSUE amount, respectively, is available at such times.

Each of the proposals raises issues of fairness, complexity, and administrability. The applicable exclusion amount first and foremost belongs to the decedent. Portability of a DSUE amount allows a surviving spouse to use a decedent's exclusion amount only to the extent it is not used by that decedent. Accordingly, the temporary regulations allow the decedent's estate full availability of the decedent's applicable exclusion amount until such time as the final estate tax liability of the decedent is computed. The temporary regulations in §20.2010–2T(c)(4) provide that the executor of a decedent's estate claiming a marital deduction for property passing to a QDOT shall compute the decedent's DSUE amount on a preliminary basis on the decedent's estate tax return for the purpose of electing portability, although such amount subsequently will be reduced by the estate tax imposed by section 2056A. The temporary regulations further provide that the DSUE amount of such a decedent shall be redetermined upon the final distribution or other taxable event on which estate tax under section 2056A is imposed, which is generally upon the death of the surviving spouse or the earlier termination of all QDOTs created for that surviving spouse. The temporary regulations provide in §20.2010–3T(c)(2) that the earliest date such a decedent's DSUE amount may be included in determining the applicable exclusion amount available to the surviving spouse or the surviving spouse's estate is the date of the event that triggers the final estate tax liability of the decedent under section 2056A. Generally, this means that such a decedent's DSUE amount will be available for transfers occurring by reason of the surviving spouse's death, but generally will not be available to the surviving spouse during life. However, the decedent's DSUE amount

will be available to apply to the surviving spouse's taxable gifts made in the year of the surviving spouse's death, or, if the event terminating the QDOT occurs prior to the surviving spouse's death, then in the year of that terminating event and/or any subsequent year during the surviving spouse's life. Treasury and the IRS request further comments on this issue. For the manner of submitting these comments, see the notice of proposed rulemaking on this subject appearing elsewhere in this issue of the Bulletin.

Special Analyses

It has been determined that this Treasury decision is not considered a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. In addition, section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations because they are excepted from the notice and comment requirements of section 553(b) and (c) of the Administrative Procedure Act under the interpretive rule and good cause exceptions provided by section 553(b)(3)(A) and (B) of that Act. These regulations are necessary to provide immediate guidance to estates of a decedent with a surviving spouse and to spouses surviving such a decedent on the application of the portability rules of section 2010(c), which applies to estates of decedents dying and gifts made after December 31, 2010. These regulations provide necessary guidance to address fundamental issues concerning the portability election, the computation of the DSUE amount, the identity of the last deceased spouse, and the application of the DSUE amount by the surviving spouse. In addition, the issues addressed by the regulations have been publicly noticed and subject to comment through the publication of Notice 2011–82. For these reasons, good cause exists for dispensing with notice and public comment pursuant to section 553(b) and (c) of the Administrative Procedure Act. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), please refer to the Special Analyses section of the preamble to the cross-referenced notice of proposed rulemaking published in this issue of the Bulletin. Pursuant to section 7805(f) of the Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these temporary regulations is Karlene Lesho, Office of the Associate Chief Counsel (Passthroughs and Special Industries). Other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR parts 20, 25, and 602 are amended as follows:

PART 20—ESTATE TAX; ESTATE OF DECEDENTS DYING AFTER AUGUST 16, 1954

Paragraph 1. The authority citation for part 20 is amended by adding entries in numerical order to read as follows:

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

Section 20.2010–0T also issued under 26 U.S.C. 2010(c)(6).

Section 20.2010–1T also issued under 26 U.S.C. 2010(c)(6).

Section 20.2010–2T also issued under 26 U.S.C. 2010(c)(6).

Section 20.2010–3T also issued under 26 U.S.C. 2010(c)(6). * * *

Par. 2. Section 20.2001–2T is added to read as follows:

§20.2001–2T Valuation of adjusted taxable gifts for purposes of determining the deceased spousal unused exclusion amount of last deceased spouse (temporary).

(a) *General rule*. Notwithstanding §20.2001–1(b), see §§20.2010–2T(d) and 20.2010–3T(d) for additional rules regarding the authority of the Internal Revenue Service to examine any gift or other tax return(s), even if the time within which a tax may be assessed under section 6501 has expired, for the purpose of determining the deceased spousal unused exclusion (DSUE) amount available under section 2010(c) of the Internal Revenue Code (Code).

(b) *Effective/applicability date*. Paragraph (a) of this section applies to the estates of decedents dying in calendar year 2011 or a subsequent year in which the applicable exclusion amount is determined under section 2010(c) of the Code by adding the basic exclusion amount and, in the case of a surviving spouse, the DSUE amount.

(c) *Expiration date*. The applicability of this section expires on or before June 15, 2015.

Par. 3. Section 20.2010–0T is added to read as follows:

§20.2010–0T Table of contents (temporary).

This section lists the table of contents for §§20.2010–1T through 20.2010–3T.

§20.2010–1T Unified credit against estate tax; in general (temporary).

(a) General rule.

(b) Special rule in case of certain gifts made before 1977.

(c) Credit limitation.

(d) Explanation of terms.

(1) Applicable credit amount.

(2) Applicable exclusion amount.

(3) Basic exclusion amount.

(4) Deceased spousal unused exclusion (DSUE) amount.

(5) Last deceased spouse.

(e) Effective/applicability date.

(f) Expiration date.

§20.2010–2T Portability provisions applicable to estate of a decedent survived by a spouse (temporary).

(a) Election required for portability.

(1) Timely filing required.

(2) Portability election upon filing of estate tax return.

(3) Portability election not made; requirements for election not to apply.

(4) Election irrevocable.

(5) Estates eligible to make the election.

(6) Persons permitted to make the election.

(7) Requirements of return.

(b) Computation required for portability election.

(1) General rule.

(2) Transitional rule.

(c) Computation of the DSUE amount.

(1) General rule.

(2) Special rule to consider gift taxes paid by decedent.

(3) [Reserved]

(4) Special rule in case of property passing to qualified domestic trust.

(5) Examples.

(d) Authority to examine returns of decedent.

(e) Effective/applicability date.

(f) Expiration date.

§20.2010–3T Portability provisions applicable to the surviving spouse's estate (temporary).

(a) Surviving spouse's estate limited to DSUE amount of last deceased spouse.

(1) In general.

(2) No DSUE amount available from last deceased spouse.

(3) Identity of last deceased spouse unchanged by subsequent marriage or divorce.

(b) Special rule in case of multiple deceased spouses and a previously-applied DSUE amount.

(1) In general.

(2) Example.

(c) Date DSUE amount taken into consideration by surviving spouse's estate.

(1) General rule.

(2) Special rule when property passes to surviving spouse in a qualified domestic trust.

(d) Authority to examine returns of deceased spouses.

(e) Availability of DSUE amount for estates of nonresidents who are not citizens.

(f) Effective/applicability date.

(g) Expiration date.

Par. 4. Section 20.2010–1T is added to read as follows:

§20.2010–1T Unified credit against estate tax; in general (temporary).

(a) *General rule*. Section 2010(a) allows the estate of every decedent a credit against the estate tax imposed by section 2001. The allowable credit is the applicable credit amount. See paragraph (d)(1) of this section for an explanation of the term *applicable credit amount*.

(b) *Special rule in case of certain gifts made before 1977*. The applicable credit amount allowable under paragraph (a) of this section must be reduced by an amount equal to 20 percent of the aggregate amount allowed as a specific exemption under section 2521 (as in effect before its repeal by the Tax Reform Act of 1976) for gifts made by the decedent after September 8, 1976, and before January 1, 1977.

(c) *Credit limitation*. The applicable credit amount allowed under paragraph (a) of this section cannot exceed the amount of the estate tax imposed by section 2001.

(d) *Explanation of terms*. The explanation of terms in this section applies to this section and to §§20.2010–2T and 20.2010–3T.

(1) *Applicable credit amount*. The term *applicable credit amount* refers to the allowable credit against estate tax imposed by section 2001 and gift tax imposed by section 2501. The applicable credit amount equals the amount of the tentative tax that would be determined under section 2001(c) if the amount on which such tentative tax is to be computed were equal to the applicable exclusion amount. The applicable credit amount is determined by applying the unified rate schedule in section 2001(c) to the applicable exclusion amount.

(2) *Applicable exclusion amount*. The *applicable exclusion amount* equals the sum of the basic exclusion amount and, in the case of a surviving spouse, the deceased spousal unused exclusion (DSUE) amount.

(3) *Basic exclusion amount*. The *basic exclusion amount* is the sum of—

(i) For any decedent dying in calendar year 2011, $5,000,000; and

(ii) For any decedent dying after calendar year 2011, $5,000,000 multiplied by the cost-of-living adjustment determined under section 1(f)(3) for that calendar year by substituting "calendar year 2010" for "calendar year 1992" in section 1(f)(3)(B) and by rounding to the nearest multiple of $10,000.

(4) *Deceased spousal unused exclusion (DSUE) amount*. The term *DSUE amount* refers, generally, to the unused portion of a decedent's applicable exclusion amount to the extent this amount does not exceed the basic exclusion amount in effect in the year of the decedent's death. For rules on computing the DSUE amount, see §§20.2010–2T(c) and 20.2010–3T(b).

(5) *Last deceased spouse*. The term *last deceased spouse* means the most recently deceased individual who, at that individual's death after December 31, 2010, was married to the surviving spouse. See §§20.2010–3T(a) and 25.2505–2T(a) of this chapter for additional rules pertaining to the identity of the last deceased spouse for purposes of determining the applicable exclusion amount of the surviving spouse.

(e) *Effective/applicability date*. Paragraphs (d)(2), (d)(3), (d)(4), and (d)(5) of this section apply to the estates of decedents dying in calendar year 2011 or a subsequent year in which the applicable exclusion amount is determined under section 2010(c) of the Internal Revenue Code by adding the basic exclusion amount and, in the case of a surviving spouse, the DSUE amount. Paragraphs (a), (b), (c), and (d)(1) of this section apply to the estates of decedents dying on or after June 15, 2012.

(f) *Expiration date*. The applicability of this section expires on or before June 15, 2015.

Par. 5. Section 20.2010–2T is added to read as follows:

§20.2010–2T Portability provisions applicable to estate of a decedent survived by a spouse (temporary).

(a) *Election required for portability*. To allow a decedent's surviving spouse to take into account that decedent's deceased spousal unused exclusion (DSUE) amount, the executor of the decedent's estate must elect portability of the DSUE amount on a timely-filed Form 706, "*United States Estate (and Generation-Skipping Transfer) Tax Return*" (estate tax return). This election is referred to in this section and in §20.2010–3T as the portability election.

(1) *Timely filing required*. An estate that elects portability will be considered, for purposes of Subtitle B and Subtitle F of the Internal Revenue Code (Code), to be required to file a return under section 6018(a). Accordingly, the due date of an estate tax return required to elect portability is 9 months after the decedent's date of death or the last day of the period covered by an extension (if an extension of time for filing has been obtained). See §§20.6075–1 and 20.6081–1 for additional rules relating to the time for filing estate tax returns.

(2) *Portability election upon filing of estate tax return*. Upon the timely filing of a complete and properly-prepared estate tax return, an executor of an estate of a decedent (survived by a spouse) will have elected portability of the decedent's DSUE amount unless the executor chooses not to

elect portability and satisfies the requirement in paragraph (a)(3)(i) of this section. See paragraph (a)(7) of this section for the return requirements related to the portability election.

(3) *Portability election not made; requirements for election not to apply*. The executor of the estate of a decedent (survived by a spouse) will not make or be considered to make the portability election if either of the following applies:

(i) The executor states affirmatively on a timely-filed estate tax return, or in an attachment to that estate tax return, that the estate is not electing portability under section 2010(c)(5). The manner in which the executor may make this affirmative statement on the estate tax return will be as set forth in the instructions issued with respect to such form ("Instructions for Form 706").

(ii) The executor does not timely file an estate tax return in accordance with paragraph (a)(1) of this section.

(4) *Election irrevocable*. An executor of the estate of a decedent (survived by a spouse) who timely files an estate tax return may make and may supersede a portability election previously made, provided that the estate tax return reporting the decision not to make a portability election is filed on or before the due date of the return, including extensions actually granted. However, see paragraph (a)(6) of this section when contrary elections are made by more than one person permitted to make the election. The portability election, once made, becomes irrevocable once the due date of the estate tax return, including extensions actually granted, has passed.

(5) *Estates eligible to make the election*. An executor may elect portability on behalf of the estate of a decedent (survived by a spouse) if the decedent dies in calendar year 2011 or during a subsequent period in which portability of a DSUE amount is in effect. However, an executor of the estate of a nonresident decedent who was not a citizen of the United States at the time of death may not elect portability on behalf of that decedent, and the timely filing of such a decedent's estate tax return will not constitute the making of a portability election.

(6) *Persons permitted to make the election*—(i) *Appointed executor*. An executor or administrator of the estate of a decedent (survived by a spouse) that is appointed, qualified, and acting within the United States, within the meaning of section 2203 (an appointed executor), may file the estate tax return on behalf of the estate of the decedent and, in so doing, elect portability of the decedent's DSUE amount. An appointed executor also may elect not to have portability apply pursuant to paragraph (a)(3) of this section.

(ii) *Non-appointed executor*. If there is no appointed executor, any person in actual or constructive possession of any property of the decedent (a non-appointed executor) may file the estate tax return on behalf of the estate of the decedent and, in so doing, elect portability of the decedent's DSUE amount, or, by complying with paragraph (a)(3) of this section, may elect not to have portability apply. A portability election made by a non-appointed executor cannot be superseded by a contrary election made by another non-appointed executor of that same decedent's estate (unless such other non-appointed executor is the successor of the non-appointed executor who made the election). See §20.6018–2 for additional rules relating to persons permitted to file the estate tax return.

(7) *Requirements of return*—(i) *General rule*. An estate tax return will be considered complete and properly-prepared for purposes of this section if it is prepared in accordance with the instructions issued for the estate tax return (Instructions for Form 706) and if the requirements of §§20.6018–2, 20.6018–3, and 20.6018–4 are satisfied. However, see paragraph (a)(7)(ii) of this section for reduced requirements applicable to certain property of certain estates.

(ii) *Reporting of value not required for certain property*—(A) *In general*. A special rule applies with respect to certain property of estates in which the executor is not required to file an estate tax return under section 6018(a), as determined without regard to paragraph (a)(1) of this section. With respect to such an estate, for bequests, devises, or transfers of property included in the gross estate, the value of which is deductible under section 2056 or 2056A (marital deduction property) or under section 2055(a) (charitable deduction property), an executor is not required to report a value for such property on the estate tax return (except to the extent provided in this paragraph (a)(7)(ii)(A)) and will be required to report only the description, ownership, and/or beneficiary of such property, along with all other information necessary to establish the right of the estate to the deduction in accordance with §§20.2056(a)–1(b)(i) through (iii) and 20.2055–1(c), as applicable. However, this rule does not apply to marital deduction property or charitable deduction property if—

(*1*) The value of such property relates to, affects, or is needed to determine, the value passing from the decedent to another recipient;

(*2*) The value of such property is needed to determine the estate's eligibility for the provisions of sections 2032, 2032A, 6166, or another provision of the Code;

(*3*) Less than the entire value of an interest in property includible in the decedent's gross estate is marital deduction property or charitable deduction property; or

(*4*) A partial disclaimer or partial qualified terminable interest property (QTIP) election is made with respect to a bequest, devise, or transfer of property includible in the gross estate, part of which is marital deduction property or charitable deduction property.

(B) *Statement required on the return*. Paragraph (a)(7)(ii)(A) of this section applies only if the executor exercises due diligence to estimate the fair market value of the gross estate, including the property described in paragraph (a)(7)(ii)(A) of this section. The Instructions for Form 706 will provide ranges of dollar values, and the executor must identify on the estate tax return an amount corresponding to the particular range within which falls the executor's best estimate of the total gross estate. Until such time as the prescribed form for the estate tax return expressly includes this estimate in the manner described in the preceding sentence, the executor must include the executor's best estimate, rounded to the nearest $250,000, on or attached to the estate tax return, signed under penalties of perjury.

(C) *Examples*. The following examples illustrate the application of paragraph (a)(7)(ii) of this section. In each example, assume that Husband (H) dies in 2011, survived by his wife (W), that both H and W are US citizens, that H's gross estate does not exceed the excess of the applicable exclusion amount for the year of his death over the total amount of H's adjusted tax-

able gifts and any specific exemption under section 2521, and that H's executor (E) timely files Form 706 solely to make the portability election.

Example 1. (i) *Facts.* The assets includible in H's gross estate consist of a parcel of real property and bank accounts held jointly with W with rights of survivorship, a life insurance policy payable to W, and a survivor annuity payable to W for her life. H made no taxable gifts during his lifetime.

(ii) *Application.* E files an estate tax return on which these assets are identified on the proper schedule, but E provides no information on the return with regard to the date of death value of these assets in accordance with paragraph (a)(7)(ii)(A) of this section. To establish the estate's entitlement to the marital deduction in accordance with §20.2056(a)–1(b) (except with regard to establishing the value of the property) and the instructions for the estate tax return, E includes with the estate tax return evidence to verify the title of each jointly held asset, to confirm that W is the sole beneficiary of both the life insurance policy and the survivor annuity, and to verify that the annuity is exclusively for W's life. Finally, E certifies on the estate return E's best estimate, determined by exercising due diligence, of the fair market value of the gross estate in accordance with paragraph (a)(7)(ii)(B) of this section. The estate tax return is considered complete and properly prepared and E has elected portability.

Example 2. (i) *Facts.* H's will, duly admitted to probate and not subject to any proceeding to challenge its validity, provides that H's entire estate is to be distributed to a QTIP trust for W. The non-probate assets includible in H's gross estate consist of a life insurance policy payable to H's children from a prior marriage, and H's individual retirement account (IRA) payable to W. H made no taxable gifts during his lifetime.

(ii) *Application.* E files an estate tax return on which all of the assets includible in the gross estate are identified on the proper schedule. In the case of the probate assets and the IRA, no information is provided with regard to date of death value in accordance with paragraph (a)(7)(ii)(A) of this section. However, E makes a QTIP election and attaches a copy of H's will creating the QTIP, and describes each such asset and its ownership to establish the estate's entitlement to the marital deduction in accordance with the instructions for the estate tax return and §20.2056(a)–1(b) (except with regard to establishing the value of the property). In the case of the life insurance policy payable to H's children, all of the regular return requirements, including reporting and establishing the fair market value of such asset, apply. Finally, E certifies on the estate return E's best estimate, determined by exercising due diligence, of the fair market value of the gross estate in accordance with paragraph (a)(7)(ii)(B) of this section. The estate tax return is considered complete and properly prepared and E has elected portability.

(iii) *Variation.* The facts are the same except that there are no non-probate assets, and E elects to make only a partial QTIP election. In this case, the regular return requirements apply to all of the property includible in the gross estate and the provisions of paragraph (a)(7)(ii) of this section do not apply.

Example 3. (i) *Facts.* H's will, duly admitted to probate and not subject to any proceeding to challenge its validity, provides that 50 percent of the property passing under the terms of H's will is to be paid to a marital trust for W and 50 percent is to be paid to a trust for W and their descendants.

(ii) *Application.* The amount passing to the non-marital trust cannot be verified without knowledge of the full value of the property passing under the will. Therefore, the value of the property of the marital trust relates to or affects the value passing to the trust for W and the descendants of H and W. Accordingly, the general return requirements apply to all of the property includible in the gross estate and the provisions of paragraph (a)(7)(ii) of this section do not apply.

(b) *Computation required for portability election*—(1) *General rule.* In addition to the requirements described in paragraph (a) of this section, an executor of a decedent's estate must include a computation of the DSUE amount on the estate tax return to elect portability and thereby allow the decedent's surviving spouse to take into account that decedent's DSUE amount. See paragraph (b)(2) of this section for a transitional rule when the estate tax return form prescribed by the Internal Revenue Service (IRS) does not show expressly the computation of the DSUE amount. See paragraph (c) of this section for rules on computing the DSUE amount.

(2) *Transitional rule.* Until such time as the prescribed form for the estate tax return expressly includes a computation of the DSUE amount, a complete and properly-prepared estate tax return will be deemed to include the computation of the DSUE amount. See paragraph (a)(7) of this section for the requirements for a return to be considered complete and properly-prepared. Once the IRS revises the prescribed form for the estate tax return to include expressly the computation of the DSUE amount, executors that previously filed an estate tax return pursuant to this transitional rule will not be required to file a supplemental estate tax return using the revised form.

(c) *Computation of the DSUE amount*—(1) *General rule.* Subject to paragraphs (c)(2) through (c)(4) of this section, the DSUE amount of a decedent with a surviving spouse is the lesser of the following amounts—

(i) The basic exclusion amount in effect in the year of the death of the decedent; or

(ii) The excess of—

(A) The decedent's applicable exclusion amount; over

(B) The sum of the amount of the taxable estate and the amount of the adjusted taxable gifts of the decedent, which together is the amount on which the tentative tax on the decedent's estate is determined under section 2001(b)(1).

(2) *Special rule to consider gift taxes paid by decedent.* Solely for purposes of computing the decedent's DSUE amount, the amount of the adjusted taxable gifts of the decedent referred to in paragraph (c)(1)(ii)(B) of this section is reduced by the amount, if any, on which gift taxes were paid for the calendar year of the gift(s).

(3) [Reserved]

(4) *Special rule in case of property passing to qualified domestic trust.* When property passes for the benefit of a surviving spouse in a qualified domestic trust (QDOT), as defined in section 2056A(a), the DSUE amount of the decedent is computed on the decedent's estate tax return for the purpose of electing portability in the same manner as this amount is computed under paragraph (c)(1) of this section, but this DSUE amount is subject to subsequent adjustments. The DSUE amount of the decedent must be redetermined upon the occurrence of the final distribution or other event (generally the death of the surviving spouse or the earlier termination of all QDOTs for that surviving spouse) on which estate tax is imposed under section 2056A. See §20.2056A–6 for rules on determining the estate tax under section 2056A. See §20.2010–3T(c)(2) regarding the timing of the availability of the decedent's DSUE amount to the surviving spouse.

(5) *Examples.* The following examples illustrate the application of this paragraph (c):

Example 1. Computation of DSUE amount. (i) *Facts.* In 2002, having made no prior taxable gift, Husband (H) makes a taxable gift valued at $1,000,000 and reports the gift on a timely-filed gift tax return. Because the amount of the gift is equal to the applicable exclusion amount for that year ($1,000,000), $345,800 is allowed as a credit against the tax, reducing the gift tax liability to zero. H dies on September 29, 2011, survived by Wife (W). H and W are US citizens and neither has any prior marriage. H's taxable estate is $1,000,000. The executor of H's estate timely files H's estate tax return and elects portability, thereby allowing W to benefit from H's DSUE amount.

(ii) *Application.* The executor of H's estate computes H's DSUE amount to be $3,000,000 (the lesser of the $5,000,000 basic exclusion amount in 2011, or the excess of H's $5,000,000 applicable exclusion

amount over the sum of the $1,000,000 taxable estate and the $1,000,000 amount of adjusted taxable gifts).

Example 2. Computation of DSUE amount when gift tax paid. (i) *Facts.* The facts are the same as in *Example 1* except that the value of H's taxable gift in 2002 is $2,000,000. After application of the applicable credit amount, H owes gift tax on $1,000,000, the amount of the gift in excess of the applicable exclusion amount for that year. H pays the gift tax owed on the transfer in 2002.

(ii) *Application.* On H's death, the executor of H's estate computes the DSUE amount to be $3,000,000 (the lesser of the $5,000,000 basic exclusion amount in 2011, or the excess of H's $5,000,000 applicable exclusion amount over the sum of the $1,000,000 taxable estate and $1,000,000 adjusted taxable gifts). H's adjusted taxable gifts of $2,000,000 were reduced for purposes of this computation by $1,000,000, the amount of taxable gifts on which gift taxes were paid.

Example 3. Computation of DSUE amount when QDOT created. (i) *Facts.* Husband (H), a US citizen, makes his first taxable gift in 2002, valued at $1,000,000, and reports the gift on a timely-filed gift tax return. No gift tax is due because the applicable exclusion amount for that year ($1,000,000) equals the fair market value of the gift. H dies in 2011 with a gross estate of $2,000,000. H's wife (W) is a US resident but not a citizen of the United States and, under H's will, a pecuniary bequest of $1,500,000 passes to a QDOT for the benefit of W. H's executor timely files an estate tax return and makes the QDOT election for the property passing to the QDOT, and H's estate is allowed a marital deduction of $1,500,000 under section 2056(d) for the value of that property. H's taxable estate is $500,000. On H's estate tax return, H's executor computes H's preliminary DSUE amount to be $3,500,000 (the lesser of the $5,000,000 basic exclusion amount in 2011, or the excess of H's $5,000,000 applicable exclusion amount over the sum of the $500,000 taxable estate and the $1,000,000 adjusted taxable gifts). No taxable events within the meaning of section 2056A occur during W's lifetime with respect to the QDOT, and W makes no taxable gifts. In 2012, W dies and the value of the assets of the QDOT is $1,800,000.

(ii) *Application.* H's DSUE amount is redetermined to be $1,700,000 (the lesser of the $5,000,000 basic exclusion amount in 2011, or the excess of H's $5,000,000 applicable exclusion amount over $3,300,000 (the sum of the $500,000 taxable estate augmented by the $1,800,000 of QDOT assets and the $1,000,000 adjusted taxable gifts)).

(d) *Authority to examine returns of decedent.* The IRS may examine returns of a decedent in determining the decedent's DSUE amount, regardless of whether the period of limitations on assessment has expired for that return. See §20.2010–3T(d) for additional rules relating to the IRS's authority to examine returns. See also section 7602 for the IRS's authority, when ascertaining the correctness of any return, to examine any returns that may be relevant or material to such inquiry.

(e) *Effective/applicability date.* This section applies to the estates of decedents dying in calendar year 2011 or a subsequent year in which the applicable exclusion amount is determined under section 2010(c) of the Code by adding the basic exclusion amount and, in the case of a surviving spouse, the DSUE amount.

(f) *Expiration date.* The applicability of this section expires on or before June 15, 2015.

Par. 6. Section 20.2010–3T is added to read as follows:

§20.2010–3T Portability provisions applicable to the surviving spouse's estate (temporary).

(a) *Surviving spouse's estate limited to DSUE amount of last deceased spouse*—(1) *In general.* A deceased spousal unused exclusion (DSUE) amount of a decedent, computed under §20.2010–2T(c), is included in determining a surviving spouse's applicable exclusion amount under section 2010(c)(2), provided—

(i) Such decedent is the last deceased spouse of such surviving spouse within the meaning of §20.2010–1T(d)(5) on the date of the death of the surviving spouse; and

(ii) The executor of the decedent's estate elected portability (see §20.2010–2T(a) and (b) for applicable requirements).

(2) *No DSUE amount available from last deceased spouse.* If the last deceased spouse of such surviving spouse had no DSUE amount, or if the executor of such a decedent's estate did not make a portability election, the surviving spouse's estate has no DSUE amount (except as provided in paragraph (b)(1)(ii) of this section) to be included in determining the applicable exclusion amount, even if the surviving spouse previously had a DSUE amount available from another decedent who, prior to the death of the last deceased spouse, was the last deceased spouse of such surviving spouse. See paragraph (b) of this section for a special rule in the case of multiple deceased spouses and a previously-applied DSUE amount.

(3) *Identity of last deceased spouse unchanged by subsequent marriage or divorce.* A decedent is the last deceased spouse (as defined in §20.2010–1T(d)(5)) of a surviving spouse even if, on the date of the death of the surviving spouse, the surviving spouse is married to another (then-living) individual. If a surviving spouse marries again and that marriage ends in divorce or an annulment, the subsequent death of the divorced spouse does not end the status of the prior deceased spouse as the last deceased spouse of the surviving spouse. The divorced spouse, not being married to the surviving spouse at death, is not the last deceased spouse as that term is defined in §20.2010–1T(d)(5).

(b) *Special rule in case of multiple deceased spouses and previously-applied DSUE amount*—(1) *In general.* A special rule applies to compute the DSUE amount included in the applicable exclusion amount of a surviving spouse who previously has applied the DSUE amount of one or more deceased spouses to taxable gifts in accordance with §25.2505–2T(b) and (c) of this chapter. If a surviving spouse has applied the DSUE amount of one or more last deceased spouses to the surviving spouse's transfers during life, and if any of those last deceased spouses is different from the surviving spouse's last deceased spouse as defined in §20.2010–1T(d)(5) at the time of the surviving spouse's death, then the DSUE amount to be included in determining the applicable exclusion amount of the surviving spouse at the time of the surviving spouse's death is the sum of—

(i) The DSUE amount of the surviving spouse's last deceased spouse as described in paragraph (a)(1) of this section; and

(ii) The DSUE amount of each other deceased spouse of the surviving spouse, to the extent that such amount was applied to one or more taxable gifts of the surviving spouse.

(2) *Example.* The following example, in which all described individuals are US citizens, illustrates the application of this paragraph (b):

Example. (i) *Facts.* Husband 1 (H1) dies on January 15, 2011, survived by Wife (W). Neither has made any taxable gifts during H1's lifetime. H1's executor elects portability of H1's DSUE amount. The DSUE amount of H1 as computed on the estate tax return filed on behalf of H1's estate is $5,000,000. On December 31, 2011, W makes taxable gifts to her children valued at $2,000,000. W reports the gifts on a timely-filed gift tax return. W is considered to have applied $2,000,000 of H1's DSUE amount to the amount of taxable gifts, in accordance with §25.2505–2T(c), and, therefore, W owes no gift tax. W has an applicable exclusion amount remaining in the amount of $8,000,000 ($3,000,000 of H1's remaining DSUE amount plus W's own $5,000,000 basic exclusion amount). After the death of H1, W mar-

ries Husband 2 (H2). H2 dies in June 2012. H2's executor elects portability of H2's DSUE amount, which is properly computed on H2's estate tax return to be $2,000,000. W dies in October 2012.

(ii) *Application*. The DSUE amount to be included in determining the applicable exclusion amount available to W's estate is $4,000,000, determined by adding the $2,000,000 DSUE amount of H2 and the $2,000,000 DSUE amount of H1 that was applied by W to W's 2011 taxable gifts. Thus, W's applicable exclusion amount is $9,000,000.

(c) *Date DSUE amount taken into consideration by surviving spouse's estate*—(1) *General rule*. A portability election made by an executor of a decedent's estate (see §20.2010–2T(a) and (b) for applicable requirements) applies as of the date of the decedent's death. Thus, the decedent's DSUE amount is included in the applicable exclusion amount of the decedent's surviving spouse under section 2010(c)(2) and will be applicable to transfers made by the surviving spouse after the decedent's death. However, such decedent's DSUE amount will not be included in the applicable exclusion amount of the surviving spouse, even if the surviving spouse had made a transfer in reliance on the availability or computation of the decedent's DSUE amount:

(i) If the executor of the decedent's estate supersedes the portability election by filing a subsequent estate tax return in accordance with §20.2010–2T(a)(4);

(ii) To the extent that the DSUE amount subsequently is reduced by a valuation adjustment or the correction of an error in calculation; or

(iii) To the extent that the surviving spouse cannot substantiate the DSUE amount claimed on the surviving spouse's return.

(2) *Special rule when property passes to surviving spouse in a qualified domestic trust*. When property passes from a decedent for the benefit of a surviving spouse in one or more qualified domestic trusts (QDOT) as defined in section 2056A(a) and the decedent's executor elects portability, the DSUE amount available to be included in the applicable exclusion amount of the surviving spouse under section 2010(c)(2) is the DSUE amount of the decedent as redetermined in accordance with §20.2010–2T(c)(4). The earliest date on which the decedent's DSUE amount may be included in the applicable exclusion amount of the surviving spouse under section 2010(c)(2) is the date of the occurrence of the final QDOT distribution or final other event (generally, the death of the surviving spouse or the earlier termination of all QDOTs for that surviving spouse) on which tax under section 2056A is imposed. However, the decedent's DSUE amount as redetermined in accordance with §20.2010–2T(c)(4) may be applied to certain taxable gifts of the surviving spouse. See §25.2505–2T(d)(2)(i) of this chapter.

(d) *Authority to examine returns of deceased spouses*. For the purpose of determining the DSUE amount to be included in the applicable exclusion amount of the surviving spouse, the Internal Revenue Service (IRS) may examine returns of each of the surviving spouse's deceased spouses whose DSUE amount is claimed to be included in the surviving spouse's applicable exclusion amount, regardless of whether the period of limitations on assessment has expired for any such return. The IRS's authority to examine returns of a deceased spouse applies with respect to each transfer by the surviving spouse to which a DSUE amount is or has been applied. Upon examination, the IRS may adjust or eliminate the DSUE amount reported on such a return; however, the IRS may assess additional tax on that return only if that tax is assessed within the period of limitations on assessment under section 6501 applicable to the tax shown on that return. See also section 7602 for the IRS's authority, when ascertaining the correctness of any return, to examine any returns that may be relevant or material to such inquiry. For purposes of these examinations to determine the DSUE amount, the surviving spouse is considered to have a material interest that is affected by the return information of the deceased spouse within the meaning of section 6103(e)(3).

(e) *Availability of DSUE amount for estates of nonresidents who are not citizens*. The estate of a nonresident surviving spouse who is not a citizen of the United States at the time of such surviving spouse's death shall not take into account the DSUE amount of any deceased spouse of such surviving spouse within the meaning of §20.2010–1T(d)(5) except to the extent allowed under any applicable treaty obligation of the United States. See section 2102(b)(3).

(f) *Effective/applicability date*. This section applies to the estates of decedents dying in calendar year 2011 or a subsequent year in which the applicable exclusion amount is determined under section 2010(c) of the Code by adding the basic exclusion amount and, in the case of a surviving spouse, the DSUE amount.

(g) *Expiration date*. The applicability of this section expires on or before June 15, 2015.

PART 25—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

Par. 7. The authority citation for part 25 is amended by adding an entry in numerical order to read as follows:

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

Section 25.2505–2T also issued under 26 U.S.C. 2010(c)(6). * * *

Par. 8. Section 25.2505–0T is added to read as follows:

§25.2505–0T Table of contents (temporary).

This section lists the table of contents for §§25.2505–1T and 25.2505–2T.

§25.2505–1T Unified credit against gift tax; in general (temporary).

(a) General rule.

(b) Applicable rate of tax.

(c) Special rule in case of certain gifts made before 1977.

(d) Credit limitation.

(e) Effective/applicability date.

(f) Expiration date.

§25.2505–2T Gifts made by a surviving spouse having a DSUE amount available (temporary).

(a) Donor who is surviving spouse is limited to DSUE amount of last deceased spouse.

(1) In general.

(2) No DSUE amount available from last deceased spouse.

(3) Identity of last deceased spouse unchanged by subsequent marriage or divorce.

(b) Manner in which DSUE amount is applied.

(c) Special rule in case of multiple deceased spouses and previously-applied DSUE amount.

(1) In general.

(2) Example.

(d) Date DSUE amount taken into consideration by donor who is a surviving spouse.

(1) General rule.

(2) Special rule when property passes to surviving spouse in a qualified domestic trust.

(e) Authority to examine returns of deceased spouses.

(f) Availability of DSUE amount for nonresidents who are not citizens.

(g) Effective/applicability date.

(h) Expiration date.

Par. 9. Section 25.2505–1T is added to read as follows:

§25.2505–1T Unified credit against gift tax; in general (temporary).

(a) *General rule*. Section 2505(a) allows a citizen or resident of the United States a credit against the tax imposed by section 2501 for each calendar year. The allowable credit is the applicable credit amount in effect under section 2010(c) that would apply if the donor died as of the end of the calendar year, reduced by the sum of the amounts allowable as a credit against the gift tax due for all preceding calendar periods. See §§25.2505–2T, 20.2010–1T, and 20.2010–2T of this chapter for additional rules and definitions related to determining the applicable credit amount in effect under section 2010(c).

(b) *Applicable rate of tax*. In determining the amounts allowable as a credit against the gift tax due for all preceding calendar periods, the unified rate schedule under section 2001(c) in effect for such calendar year applies instead of the rates of tax actually in effect for preceding calendar periods. See sections 2505(a) and 2502(a)(2).

(c) *Special rule in case of certain gifts made before 1977*. The applicable credit amount allowable under paragraph (a) of this section must be reduced by an amount equal to 20 percent of the aggregate amount allowed as a specific exemption under section 2521 (as in effect before its repeal by the Tax Reform Act of 1976) for gifts made by the decedent after September 8, 1976, and before January 1, 1977.

(d) *Credit limitation*. The applicable credit amount allowed under paragraph (a) of this section for any calendar year shall not exceed the amount of the tax imposed by section 2501 for such calendar year.

(e) *Effective/applicability date*. Paragraph (a) of this section applies to gifts made on or after January 1, 2011. Paragraphs (b), (c), and (d) of this section apply to gifts made on or after June 15, 2012.

(f) *Expiration date*. The applicability of this section expires on or before June 15, 2015.

Par. 10. Section 25.2505–2T is added to read as follows:

§25.2505–2T Gifts made by a surviving spouse having a DSUE amount available (temporary).

(a) *Donor who is surviving spouse is limited to DSUE amount of last deceased spouse*—(1) *In general*. In computing a surviving spouse's gift tax liability with regard to a transfer subject to the tax imposed by section 2501 (taxable gift), a deceased spousal unused exclusion (DSUE) amount of a decedent, computed under §20.2010–2T(c) of this chapter, is included in determining the surviving spouse's applicable exclusion amount under section 2010(c)(2), provided:

(i) Such decedent is the last deceased spouse of such surviving spouse within the meaning of §20.2010–1T(d)(5) of this chapter at the time of the surviving spouse's taxable gift; and

(ii) The executor of the decedent's estate elected portability (see §20.2010–2T(a) and (b) of this chapter for applicable requirements).

(2) *No DSUE amount available from last deceased spouse*. If on the date of the surviving spouse's taxable gift the last deceased spouse of such surviving spouse had no DSUE amount or if the executor of the estate of such last deceased spouse did not elect portability, the surviving spouse has no DSUE amount (except as and to the extent provided in paragraph (c)(1)(ii) of this section) to be included in determining his or her applicable exclusion amount, even if the surviving spouse previously had a DSUE amount available from another decedent who, prior to the death of the last deceased spouse, was the last deceased spouse of such surviving spouse. See paragraph (c) of this section for a special rule in the case of multiple deceased spouses.

(3) *Identity of last deceased spouse unchanged by subsequent marriage or divorce*. A decedent is the last deceased spouse (as defined in §20.2010–1T(d)(5) of this chapter) of a surviving spouse even if, on the date of the surviving spouse's taxable gift, the surviving spouse is married to another (then-living) individual. If a surviving spouse marries again and that marriage ends in divorce or an annulment, the subsequent death of the divorced spouse does not end the status of the prior deceased spouse as the last deceased spouse of the surviving spouse. The divorced spouse, not being married to the surviving spouse at death, is not the last deceased spouse as that term is defined in §20.2010–1T(d)(5) of this chapter.

(b) *Manner in which DSUE amount is applied*. If a donor who is a surviving spouse makes a taxable gift and a DSUE amount is included in determining the surviving spouse's applicable exclusion amount under section 2010(c)(2), such surviving spouse will be considered to apply such DSUE amount to the taxable gift before the surviving spouse's own basic exclusion amount.

(c) *Special rule in case of multiple deceased spouses and previously-applied DSUE amount*—(1) *In general*. A special rule applies to compute the DSUE amount included in the applicable exclusion amount of a surviving spouse who previously has applied the DSUE amount of one or more deceased spouses. If a surviving spouse applied the DSUE amount of one or more last deceased spouses to the surviving spouse's previous lifetime transfers, and if any of those last deceased spouses is different from the surviving spouse's last deceased spouse as defined in §20.2010–1T(d)(5) of this chapter at the time of the current taxable gift by the surviving spouse, then the DSUE amount to be included in determining the applicable exclusion amount of the surviving spouse that will be applicable at the time of the current taxable gift is the sum of—

(i) The DSUE amount of the surviving spouse's last deceased spouse as described in paragraph (a)(1) of this section; and

(ii) The DSUE amount of each other deceased spouse of the surviving spouse to the extent that such amount was applied to one or more previous taxable gifts of the surviving spouse.

(2) *Example*. The following example, in which all described individuals are US citizens, illustrates the application of this paragraph (c):

Example. (i) *Facts*. Husband 1 (H1) dies on January 15, 2011, survived by Wife (W). Neither has made any taxable gifts during H1's lifetime. H1's executor elects portability of H1's deceased spousal unused exclusion (DSUE) amount. The DSUE amount of H1 as computed on the estate tax return filed on behalf of H1's estate is $5,000,000. On December 31, 2011, W makes taxable gifts to her children valued at $2,000,000. W reports the gifts on a timely-filed gift tax return. W is considered to have applied $2,000,000 of H1's DSUE amount to the 2011 taxable gifts, in accordance with paragraph (b) of this section, and, therefore, W owes no gift tax. W is considered to have an applicable exclusion amount remaining in the amount of $8,000,000 ($3,000,000 of H1's remaining DSUE amount plus W's own $5,000,000 basic exclusion amount). After the death of H1, W marries Husband 2 (H2). H2 dies on June 30, 2012. H2's executor elects portability of H2's DSUE amount, which is properly computed on H2's estate tax return to be $2,000,000.

(ii) *Application*. The DSUE amount to be included in determining the applicable exclusion amount available to W for gifts during the second half of 2012 is $4,000,000, determined by adding the $2,000,000 DSUE amount of H2 and the $2,000,000 DSUE amount of H1 that was applied by W to W's 2011 taxable gifts. Thus, W's applicable exclusion amount during the balance of 2012 is $9,000,000.

(d) *Date DSUE amount taken into consideration by donor who is a surviving spouse*—(1) *General rule*. A portability election made by an executor of a decedent's estate (see §20.2010–2T(a) and (b) of this chapter for applicable requirements) applies as of the date of the decedent's death. Thus, the decedent's DSUE amount is included in the applicable exclusion amount of the decedent's surviving spouse under section 2010(c)(2) and will be applicable to transfers made by the surviving spouse after the decedent's death. However, such decedent's DSUE amount will not be included in the applicable exclusion amount of the surviving spouse, even if the surviving spouse had made a taxable gift in reliance on the availability or computation of the decedent's DSUE amount:

(i) If the executor of the decedent's estate supersedes the portability election by filing a subsequent estate tax return in accordance with §20.2010–2T(a)(4) of this chapter;

(ii) To the extent that the DSUE amount subsequently is reduced by a valuation adjustment or the correction of an error in calculation; or

(iii) To the extent that the DSUE amount claimed on the decedent's return cannot be determined.

(2) *Special rule when property passes to surviving spouse in a qualified domestic trust*—(i) *In general*. When property passes from a decedent for the benefit of a surviving spouse in one or more qualified domestic trusts (QDOT) as defined in section 2056A(a) and the decedent's executor elects portability, the DSUE amount available to be included in the applicable exclusion amount of the surviving spouse under section 2010(c)(2) is the DSUE amount of the decedent as redetermined in accordance with §20.2010–2T(c)(4) of this chapter. The earliest date on which the decedent's DSUE amount may be included in the applicable exclusion amount of the surviving spouse under section 2010(c)(2) is the date of the occurrence of the final QDOT distribution or final other event (generally, the death of the surviving spouse or the earlier termination of all QDOTs for that surviving spouse) on which tax under section 2056A is imposed. However, the decedent's DSUE amount as redetermined in accordance with §20.2010–2T(c)(4) of this chapter may be applied to the surviving spouse's taxable gifts made in the year of the surviving spouse's death, or if the terminating event occurs prior to the surviving spouse's death, then in the year of that terminating event and/or any subsequent year during the surviving spouse's life.

(ii) *Example*. The following example illustrates the application of this paragraph (d)(2):

Example. (i) *Facts*. Husband (H), a US citizen, dies in January 2011 having made no taxable gifts during his lifetime. H's gross estate is $3,000,000. H's wife (W) is a US resident but not a citizen of the United States and, under H's will, a pecuniary bequest of $2,000,000 passes to a QDOT for the benefit of W. H's executor timely files an estate tax return and makes the QDOT election for the property passing to the QDOT, and H's estate is allowed a marital deduction of $2,000,000 under section 2056(d) for the value of that property. H's taxable estate is $1,000,000. On H's estate tax return, H's executor computes H's preliminary DSUE amount to be $4,000,000. No taxable events within the meaning of section 2056A occur during W's lifetime with respect to the QDOT. W makes a taxable gift of $1,000,000 to X in December 2011 and a taxable gift of $1,000,000 to Y in January 2012. W dies in September 2012, not having married again, when the value of the assets of the QDOT is $2,200,000.

(ii) *Application*. H's DSUE amount is redetermined to be $1,800,000 (the lesser of the $5,000,000 basic exclusion amount in 2011, or the excess of H's $5,000,000 applicable exclusion amount over $3,200,000 (the sum of the $1,000,000 taxable estate augmented by the $2,200,000 of QDOT assets)). On W's gift tax return filed for 2011, W cannot apply any DSUE amount to the gift made to X. However, because W's gift to Y was made in the year that W died, W's executor will apply $1,000,000 of H's redetermined DSUE amount to the gift on W's gift tax return filed for 2012. The remaining $800,000 of H's redetermined DSUE amount is included in W's applicable exclusion amount to be used in computing W's estate tax liability.

(e) *Authority to examine returns of deceased spouses*. For the purpose of determining the DSUE amount to be included in the applicable exclusion amount of the surviving spouse, the Internal Revenue Service (IRS) may examine returns of each of the surviving spouse's deceased spouses whose DSUE amount is claimed to be included in the surviving spouse's applicable exclusion amount, regardless of whether the period of limitations on assessment has expired for any such return. The IRS's authority to examine returns of a deceased spouse applies with respect to each transfer by the surviving spouse to which a DSUE amount is or has been applied. Upon examination, the IRS may adjust or eliminate the DSUE amount reported on such a return; however, the IRS may assess additional tax on that return only if that tax is assessed within the period of limitations on assessment under section 6501 applicable to the tax shown on that return. See also section 7602 for the IRS's authority, when ascertaining the correctness of any return, to examine any returns that may be relevant or material to such inquiry.

(f) *Availability of DSUE amount for nonresidents who are not citizens*. A nonresident surviving spouse who was not a citizen of the United States at the time of making a transfer subject to tax under chapter 12 of the Internal Revenue Code shall not take into account the DSUE amount of any deceased spouse except to the extent allowed under any applicable treaty obligation of the United States. See section 2102(b)(3).

(g) *Effective/applicability date*. This section applies to gifts made in calendar year 2011 or in a subsequent year in which the applicable exclusion amount is determined under section 2010(c) of the Code by adding the basic exclusion amount and, in the case of a surviving spouse, the DSUE amount.

(h) *Expiration date*. The applicability of this section expires on or before June 15, 2015.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 11. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 12. In §602.101, paragraph (b) is amended by adding the following entry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB Control No.
* * * * *	
20.2010–2T	1545–0015
* * * * *	

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

Approved June 12, 2012.

Emily S. McMahon,
Acting Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on June 15, 2012, 8:45 a.m., and published in the issue of the Federal Register for June 18, 2012, 77 F.R. 36150)

Section 7874.—Rules Relating to Expatriated Entities and Their Foreign Parents

26 CFR 1.7874–2: Surrogate foreign corporations.

T.D. 9591

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Surrogate Foreign Corporations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations regarding whether a foreign corporation is treated as a surrogate foreign corporation. The final regulations affect certain domestic corporations and partnerships (and certain parties related thereto), and foreign corporations that acquire substantially all of the properties of such domestic corporations or partnerships.

DATES: *Effective Date:* These regulations are effective on June 12, 2012.

Applicability Dates: For dates of applicability, see §§1.7874–1(g) and 1.7874–2(l).

FOR FURTHER INFORMATION CONTACT: Milton M. Cahn, (202) 622–3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On June 6, 2006, temporary regulations under section 7874 of the Internal Revenue Code (Code) (T.D. 9265, 2006–2 C.B. 1) were published in the **Federal Register** (71 FR 32437) concerning the treatment of a foreign corporation as a surrogate foreign corporation (2006 temporary regulations). A notice of proposed rulemaking (REG–112994–06, 2006–2 C.B. 47) cross-referencing the 2006 temporary regulations was published in the same issue of the **Federal Register** (71 FR 32495). On July 28, 2006, Notice 2006–70, 2006–2 C.B. 252, was published, announcing a modification to the effective date contained in the 2006 temporary regulations. See §601.601(d)(2)(ii)(*b*). On June 12, 2009, the 2006 temporary regulations and the related notice of proposed rulemaking were withdrawn and replaced with new temporary regulations (2009 temporary regulations), which generally applied to acquisitions completed on or after June 9, 2009. T.D. 9453, 2009–28 I.R.B. 114 (74 FR 27920). A notice of proposed rulemaking (REG–112994–06, 2009–28 I.R.B. 144) cross-referencing the 2009 temporary regulations was published in the same issue of the **Federal Register** (74 FR 27947). No public hearing was requested or held; however, comments were received. All comments are available at *www.regulations.gov* or upon request. After consideration of the comments, the 2009 proposed regulations are adopted as final regulations with the modifications described in this preamble. The 2009 temporary regulations are removed. As discussed in paragraph A. of this preamble, new temporary regulations under section 7874 regarding whether a foreign corporation has substantial business activities in a foreign country, and a corresponding notice of proposed rulemaking, are published elsewhere in this issue of the Bulletin.

Summary of Comments and Explanation of Revisions

A. *Substantial Business Activities*

A foreign corporation is generally treated as a surrogate foreign corporation under section 7874(a)(2)(B) if pursuant to a plan (or a series of related transactions): (i) the foreign corporation completes after March 4, 2003, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation; (ii) after the acquisition at least 60 percent of the stock (by vote or value) of the foreign corporation is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation; and (iii) after the acquisition, the expanded affiliated group that includes the foreign corporation does not have substantial business activities in the foreign country (relevant foreign country) in which, or under the law of

which, the foreign corporation is created or organized, when compared to the total business activities of the expanded affiliated group. Similar provisions apply if a foreign corporation acquires substantially all of the properties constituting a trade or business of a domestic partnership.

The 2006 temporary regulations provided that the determination of whether the expanded affiliated group has substantial business activities in the relevant foreign country is based on all the facts and circumstances. The 2006 temporary regulations also provided a safe harbor, which generally was satisfied if at least ten percent of the employees, assets, and sales of the expanded affiliated group were in the relevant foreign country. The 2009 temporary regulations retained the facts and circumstances general rule provided in the 2006 temporary regulations, with certain modifications, but removed the safe harbor.

Comments were received regarding the determination as to whether an expanded affiliated group has substantial business activities in a foreign country. These comments are discussed in the preamble to temporary regulations, published elsewhere in this issue of the Bulletin, that provide guidance on the substantial business activities test.

B. *Options*

1. *General approach*

The 2009 temporary regulations generally provide that, for purposes of section 7874, an option or similar interest (together, an "option") with respect to a corporation is treated as stock of the corporation with a value equal to the holder's claim on the equity of the corporation. For this purpose, the equity of the corporation does not include the value of any property the holder of the option would be required to provide to the corporation pursuant to the terms of the option if such option were exercised. The 2009 temporary regulations provide similar rules for an option with respect to a partnership.

A comment suggested that, subject to an anti-abuse rule, options should be ignored for purposes of section 7874. The comment asserts that this approach, consistent with the treatment of options under other Code sections, would be more administrable; the comment recognized, however, that unlike the approach taken in the 2009 temporary regulations, this approach does not properly take into account the economic interest of an option holder. Alternatively, the comment suggested that if the approach taken in the 2009 temporary regulations is retained, certain types of options (for example, publicly traded options and customary compensatory options) should be excluded from the general rule.

The Internal Revenue Service (IRS) and the Department of the Treasury (Treasury Department) believe that the claim-on-equity approach in the 2009 temporary regulations is preferable to disregarding options subject to an anti-avoidance rule. The IRS and the Treasury Department believe this approach most properly reflects the economics of the transaction and is not easily manipulated. Moreover, the IRS and the Treasury Department believe that the simplicity of uniformly treating all types of options outweighs the benefits of excluding, or providing other special rules for, certain types of options. Accordingly, the claim-on-equity approach provided in the 2009 temporary regulations is retained, with certain modifications, in these final regulations.

2. *Voting power*

Certain portions of section 7874 also look to the voting power of stock. For example, one of the requirements for a foreign corporation to be treated as a surrogate foreign corporation is that, after the acquisition, at least 60 percent of the stock (by vote or value) of the entity is held, in the case of an acquisition with respect to a domestic corporation, by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation. Section 7874(a)(2)(B)(ii). As discussed in section B.1. of this preamble, however, the 2009 temporary regulations only address options with respect to the amount of stock treated as held by value; they do not address the effect of options on voting power.

A comment suggested that if the general approach of the 2009 temporary regulations is retained, the effect options have on voting power, if any, should be addressed. Specifically, the comment suggested that options could be treated as: (i) not having voting power; (ii) having voting power corresponding to the number of shares the value of which equals the claim on equity; or (iii) having voting power corresponding to the number of shares that would be obtained upon exercise of the option.

In response to this comment, the final regulations provide that for purposes of determining the voting power of stock under section 7874, an option will be treated as exercised if a principal purpose of the issuance or acquisition of the option is to avoid treating the foreign corporation as a surrogate foreign corporation. In all other cases, options are not taken into account for purposes of determining the voting power of stock under section 7874.

3. *Effect of options on equity holders*

A comment requested clarification that if an option is treated as stock under the claim-on-equity approach, then the ownership percentages of shareholders are reduced. The IRS and the Treasury Department believe that the value of stock inherently reflects the existence of options that have a claim on equity. Therefore, no adjustment to the value of stock under the regulations is necessary. For example, if the stock of a foreign corporation has an aggregate value of $100x (which reflects the existence of options) and there is a single option outstanding with a claim on equity of $10x with respect to the foreign corporation, then under the regulations the total value of the stock of the foreign corporation is treated as $110x for purposes of section 7874. An example in the regulations is modified to clarify this result.

4. *Other rules*

The 2009 temporary regulations provide that, with respect to a foreign corporation, the general option rule does not apply if a principal purpose of the issuance or acquisition of the option is to avoid the foreign corporation being treated as a surrogate foreign corporation. The 2009 temporary regulations do not contain a similar rule with respect to domestic corporations or domestic partnerships.

A comment questioned why the anti-abuse rule only applies to foreign corporations and noted that avoidance concerns may equally be present with options in domestic corporations or partnerships. Accordingly, the comment suggested that the

anti-abuse rule be extended to apply to options with respect to domestic corporations and domestic partnerships. The IRS and the Treasury Department agree with this comment. As a result, the final regulations modify the anti-abuse rule such that it applies to options with respect to all corporations and partnerships, domestic or foreign.

Another comment suggested that the regulations include special rules to take into account certain types of options, such as options subject to vesting and nontransferable options. In response to this comment, the final regulations provide that the claim-on-equity approach does not apply if, at the time of the acquisition, the probability that the option will be exercised is remote.

The final regulations clarify that the rules addressing options also apply for purposes of determining the membership of an expanded affiliated group under section 7874(c)(1). In addition, the text of the final regulations is clarified to provide that a claim on equity equals the value of the stock or partnership interest that may be acquired pursuant to the option, less the exercise price (but in no case is a claim on equity less than zero).

C. *Insolvent Entities*

The 2009 temporary regulations provide that, for purposes of section 7874, if immediately prior to the first date properties are acquired as part of an acquisition described in section 7874(a)(2)(B)(i), a domestic corporation is in a title 11 or similar case (as defined in section 368(a)(3)), or the liabilities of the domestic corporation exceed the value of its assets, then any claim by a creditor against the domestic corporation shall be treated as stock of the domestic corporation. A similar rule applies with respect to a domestic partnership, or a foreign partnership that owns stock of a domestic corporation.

A comment was received stating that, in certain cases, the creditors should be viewed as purchasers of the insolvent entity's assets and, as a result, the transaction should not be subject to section 7874. The comment further stated that applying section 7874 to such creditors could provide third-party bidders for the entity's assets an undue advantage over existing creditors because such bidders would not be subject to section 7874. Accordingly, the comment suggested that the insolvency rule be modified to only apply where creditors acquire the insolvent entity's debt pursuant to a plan to acquire its stock or assets.

The IRS and the Treasury Department believe that, for purposes of section 7874, the creditors of an insolvent entity should be considered the equity holders of the entity. Furthermore, the IRS and the Treasury Department do not believe that insolvent entities should be treated more favorably than other entities under section 7874. Accordingly, this comment is not adopted.

D. *Acquisitions of Multiple Domestic Entities and Disregard of Affiliate-Owned Stock*

The 2009 temporary regulations generally provide that if, pursuant to a plan (or series of related transactions), a foreign corporation completes two or more acquisitions described in section 7874(a)(2)(B)(i) involving domestic corporations or partnerships (domestic entities) then, for purposes of section 7874(a)(2)(B)(ii), the acquisitions are treated as a single acquisition and the domestic entities are treated as a single domestic entity.

Section 7874(c)(2)(A) and §1.7874–1 provide special rules for determining ownership under section 7874(a)(2)(B)(ii) for stock held by members of the expanded affiliated group that includes the foreign corporation. Section 7874(c)(2)(B) provides that stock of the foreign corporation that is sold in a public offering related to the acquisition described in section 7874(a)(2)(B)(i) is not taken into account for purposes of determining ownership under section 7874(a)(2)(B)(ii).

A comment requested clarification as to the application of section 7874(c)(2)(A) and §1.7874–1 when acquisitions of two or more domestic entities are treated as a single domestic entity under the 2009 temporary regulations. The IRS and the Treasury Department are studying the manner in which §1.7874–1 should interact with various rules under section 7874, including the rules in section 7874(c)(2)(B), §1.7874–2(e), and Notice 2009–78, 2009–40 I.R.B. 452 (determination of the ownership fraction when stock is issued in exchange for certain types of property). See §601.601(d)(2)(ii)(*b*). Accordingly, no change has been made to this regulation, but the IRS and the Treasury Department request comments regarding the interaction of §1.7874–1 and other rules under section 7874 related to the ownership fraction.

E. *Downstream Transactions*

The final regulations clarify that an acquisition by a corporation of its stock from another corporation or a partnership is an acquisition of the transferor's properties for purposes of section 7874(a)(2)(B)(i). This rule applies even though, for Federal tax purposes, the acquired stock no longer exists after the transaction. Thus, for example, if a domestic corporation that holds stock in a foreign corporation merges into the foreign corporation, the foreign corporation is, for purposes of section 7874(a)(2)(B)(i), treated as acquiring properties of the domestic corporation in the form of the foreign corporation's stock.

Effective/Applicability Dates

These final regulations apply to acquisitions completed on or after June 7, 2012.

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 this regulation and because the regulation does not impose a collection of information on small entities, the requirements of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) do not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding this regulation 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 Milton M. Cahn of the Office of Associate Chief Counsel (International). 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 continues to read in part as follows:

Authority: 26 USC 7805 * * *

Sections 1.7874–1 and 1.7874–2 also issued under 26 U.S.C. 7874(c)(6) and (g). * * *

Par. 2 Section 1.7874–1 is amended by:

1. Revising paragraph (e).

2. Adding two sentences at the end of paragraph (g).

The revision and addition read as follows:

§1.7874–1 Disregard of affiliate-owned stock.

* * * * *

(e) *Stock held by a partnership*. For purposes of this section, each partner in a partnership shall be treated as holding its proportionate share of stock held by the partnership, as determined under the rules and principles of sections 701 through 777.

* * * * *

(g) * * * Paragraph (e) of this section shall apply to acquisitions completed on or after June 7, 2012. See §1.7874–1T(e), as contained in 26 CFR part 1 revised as of April 1, 2012, for acquisitions completed before June 7, 2012.

§1.7874–1T [Removed]

Par. 3. Section 1.7874–1T is removed.

Par. 4. Section 1.7874–2 is added to read as follows:

§1.7874–2 Surrogate foreign corporation.

(a) *Scope*. This section provides rules for determining whether a foreign corporation is treated as a surrogate foreign corporation under section 7874(a)(2)(B). Paragraph (b) of this section provides definitions and special rules. Paragraph (c) of this section provides rules to determine whether a foreign corporation has acquired properties held by a domestic corporation (or a partnership). Paragraph (d) of this section provides rules that apply when two or more foreign corporations complete, in the aggregate, an acquisition described in section 7874(a)(2)(B)(i). Paragraph (e) of this section provides rules that apply when a single foreign corporation completes more than one acquisition described in section 7874(a)(2)(B)(i). Paragraph (f) of this section provides rules to identify the stock of a foreign corporation that is held by reason of holding stock in a domestic corporation (or an interest in a domestic partnership). Paragraph (g) of this section provides rules that treat certain publicly traded foreign partnerships as foreign corporations for purposes of section 7874. Paragraph (h) of this section provides rules concerning the treatment of certain options (or similar interests) for purposes of section 7874. Paragraph (i) of this section provides rules that treat certain interests (including debt, stock, or a partnership interest) as stock of a foreign corporation for purposes of section 7874. Paragraph (j) of this section provides rules concerning the conversion of a foreign corporation to a domestic corporation by reason of section 7874(b). Paragraph (k) of this section provides examples that illustrate the rules of this section. Paragraph (l) of this section provides the effective/applicability date of this section.

(b) *Definitions and special rules*. Except as otherwise indicated, the following definitions and special rules apply for purposes of this section.

(1) The rules of this section are subject to section 7874(c)(4).

(2) A *former shareholder* of a domestic corporation is any person that held stock in the domestic corporation before the acquisition described in section 7874(a)(2)(B)(i), including any person that holds stock in the domestic corporation both before and after the acquisition.

(3) A *former partner* of a domestic partnership is any person that held an interest in the domestic partnership before the acquisition described in section 7874(a)(2)(B)(i), including any person that holds an interest in the domestic partnership both before and after the acquisition.

(4) An *interest in a partnership* includes a capital or profits interest.

(5) References to *properties held* by a domestic corporation include properties held directly or indirectly by the domestic corporation.

(6) The rules and principles of sections 701 through 777 shall be applied for purposes of determining a proportionate amount (or share) of properties held by a partnership (such as stock).

(7) Any reference to the acquisition of properties held by a domestic corporation (or a partnership) includes a direct or indirect acquisition of such properties.

(8) In the case of an acquisition of stock of a domestic corporation or an interest in a partnership, the proportionate amount of properties held by the domestic corporation (or the partnership) that is treated as indirectly acquired shall, as applicable, be determined at the time of the acquisition based on the relative value of—

(i) The stock acquired compared to all outstanding stock of the domestic corporation; or

(ii) The interest acquired compared to all interests in the partnership.

(9) The determination of whether a foreign corporation is a surrogate foreign corporation is made after the acquisition described in section 7874(a)(2)(B)(i). A foreign corporation that is treated as a surrogate foreign corporation (including a surrogate foreign corporation treated as a domestic corporation described in section 7874(b)) shall continue to be treated as a surrogate foreign corporation (or a domestic corporation), even if the conditions of section 7874(a)(2)(B)(ii) and (iii) are not satisfied at a later date.

(c) *Acquisition of properties*—(1) *Indirect acquisition of properties*. For purposes of section 7874(a)(2)(B)(i), an indirect acquisition of properties held by a domestic corporation (or a partnership) includes, but is not limited to, the acquisitions described in paragraphs (c)(1)(i) through (iv) of this section. An acquisition of less than all of the stock of a domestic corporation (or interests in a partnership) shall constitute an indirect acquisition of a proportionate amount of the properties held by the domestic corporation or the partnership. See paragraph (b)(8) of this section for rules determining the proportionate amount of properties indirectly acquired.

(i) An acquisition of stock of a domestic corporation. See *Example 1* of paragraph (k) of this section for an illustration of the rules of this paragraph (c)(1)(i).

(ii) An acquisition of an interest in a partnership. See *Example 2* of paragraph

(k) of this section for an illustration of the rules of this paragraph (c)(1)(ii).

(iii) An acquisition by a corporation (acquiring corporation) of properties held by a domestic corporation (or a partnership) in exchange for stock of a foreign corporation (foreign issuing corporation) that is part of the expanded affiliated group that includes the acquiring corporation after the acquisition shall be treated as an acquisition by the foreign issuing corporation. See *Example 3* of paragraph (k) of this section for an illustration of the rules of this paragraph (c)(1)(iii).

(iv) An acquisition by a partnership (acquiring partnership) of properties held by a domestic corporation (or a partnership) in exchange for stock of a foreign corporation that is part of the expanded affiliated group that would include the acquiring partnership after the acquisition (if the partnership were a corporation) shall be treated as an acquisition by the foreign issuing corporation.

(2) *Acquisition of stock of a foreign corporation*. An acquisition of stock of a foreign corporation that owns directly or indirectly stock of a domestic corporation (or an interest in a partnership) shall not constitute an indirect acquisition of any properties held by the domestic corporation (or the partnership). See *Example 4* of paragraph (k) of this section for an illustration of the rules of this paragraph (c)(2).

(3) *Downstream transactions*. An acquisition by a corporation of its stock from another corporation or a partnership (for example, as a result of a downstream merger) is an acquisition of the other corporation's or partnership's properties for purposes of section 7874(a)(2)(B)(i).

(d) *Acquisitions by multiple foreign corporations*. If, pursuant to a plan (or a series of related transactions), two or more foreign corporations complete, in the aggregate, an acquisition described in section 7874(a)(2)(B)(i), then each foreign corporation shall be treated as completing the acquisition for purposes of determining whether such foreign corporation is treated as a surrogate foreign corporation. See *Examples 5* and *6* of paragraph (k) of this section for illustrations of the rules of this paragraph (d).

(e) *Acquisitions of multiple domestic entities*. If, pursuant to a plan (or a series of related transactions), a foreign corporation completes two or more acquisitions described in section 7874(a)(2)(B)(i) involving domestic corporations and/or domestic partnerships (domestic entities), then, for purposes of section 7874(a)(2)(B)(ii), the acquisitions shall be treated as a single acquisition and the domestic entities shall be treated as a single domestic entity. If the transaction involves one or more domestic corporations and one or more domestic partnerships, the stock of the foreign corporation held by former shareholders and former partners by reason of holding stock or a partnership interest in the domestic entities shall be aggregated for purposes of determining whether the ownership condition of section 7874(a)(2)(B)(ii) is satisfied. See *Example 7* of paragraph (k) of this section for an illustration of the rules of this paragraph (e).

(f) *Stock held by reason of holding stock in a domestic corporation or an interest in a domestic partnership*—(1) *Specified transactions*. For purposes of section 7874(a)(2)(B)(ii), stock of a foreign corporation that is held by reason of holding stock in a domestic corporation (or an interest in a domestic partnership) includes, but is not limited to, the stock described in paragraphs (f)(1)(i) through (iii) of this section.

(i) Stock of a foreign corporation received in exchange for, or with respect to, stock of a domestic corporation.

(ii) Stock of a foreign corporation received in exchange for, or with respect to, an interest in a domestic partnership.

(iii) To the extent that paragraph (f)(1)(ii) of this section does not apply, stock of a foreign corporation received by a domestic partnership in exchange for all or part of its properties. In such a case, each partner in the domestic partnership shall be treated as holding its proportionate share of the stock of the foreign corporation by reason of holding an interest in the domestic partnership.

(2) *Transactions involving other property*—(i) *Stock of a domestic corporation*. If, pursuant to the same transaction, stock of a foreign corporation is received in exchange for, or with respect to, stock of a domestic corporation and other property, the stock of the foreign corporation that was received in exchange for, or with respect to, the stock of the domestic corporation shall be determined based on the relative value of the stock of the domestic corporation compared to the aggregate value of such stock and the other property.

(ii) *Interest in a domestic partnership*. If, pursuant to the same transaction, stock of a foreign corporation is received in exchange for, or with respect to, an interest in a domestic partnership and other property, the stock of the foreign corporation that was received in exchange for, or with respect to, the interest in the domestic partnership shall be determined based on the relative value of the interest in the domestic partnership compared to the aggregate value of such interest and the other property.

(3) See *Examples 8* through *10* of paragraph (k) of this section for illustrations of the rules of this paragraph (f).

(g) *Publicly traded foreign partnerships*—(1) *Treatment as a foreign corporation*. For purposes of section 7874, a publicly traded foreign partnership described in paragraph (g)(2) of this section shall be treated as a foreign corporation that is organized in the foreign country in which, or under the law of which, the publicly traded foreign partnership was created or organized, and the partnership interests in the publicly traded foreign partnership shall be treated as stock of the foreign corporation. For purposes of determining whether the foreign corporation shall be treated as a surrogate foreign corporation, a deemed acquisition of assets and liabilities by reason of §1.708–1(b)(4) shall not constitute an acquisition described in section 7874(a)(2)(B)(i).

(2) *Publicly traded foreign partnership*. A publicly traded foreign partnership described in this paragraph (g)(2) is any foreign partnership that would, but for section 7704(c), be treated as a corporation under section 7704(a)—

(i) At the time of the acquisition described in section 7874(a)(2)(B)(i); or

(ii) At any time after the acquisition pursuant to a plan that existed at the time of the acquisition. For this purpose, a plan shall be deemed to exist at the time of the acquisition if the foreign partnership would, but for section 7704(c), be treated as a corporation under section 7704(a) at any time during the two-year period following the completion of the acquisition.

(3) *Surrogate foreign corporation to which section 7874(b) applies*. If paragraph (g)(1) of this section applies to a publicly traded foreign partnership and

the foreign corporation is a surrogate foreign corporation to which section 7874(b) applies, the publicly traded foreign partnership shall be treated as a domestic corporation for purposes of the Internal Revenue Code (Code). See paragraph (g)(6) of this section for the timing and treatment of the conversion of the publicly traded foreign partnership to a domestic corporation. See *Example 11* of paragraph (k) of this section for an illustration of the rules of this paragraph (g)(3).

(4) *Surrogate foreign corporation to which section 7874(b) does not apply*. If paragraph (g)(1) of this section applies to a publicly traded foreign partnership and the foreign corporation is a surrogate foreign corporation to which section 7874(b) does not apply, the publicly traded foreign partnership shall continue to be treated as a foreign partnership for purposes of the Code, but section 7874(a)(1) shall apply to any expatriated entity (as defined in section 7874(a)(2)(A)). See *Example 13* of paragraph (k) of this section for an illustration of the rules of this paragraph (g)(4).

(5) *Foreign corporation not treated as a surrogate foreign corporation*. If paragraph (g)(1) of this section applies to a publicly traded foreign partnership and the foreign corporation is not treated as a surrogate foreign corporation, the status of the publicly traded foreign partnership as a foreign partnership shall not be affected by section 7874. See *Example 12* of paragraph (k) of this section for an illustration of the rules of this paragraph (g)(5).

(6) *Conversion to a domestic corporation*. Except for purposes of determining whether the publicly traded foreign partnership is a surrogate foreign corporation, if paragraph (g)(1) of this section applies to a publicly traded foreign partnership and the foreign corporation is a surrogate foreign corporation to which section 7874(b) applies, then at the later of the end of the day immediately preceding the first date properties are acquired as part of the acquisition described in section 7874(a)(2)(B)(i) or immediately after the formation of the publicly traded foreign partnership, the publicly traded foreign partnership shall be treated as transferring all of its assets and liabilities to a newly formed domestic corporation in exchange solely for stock of the domestic corporation, and then distributing such stock to its partners in proportion to their partnership interests in liquidation of the partnership. The treatment of the transfer of assets and liabilities to the domestic corporation and the distribution of the stock of the domestic corporation to the partners in liquidation of the partnership shall be determined under all relevant provisions of the Code and general tax principles.

(h) *Options*—(1) *Value*. Except to the extent otherwise provided in this paragraph (h), for purposes of section 7874, including for purposes of determining the membership of an expanded affiliated group under section 7874(c)(1), an option with respect to a corporation or partnership will be treated as stock in the corporation, or an interest in the partnership, as applicable, with a value equal to the holder's claim on the equity of the corporation or partnership. For this purpose, claim on the equity equals the value of the stock or partnership interest that may be acquired pursuant to the option, less the exercise price (but in no case is a claim on the equity less than zero). Also for this purpose, the equity of the corporation or partnership shall not include the amount of any property the holder of the option would be required to provide to the corporation or partnership under the terms of the option if such option were exercised. See *Example 14* and *Example 16* of paragraph (k) of this section for illustrations of the rules of this paragraph (h)(1).

(2) *Voting power*. Except to the extent otherwise provided in this paragraph (h), for purposes of determining the voting power of a foreign corporation under section 7874, including for purposes of determining the membership of an expanded affiliated group under section 7874(c)(1), an option will be treated as exercised only if a principal purpose of the issuance or transfer of the option is to avoid the foreign corporation being treated as a surrogate foreign corporation.

(3) *Timing*. For purposes of this paragraph (h), the value of the holder's claim on the equity is determined—

(i) In the case of a domestic corporation or a domestic partnership, immediately before the acquisition described in section 7874(a)(2)(B)(i).

(ii) In the case of a foreign corporation or foreign partnership, immediately after the acquisition described in section 7874(a)(2)(B)(i).

(4) *Certain options disregarded*. The rules of paragraph (h)(1) of this section shall not apply to an option if—

(i) A principal purpose of the issuance or acquisition of the option is to avoid the foreign corporation being treated as a surrogate foreign corporation, or

(ii) At the time of the acquisition described in section 7874(a)(2)(B)(i), the probability of the option being exercised is remote.

(5) *Options and interests similar to an option*. For purposes of this paragraph (h), an option includes an interest similar to an option. Examples of options (including interests similar to options) include, but are not limited to, a warrant, a convertible debt instrument, an instrument other than debt that is convertible into stock or a partnership interest, a put, stock or a partnership interest subject to risk of forfeiture, a contract to acquire or sell stock or a partnership interest, and an exchangeable share or exchangeable partnership interest.

(6) *Multiple claims on equity*. Paragraph (h)(1) of this section shall not apply to an option to the extent treating the option as stock or a partnership interest would duplicate a shareholder's or partner's claim on the equity of the corporation or partnership by reason of holding stock in the corporation or an interest in the partnership. See *Example 15* of paragraph (k) of this section for an illustration of the rules of this paragraph (h)(6).

(i) *Interests treated as stock of a foreign corporation*—(1) *Stock or other interests*. If the conditions of paragraphs (i)(1)(i) and (ii) of this section are satisfied, then, for purposes of section 7874, any interest (including stock or a partnership interest) that is not otherwise treated as stock of a foreign corporation (including under paragraph (h) of this section) shall be treated as stock of the foreign corporation. See *Examples 17* and *18* of paragraph (k) of this section for illustrations of the rules of this paragraph (i)(1).

(i) The interest provides the holder distribution rights that are substantially similar in all material respects to the distribution rights provided by stock in the foreign corporation. For this purpose, distribution rights include rights to dividends (or partnership distributions), distributions in redemption of the interest (in whole or in part), distributions in liquidation, or other similar distributions that represent a return

on, or of, the holder's investment in the interest.

(ii) Treating the interest as stock of the foreign corporation has the effect of treating the foreign corporation as a surrogate foreign corporation under section 7874(a)(2)(B).

(2) *Creditor claims*—(i) *Domestic corporation*. For purposes of section 7874, if, immediately prior to the first date properties are acquired as part of an acquisition described in section 7874(a)(2)(B)(i), a domestic corporation is in a title 11 or similar case (as defined in section 368(a)(3)), or the liabilities of the domestic corporation exceed the value of its assets, then each creditor of the domestic corporation shall be treated as a shareholder of the domestic corporation and any claim of the creditor against the domestic corporation shall be treated as stock of the domestic corporation. See *Example 19* of paragraph (k) of this section for an illustration of the rules of this paragraph (i)(2)(i).

(ii) *Domestic or foreign partnership*. For purposes of section 7874, if, immediately prior to the first date properties are acquired as part of an acquisition described in section 7874(a)(2)(B)(i), a partnership (foreign or domestic) is in a title 11 or similar case (as defined in section 368(a)(3)), or the liabilities of the partnership exceed the value of its assets, then each creditor of the partnership shall be treated as a partner in the partnership and any claim of the creditor against the partnership shall be treated as an interest in the partnership.

(iii) *Treatment of creditor as shareholder or partner*. A creditor that is treated as a shareholder or partner under paragraph (i)(2)(i) or (ii) of this section shall be treated as a shareholder or partner for all purposes of section 7874. See, for example, §1.7874–1(c) and paragraph (f) of this section. See *Example 19* of paragraph (k) of this section for an illustration of the rules of this paragraph (i)(2)(iii).

(j) *Application of section 7874(b)*—(1) *Conversion to a domestic corporation*. Except for purposes of determining whether a foreign corporation is treated as a surrogate foreign corporation, the conversion of a foreign corporation to a domestic corporation by reason of section 7874(b) shall constitute a reorganization described in section 368(a)(1)(F) that occurs at the later of the end of the day immediately preceding the first date properties are acquired as part of the acquisition described in section 7874(a)(2)(B)(i) or immediately after the formation of the foreign corporation. See, for example, §§1.367(b)–2 and 1.367(b)–3 for certain consequences of the reorganization. The treatment of all other aspects of the conversion shall be determined under the relevant provisions of the Code and general tax principles. See *Example 20* of paragraph (k) of this section for an illustration of the rules of this paragraph (j)(1).

(2) *Entity classification*. A foreign corporation that is treated as a domestic corporation under section 7874(b) is not an eligible entity as defined in §301.7701–3(a), and therefore may not elect to be classified as other than an association (and thus cannot be treated as other than a corporation) for Federal tax purposes.

(3) *Application of section 367*. If a foreign corporation is treated as a domestic corporation under section 7874(b), section 367 shall not apply to any transfer of property by a United States person to such foreign corporation as part of the acquisition described in section 7874(a)(2)(B)(i). However, section 367 shall apply to the conversion of the foreign corporation to a domestic corporation. See paragraph (j)(1) of this section. See *Example 20* of paragraph (k) of this section for an illustration of the rules of this paragraph (j)(3).

(k) *Examples*—(1) *Assumed facts*. Except as otherwise stated, assume the following for purposes of the examples included in paragraph (k)(2) of this section.

(i) DC1 and DC2 are domestic corporations.

(ii) FA, FP, F1, F2, F3, and F4 are foreign corporations organized in Country A.

(iii) DPS is a domestic partnership that conducts a trade or business.

(iv) FPS is a foreign partnership that is not publicly traded.

(v) Under the terms of the partnership agreements of DPS and FPS, each partner's share in the partnership's items of income, gain, deduction, and loss is determined in accordance with the partner's partnership interest percentage in the partnership, as stated in the examples.

(vi) A, B, and C are unrelated individuals.

(vii) Each entity has a single class of equity outstanding and is unrelated to all other entities.

(viii) All transactions are completed pursuant to a plan.

(ix) All acquisitions of properties are completed after March 4, 2003.

(x) Section 7874(c)(4) does not apply, and no option is issued or acquired with a principal purpose to avoid a foreign corporation being treated as a surrogate foreign corporation.

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

Example 1. Acquisition of stock of a domestic corporation. (i) *Facts*. FA acquires 25% of the outstanding stock of DC1.

(ii) *Analysis*. Under paragraph (c)(1)(i) of this section, for purposes of section 7874(a)(2)(B)(i), FA is treated as acquiring 25% of the properties held by DC1 on the date of the stock acquisition.

Example 2. Acquisition of a partnership interest. (i) *Facts*. DPS wholly owns DC1. FA acquires a 40% interest in DPS.

(ii) *Analysis*. Under paragraph (c)(1)(ii) of this section, for purposes of section 7874(a)(2)(B)(i), FA is treated as acquiring 40 percent of the DC1 stock held by DPS on the date of the acquisition of the partnership interest. Further, under paragraph (c)(1)(i) of this section, for purposes of section 7874(a)(2)(B)(i), FA is treated as acquiring 40% of the properties held by DC1 on the date of the acquisition of the partnership interest.

Example 3. Acquisition of stock by a subsidiary. (i) *Facts*. FP wholly owns FA. FA acquires all the outstanding stock of DC1 in exchange solely for FP stock. FP and FA are members of the same expanded affiliated group after the acquisition.

(ii) *Analysis*. Under paragraph (c)(1)(i) of this section, for purposes of section 7874(a)(2)(B)(i), FA is treated as acquiring 100% of the properties held by DC1 on the date of the stock acquisition. Further, under paragraph (c)(1)(iii) of this section, for purposes of section 7874(a)(2)(B)(i), FP is also treated as acquiring 100% of the properties held by DC1 on the date of the stock acquisition. The result would be the same if instead FA had directly acquired all the properties held by DC1 in exchange for FP stock.

Example 4. *Acquisition of stock of a foreign corporation*. (i) *Facts*. FP wholly owns DC1. FA acquires all of the outstanding stock of FP.

(ii) *Analysis*. Under paragraph (c)(2) of this section, for purposes of section 7874(a)(2)(B)(i), FA is not treated as acquiring any properties held by DC1 on the date of the acquisition of the FP stock.

Example 5. Acquisition of stock by multiple foreign corporations. (i) *Facts*. Pursuant to the same plan, the shareholders of DC1 transfer all of their DC1 stock equally to F1, F2, F3, and F4 in exchange solely for stock of each foreign corporation.

(ii) *Analysis*. Under paragraph (c)(1)(i) of this section, in the aggregate F1, F2, F3, and F4 are treated as acquiring substantially all of the properties held by DC1. Because the acquisition was pursuant to the same plan, under paragraph (d) of this section, F1, F2, F3, and F4 are each treated as acquiring substantially all of the properties held by DC1 for purposes of determining whether each foreign corporation shall be treated as a surrogate foreign corporation.

Example 6. Acquisition of assets by multiple foreign corporations. (i) *Facts.* Individual A wholly owns DC1. DC1 forms F1, F2, F3, and F4, and transfers an equal portion of its properties to each corporation in exchange solely for stock of the corporation. Pursuant to the same plan DC1 then distributes the stock of each foreign corporation to individual A.

(ii) *Analysis.* Because pursuant to the same plan F1, F2, F3, and F4 acquired, in the aggregate, substantially all of the properties held by DC1, under paragraph (d) of this section, F1, F2, F3, and F4 are each treated as acquiring substantially all of the properties held by DC1 for purposes of determining whether each foreign corporation shall be treated as a surrogate foreign corporation.

Example 7. Acquisition of multiple domestic corporations. (i) *Facts.* Individual A wholly owns DC1, and individual B wholly owns DC2. Pursuant to the same plan, individuals A and B transfer all of their DC1 stock and DC2 stock to FA, a newly formed corporation, in exchange solely for all 100 shares of FA stock outstanding.

(ii) *Analysis.* Under paragraph (c)(1)(i) of this section, for purposes of section 7874(a)(2)(B)(i), FA is treated as acquiring all of the properties held by DC1 and DC2 on the date of the stock acquisition. Under paragraph (e) of this section, because pursuant to the same plan FA acquired substantially all of the properties held by DC1 and DC2, for purposes of determining whether FA shall be treated as a surrogate foreign corporation, DC1 and DC2 shall be treated as a single domestic corporation, of which individuals A and B are former shareholders. Thus, individuals A and B are treated as holding all 100 shares of the FA stock by reason of holding stock of such domestic corporation, and the ownership fraction under section 7874(a)(2)(B)(ii) is 100/100, or 100%.

Example 8. Exchange of stock and other property. (i) *Facts.* Individual A wholly owns DC1 and F1. DC1 has a $40x value and F1 has a $60x value. Individual A transfers all of the DC1 stock and F1 stock to FA, a newly formed corporation, in exchange solely for FA stock.

(ii) *Analysis.* Under paragraphs (f)(1)(i) and (f)(2)(i) of this section, for purposes of section 7874(a)(2)(B)(ii), individual A is considered to hold 40% of the FA stock by reason of holding stock in DC1 ($100x FA stock multiplied by $40x/$100x, the relative value of the DC1 stock to all the property transferred by A to FA).

Example 9. Stock received as a distribution. (i) *Facts.* Pursuant to a divisive reorganization described in section 368(a)(1)(D), DC1 contributes substantially all of its properties to FA, a newly formed corporation, in exchange solely for FA stock and then distributes the FA stock to its shareholders in a transaction qualifying under section 355.

(ii) *Analysis.* Under paragraph (f)(1)(i) of this section, for purposes of section 7874(a)(2)(B)(ii), the FA stock received by the DC1 shareholders as a distribution with respect to the DC1 stock is considered held by reason of holding stock in DC1. The result would be the same if the transaction did not qualify as a reorganization (for example, if the distribution were subject to sections 301 and 311(b)).

Example 10. Incorporation of a partnership trade or business. (i) *Facts.* Individuals A and B equally own DPS. DPS transfers substantially all of its properties constituting a trade or business to FA, a newly formed corporation, solely in exchange for FA stock. DPS retains the FA stock after the transaction.

(ii) *Analysis.* Under paragraph (f)(1)(iii) of this section, for purposes of section 7874(a)(2)(B)(ii), individuals A and B are treated as holding a proportionate amount (that is, an equal amount) of the FA stock held by DPS by reason of holding an interest in DPS.

Example 11. Publicly traded foreign partnership treated as domestic corporation. (i) *Facts.* Pursuant to a plan, DC1 and individual B organize a limited liability company (HPS) under the law of Country A. DC1 owns 90% of the membership interests in HPS, and B owns 10% of the membership interests in HPS. HPS is a foreign eligible entity under §301.7701–2, and DC1 and B make an election under §301.7701–3 to treat HPS as a partnership for Federal tax purposes as of the date of the formation of HPS. HPS forms DC2. One day after the formation of HPS, DC2 merges with and into DC1. Pursuant to the merger agreement, the DC1 shareholders exchange their DC1 stock solely for membership interests in HPS. After the merger HPS wholly owns DC1, and the former shareholders of DC1 own a greater than 80% interest in HPS by reason of holding stock of DC1. Public trading of the HPS ownership interests begins the day after the date on which the merger is completed. HPS is not treated as a corporation under section 7704(a) by reason of section 7704(c). If HPS were a corporation, the condition of section 7874(a)(2)(B)(iii) would be satisfied.

(ii) *Analysis.* HPS is a publicly traded foreign partnership that is described in paragraph (g)(2) of this section. Therefore, under paragraph (g)(1) of this section, for purposes of section 7874, HPS is treated as a foreign corporation organized under the law of Country A and the membership interests in HPS are treated as stock of the foreign corporation. The foreign corporation is treated as a surrogate foreign corporation under section 7874(a)(2)(B) because, pursuant to the merger, HPS acquired substantially all of the properties held by DC1, the former shareholders of DC1 hold at least 60% of the stock of the foreign corporation by reason of holding stock of DC1, and the expanded affiliated group that includes the foreign corporation does not have substantial business activities in Country A when compared to the total business activities of the expanded affiliated group. Further, because the former shareholders of DC1 hold at least 80% of the stock of the foreign corporation by reason of holding stock of DC1, section 7874(b) applies to the surrogate foreign corporation, and therefore HPS is treated as a domestic corporation for purposes of the Code. Under paragraph (g)(6) of this section, except for purposes of determining whether HPS is a surrogate foreign corporation, at the end of the day immediately preceding the date of the merger of DC2 with and into DC1, HPS is treated as transferring all of its assets and liabilities to a new domestic corporation in exchange solely for stock of the domestic corporation. HPS is then treated as proportionately distributing such stock to its membership interest holders in liquidation of the partnership. In addition, as a result of the merger of DC2 with and into DC1, the former shareholders of DC1 shall be treated as receiving stock of a domestic corporation in exchange for their DC1 stock.

Example 12. Publicly traded foreign partnership not treated as a surrogate foreign corporation. (i) *Facts.* The facts are the same as in *Example 11* of this section, except that, after the acquisition, the expanded affiliated group that includes HPS (treated as a foreign corporation for this purpose) has substantial business activities in Country A when compared to the total business activities of the expanded affiliated group.

(ii) *Analysis.* Under paragraph (g)(1) of this section, for purposes of section 7874, HPS is treated as a foreign corporation and the membership interests in HPS are treated as stock of the foreign corporation. However, the foreign corporation is not treated as a surrogate foreign corporation under section 7874(a)(2)(B) because, after the acquisition, the expanded affiliated group that includes HPS has substantial business activities in Country A when compared to the total business activities of the expanded affiliated group. Therefore, under paragraph (g)(5) of this section, section 7874 does not apply and the status of HPS as a foreign partnership is not affected. In addition, DC1 is not treated as an expatriated entity under section 7874(a) by reason of the acquisition.

Example 13. Publicly traded foreign partnership treated as a surrogate foreign corporation but not as a domestic corporation. (i) *Facts.* FPS is a publicly traded foreign partnership organized in Country A that, by reason of section 7704(c), is not treated as a corporation under section 7704(a). FPS acquires all the stock of DC1 in exchange for partnership interests in FPS. After the acquisition, the former shareholders of DC1 hold a 75%-interest in FPS by reason of holding DC1 stock. After the acquisition, the expanded affiliated group that includes FPS (treated as a foreign corporation for this purpose) does not have substantial business activities in Country A when compared to the total business activities of the expanded affiliated group.

(ii) *Analysis.* Under paragraph (g)(1) of this section, for purposes of section 7874, FPS is treated as a foreign corporation and the partnership interests in FPS are treated as stock of the foreign corporation. FPS is treated as a surrogate foreign corporation because the conditions of section 7874(a)(2)(B) are satisfied. However, because the former shareholders of DC1 hold less than an 80%-interest in FPS by reason of holding DC1 stock, section 7874(b) does not apply to FPS. Therefore, under paragraph (g)(4) of this section FPS continues to be treated as a foreign partnership for purposes of the Code, but section 7874(a)(1) applies to DC1 and any other expatriated entity.

Example 14. Warrant to acquire stock from the foreign corporation. (i) *Facts.* Individual A wholly owns DC1. DC1 has a $200x value. Individual B wholly owns FA. The value of B's FA stock is $400x. Individual C holds a warrant to acquire FA stock from FA at an exercise price of $20x. Individual A transfers all of its DC1 stock to FA in exchange solely for FA stock with a value of $200x. At the time of the transfer, the FA stock that individual C can acquire pursuant to the warrant has a $70x value.

(ii) *Analysis.* Under paragraphs (h)(1) of this section, for purposes of section 7874, individual C is treated as owning FA stock with a $50x value. This amount represents individual C's claim on the equity of FA after the acquisition ($70x value of FA stock that may be acquired pursuant to the warrant, less the $20x exercise price), without taking into account the $20x individual C would be required to provide to FA upon the exercise of the warrant. Thus, for purposes of section 7874, the value of the stock of FA imme-

diately after the transaction is $650x ($600x of FA stock, plus C's $50x claim on the equity of FA). C's warrant is not taken into account for purposes of determining the voting power of FA under section 7874.

Example 15. Option to acquire stock from another shareholder. (i) *Facts.* The facts are the same as in *Example 14* except that, instead of holding a warrant issued by FA, individual C holds an option to acquire FA stock from individual B for an exercise price of $20x. At the time of the acquisition, the FA stock that individual C can acquire under the option has a $70x value.

(ii) *Analysis.* Under paragraph (h)(6) of this section, for purposes of section 7874, individual C is not treated as owning FA stock by reason of holding the option because treating the option as FA stock would have the effect of partially duplicating individual B's claim on the equity of FA at the time of the acquisition by reason of holding FA stock. However, all of the FA stock owned by individual B will be taken into account for purposes of section 7874. C's warrant is not taken into account for purposes of determining voting power of FA under section 7874.

Example 16. *Warrant to acquire stock from the domestic corporation.* (i) *Facts.* A DC1 employee holds a warrant to acquire DC1 stock from DC1. In connection with the acquisition by FA of substantially all of the properties held by DC1, the DC1 employee receives a warrant from FA to acquire 15 shares of FA stock in exchange for the warrant to acquire DC1 stock.

(ii) *Analysis.* Under paragraphs (h)(1) of this section, for purposes of section 7874, the warrant held by the DC1 employee is treated as DC1 stock with a value equal to the employee's claim on the equity of DC1 immediately before the acquisition. Further, for purposes of section 7874, the DC1 employee is treated as holding FA stock with a value equal to the employee's claim on the equity of FA after the acquisition by reason of holding the warrant to acquire DC1 stock (treated as DC1 stock for this purpose). The option held by the DC1 employee is not taken into account for purposes of determining the voting power of FA under section 7874.

Example 17. Stock in a subsidiary treated as stock of a foreign parent corporation. (i) *Facts.* (A) Individuals A and B equally own DC1. FA, a newly formed corporation, issues stock in a public offering for cash. FA contributes part of the cash from the public offering to DC2, a newly formed corporation, in exchange for all the stock of DC2. DC2 merges with and into DC1 with DC1 surviving. Pursuant to the merger agreement, individuals A and B exchange their DC1 stock for cash and shares of class B stock of DC1. Following the merger FA owns all the class A stock of DC1. FA does not hold significant assets other than the class A stock of DC1. Individuals A and B own all the class B stock of DC1. DC1 has no other class of stock outstanding.

(B) The class B stock entitles individuals A and B to dividend distributions approximately equal to any dividend distributions made by FA with respect to its publicly traded stock. In certain circumstances, the class B stock also permits individuals A and B to require DC1 to redeem the stock at fair market value. The class B stock does not provide individuals A and B voting rights with respect to FA.

(ii) *Analysis.* The dividend rights provided by the class B stock are substantially similar in all material respects to the dividend rights provided by the FA stock. In addition, because FA does not hold significant assets other than the class A stock, the value of the class B stock held by individuals A and B is approximately equal to the value of a corresponding amount of publicly traded FA stock. The distribution rights on liquidation (or redemption) provided by the class B stock, therefore, are substantially similar in all material respects to the distribution rights on liquidation (or redemption) provided by the FA stock. As a result, the distribution rights provided by the class B stock are substantially similar in all material respects to the distribution rights provided by the publicly traded FA stock. Thus, if treating the class B stock as FA stock would have the effect of treating FA as a surrogate foreign corporation, under paragraph (i)(1) of this section the class B stock will be treated as FA stock for purposes of section 7874.

Example 18. Partnership interest treated as stock of foreign acquiring corporation. (i) *Facts.* (A) Individuals A and B equally own DC1. FA, a newly formed corporation, issues stock in a public offering for cash. Individuals A and B and FA organize FPS. FA transfers part of the cash from the public offering to FPS in exchange for a class A partnership interest. FA does not hold any significant assets other than the class A partnership interest. Individuals A and B transfer their DC1 stock to FPS in exchange for class B partnership interests.

(B) The class B partnership interests entitle individuals A and B to cash distributions from FPS approximately equal to any dividend distributions made by FA with respect to its publicly traded stock. In certain circumstances, the class B partnership interests also permit individuals A and B to require FPS to redeem the interests in exchange for cash equal to the value of an amount of FA stock as determined on the redemption date. The class B partnership interests do not provide individuals A or B voting rights with respect to FA.

(ii) *Analysis.* The non-liquidating distribution rights provided by the class B partnership interests are substantially similar in all material respects to the dividend rights provided by the FA stock. Because FA does not hold any significant assets other than the class A partnership interest, the value of the class B partnership interests held by individuals A and B is approximately equal to a corresponding amount of FA stock. The distribution rights on liquidation (or redemption) provided by the class B partnership interests, therefore, are substantially similar in all material respects to distribution rights on liquidation (or redemption) provided by the FA stock. Thus, the distribution rights provided by the class B partnership interests are substantially similar in all material respects to the distribution rights provided by the publicly traded FA stock. As a result, if treating the class B partnership interests as FA stock would have the effect of treating FA as a surrogate foreign corporation, under paragraph (i)(1) of this section the class B partnership interests will be treated as FA stock for purposes of section 7874.

Example 19. Creditor treated as a shareholder. (i) *Facts.* Individuals A and B equally own DC1. The liabilities of DC1 exceed the value of its assets. Pursuant to a plan, FA, a newly formed corporation, acquires substantially all of the properties held by DC1 in exchange solely for FA stock. Pursuant to the plan, the DC1 stock held by individuals A and B is cancelled, and the creditors of DC1 receive all the FA stock in exchange for their claims against DC1.

(ii) *Analysis.* Because immediately before the first date on which properties are acquired as part of the acquisition described in section 7874(a)(2)(B)(i) the liabilities of DC1 exceed the value of its assets, under paragraph (i)(2)(i) of this section, for purposes of section 7874, the creditors of DC1 are treated as shareholders of DC1 and the creditors' claims against DC1 are treated as DC1 stock. Therefore, for purposes of section 7874(a)(2)(B)(ii), the FA stock received by the creditors of DC1 by reason of their claims against DC1 is considered held by former shareholders of DC1 by reason of holding DC1 stock.

Example 20. Conversion to a domestic corporation and application of section 367. (i) *Facts.* Individuals A and B are United States persons and equally own DC1. Pursuant to a plan, individuals A and B transfer their DC1 stock to FA in exchange solely for 80% of the outstanding FA stock. After the acquisition, the expanded affiliated group that includes FA does not have substantial business activities in Country A when compared to the total business activities of the expanded affiliated group.

(ii) *Analysis.* Under paragraph (c)(1)(i) of this section, for purposes of section 7874(a)(2)(B)(i), FA is treated as acquiring all of the properties held by DC1 on the date of the stock acquisition. After the acquisition, the former shareholders of DC1 own 80% of the stock of FA by reason of holding DC1 stock. Therefore, FA is a surrogate foreign corporation that is treated as a domestic corporation under section 7874(b). Under paragraph (j)(1) of this section, except for purposes of determining whether FA is treated as a surrogate foreign corporation, the conversion of FA to a domestic corporation constitutes a reorganization described in section 368(a)(1)(F) that occurs at the end of the day immediately preceding the date of the stock acquisition. Section 367 applies to the conversion of FA to a domestic corporation. See, for example, §§1.367(b)–2 and 1.367(b)–3 for the consequences of the conversion. Under paragraph (j)(3) of this section, section 367 does not apply to the transfers of DC1 stock by individuals A and B to FA.

(l) *Effective/applicability date.* This section applies to acquisitions completed on or after June 7, 2012. For acquisitions completed prior to June 7, 2012, see §1.7874–2T(o), as contained in 26 CFR part 1, revised as of April 1, 2012.

§1.7874–2T [Removed]

Par. 5. Section 1.7874–2T is removed.

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

Approved June 4, 2012.

Emily S. McMahon,
Acting Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on June 7, 2012, 4:15 p.m., and published in the issue of the Federal Register for June 12, 2012, 77 F.R. 34788)

26 CFR 1.7874–3T: Substantial business activities (temporary).

T.D. 9592

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Substantial Business Activities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary Regulations.

SUMMARY: This document contains temporary regulations regarding whether a foreign corporation has substantial business activities in a foreign country. These regulations affect certain domestic corporations and partnerships (and certain parties related thereto), and foreign corporations that acquire substantially all of the properties of such domestic corporations or partnerships. The text of these temporary regulations serves as the text of the proposed regulations (REG–107889–12) set forth in the notice of proposed rulemaking on this subject also published in this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective on June 12, 2012.

Applicability Date: For date of applicability, see §1.7874–3T(f).

FOR FURTHER INFORMATION CONTACT: Mary W. Lyons, (202) 622–3860 and David A. Levine, (202) 622–3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On June 6, 2006, temporary regulations under section 7874 (T.D. 9265, 2006–2 C.B. 1) were published in the **Federal Register** (71 FR 32437) concerning the treatment of a foreign corporation as a surrogate foreign corporation (2006 temporary regulations). A notice of proposed rulemaking (REG–112994–06, 2006–2 C.B. 47) cross-referencing the 2006 temporary regulations was published in the same issue of the **Federal Register** (71 FR 32495). On July 28, 2006, Notice 2006–70, 2006–2 C.B. 252, was published, announcing a modification to the effective date contained in the 2006 temporary regulations. See §601.601(d)(2)(ii)(*b*). On June 12, 2009, the 2006 temporary regulations and the related notice of proposed rulemaking were withdrawn and replaced with new temporary regulations (2009 temporary regulations), which generally applied to acquisitions completed on or after June 9, 2009. T.D. 9453 (74 FR 27920, 2009–28 I.R.B. 114). A notice of proposed rulemaking cross-referencing the 2009 temporary regulations was published in the same issue of the **Federal Register** (74 FR 27947, 2009–28 I.R.B. 144). No public hearing was requested or held; however, comments were received. All comments are available at *www.regulations.gov* or upon request. After consideration of the comments received regarding whether a foreign corporation has substantial business activities in a foreign country, the Internal Revenue Service (IRS) and the Department of the Treasury (Treasury Department) have decided to issue new temporary regulations under §1.7874–3T (2012 temporary regulations) and a new notice of proposed rulemaking that provide guidance regarding this determination. The other portions of the 2009 temporary regulations are finalized in a separate Treasury Decision published elsewhere in this issue of the Bulletin.

Explanation of Provisions

A. *General Approach*

A foreign corporation is generally treated as a surrogate foreign corporation under section 7874(a)(2)(B) if pursuant to a plan (or a series of related transactions): (i) the foreign corporation completes after March 4, 2003, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation; (ii) after the acquisition at least 60 percent of the stock (by vote or value) of the foreign corporation is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation; and (iii) after the acquisition, the expanded affiliated group that includes the foreign corporation does not have substantial business activities in the foreign country (relevant foreign country) in which, or under the law of which, the foreign corporation is created or organized, when compared to the total business activities of the expanded affiliated group. Similar provisions apply if a foreign corporation acquires substantially all of the properties constituting a trade or business of a domestic partnership.

The 2006 temporary regulations provided that the determination of whether the expanded affiliated group has substantial business activities in the relevant foreign country is based on all the facts and circumstances. The 2006 temporary regulations also provided a safe harbor, which generally was satisfied if at least ten percent of the employees, assets, and sales of the expanded affiliated group were in the relevant foreign country. The 2009 temporary regulations retained the facts and circumstances general rule provided in the 2006 temporary regulations, with certain modifications, but removed the safe harbor.

The IRS and the Treasury Department received comments requesting additional guidance on the level of business activities necessary for an expanded affiliated group to have substantial business activities in the relevant foreign country. One comment suggested providing a new safe harbor, which would require a higher percentage of business activities in the relevant foreign country than was required under the safe harbor included in the 2006 temporary regulations. The comment also recommended different safe harbors depending on the extent of the expanded affiliated group's business activities in the United States.

After consideration of the comments and the underlying policies of section 7874, the IRS and the Treasury Department believe the facts and circumstances test of the 2009 temporary regulations should be replaced with a bright-line rule describing the threshold of activities required for an expanded affiliated group to have substantial business activities in the relevant foreign country. The IRS and the Treasury Department believe that such a rule will provide more certainty in applying section 7874 to particular transactions than the 2009 temporary regulations and

will improve the administrability of this provision.

B. *Threshold of Business Activities*

The 2012 temporary regulations provide that an expanded affiliated group will have substantial business activities in the relevant foreign country only if at least 25 percent of the group employees, group assets, and group income are located or derived in the relevant foreign country, determined as follows:

1. *Group employees*

The 2012 temporary regulations set forth two tests, each of which must be satisfied, based on employees of members of the expanded affiliated group (group employees). The first test is calculated as the number of group employees based in the relevant foreign country divided by the total number of group employees determined on the applicable date discussed in section B.4. of this preamble. The second test is calculated as employee compensation with respect to group employees based in the relevant foreign country divided by the total employee compensation with respect to all group employees determined during the one-year testing period.

2. *Group assets*

The group assets test is calculated as the value of the group assets located in the relevant foreign country divided by the total value of all group assets determined on the applicable date. The term group assets generally means tangible personal property or real property used or held for use in the active conduct of a trade or business by members of the expanded affiliated group. For this purpose, group assets include certain property rented by members of the expanded affiliated group, with the value of such rented property being deemed to be eight times the net annual rent paid or accrued with respect to such property. The IRS and the Treasury Department believe that using an eight-times multiple for this purpose is administrable and consistent with the treatment of rented property for other purposes. See, for example, Uniform Division of Income for Tax Purposes Act, §§10 and 11. In order to constitute group assets, such rented property must satisfy the other applicable requirements for group assets, including that the property is used or held for use in the active conduct of a trade or business.

3. *Group income*

The group income test is calculated as the group income derived in the relevant foreign country divided by the total group income determined during the one-year testing period. The term group income means gross income of members of the expanded affiliated group from transactions occurring in the ordinary course of business with customers that are not related persons. Group income is considered to be derived in a foreign country only if the customer is located in such country.

4. *Applicable date*

Section 7874(a)(2)(B)(iii) provides that the determination of whether the expanded affiliated group has substantial business activities is made after the acquisition. However, the IRS and the Treasury Department believe that when the acquisition occurs other than at the end of a month the factors used to determine whether the substantial business activities test is satisfied may not be readily determinable in some cases. Accordingly, the 2012 temporary regulations provide that the number of group employees and the value of group assets can be measured as of the applicable date, which is either the date on which the acquisition is completed or the last day of the month immediately preceding the month in which the acquisition is completed. The applicable date is also used to determine the testing period, which is used in computing group income and employee compensation. When the applicable date is the last day of the month immediately preceding the month in which the acquisition is completed, group employees, employee compensation, group assets, and group income consist of those items or amounts of members that comprise the expanded affiliated group determined at the close of the acquisition date.

C. *Attribution from a Partnership*

The 2009 temporary regulations provided that for purposes of the substantial business activities test, a member of an expanded affiliated group that holds at least a ten-percent capital and profits interest in a partnership takes into account its proportionate share of all items of the partnership. The IRS and the Treasury Department believe that the policies of section 7874 are better advanced if the treatment of partnerships is made consistent with that of corporations for purposes of applying the substantial business activities test on a group basis. Accordingly, the 2012 temporary regulations provide that the items of a partnership should be taken into account for this purpose only if one or more members of the expanded affiliated group holds, in the aggregate, more than 50 percent (by value) of the interests in the partnership. The IRS and the Treasury Department further believe that, consistent with the treatment of corporations, if this ownership requirement is satisfied, then all the items of the partnership should be taken into account for this purpose.

D. *Effective Date*

Subject to a transition rule, the 2012 temporary regulations apply to acquisitions completed on or after June 7, 2012.

Special Analyses

It has been determined that that these temporary regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to the 2012 temporary regulations and because the regulations do not impose a collection of information on small entities, the requirements of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Code, the 2012 temporary regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Requests for Comments

The IRS and the Treasury Department are considering to what extent partners of a partnership should be treated as if they were employees solely for purposes of the two tests based on group employees, and

specifically request comments on these issues. For information on how to submit comments or request a public hearing, see the section ''Comments and Requests for a Public Hearing'' set forth in the notice of proposed rulemaking published elsewhere in this issue of the Bulletin.

Drafting Information

The principal authors of the 2012 temporary regulations are Mary W. Lyons and David A. Levine of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

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 continues to read in part as follows:

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

Section 1.7874–3T is also issued under 26 U.S.C. 7874(c)(6) and (g).* * *

Par. 2. Section 1.7874–3T is added to read as follows:

§1.7874–3T Substantial business activities (temporary).

(a) *Scope*. This section provides rules regarding whether a foreign corporation has substantial business activities in the relevant foreign country when compared to the total business activities of the expanded affiliated group for purposes of section 7874(a)(2)(B)(iii). Paragraph (b) of this section sets forth the threshold of business activities that constitute substantial business activities. Paragraph (c) of this section describes certain items not to be taken into account as located or derived in the relevant foreign country. Paragraph (d) of this section provides definitions and certain rules of application. Paragraph (e) of this section provides rules regarding the treatment of a partnership in which one or more members of an expanded affiliated group own an interest. Paragraph (f) of this section provides the dates of applicability and expiration.

(b) *Threshold of business activities*. The expanded affiliated group will have substantial business activities in the relevant foreign country after the acquisition when compared to the total business activities of the expanded affiliated group only if, subject to paragraph (c) of this section, each of the tests described in paragraphs (b)(1) through (b)(3) of this section is satisfied.

(1) *Group employees*—(i) *Number of employees*. The number of group employees based in the relevant foreign country is at least 25 percent of the total number of group employees on the applicable date.

(ii) *Employee compensation*. The employee compensation incurred with respect to group employees based in the relevant foreign country is at least 25 percent of the total employee compensation incurred with respect to all group employees during the testing period.

(2) *Group assets*. The value of the group assets located in the relevant foreign country is at least 25 percent of the total value of all group assets on the applicable date.

(3) *Group income*. The group income derived in the relevant foreign country is at least 25 percent of the total group income during the testing period.

(c) *Items not to be considered*. The following items are not taken into account in the numerator, but are taken into account in the denominator, for each of the tests described in paragraphs (b)(1) through (b)(3) of this section:

(1) Any group assets, group employees, or group income attributable to business activities that are associated with properties or liabilities the transfer of which is disregarded under section 7874(c)(4).

(2) Any group assets or group employees located in, or group income derived in, the relevant foreign country as part of a plan with a principal purpose of avoiding the purposes of section 7874.

(3) Any group assets or group employees located in, or group income derived in, the relevant foreign country if such group assets or group employees, or the business activities to which such group income is attributable, are subsequently transferred to another country in connection with a plan that existed at the time of the acquisition described in section 7874(a)(2)(B)(i).

(d) *Definitions and application of rules*. The following definitions and rules apply for purposes of this section:

(1) The term *acquisition date* means the date on which the acquisition described in section 7874(a)(2)(B)(i) is completed.

(2) The term *applicable date* means either of the following dates, applied consistently for all purposes of this section:

(i) The acquisition date; or

(ii) The last day of the month immediately preceding the month in which the acquisition described in section 7874(a)(2)(B)(i) is completed.

(3) The term *employee compensation* means all amounts incurred by members of the expanded affiliated group that directly relate to services performed by group employees (including, for example, wages, salaries, deferred compensation, employee benefits, and employer payroll taxes). Employee compensation is determined in U.S. dollars translated, if necessary, using the weighted average exchange rate (as defined in §1.989(b)–1) for the testing period.

(4) The term *expanded affiliated group* means the affiliated group defined in section 7874(c)(1) determined at the close of the acquisition date. The term *member of the expanded affiliated group* means an entity included in the expanded affiliated group. A reference to a member of the expanded affiliated group includes a predecessor with respect to such member.

(5) The term *group assets* means tangible personal property or real property used or held for use in the active conduct of a trade or business by members of the expanded affiliated group, provided such property is owned by members of the expanded affiliated group at the close of the acquisition date. A group asset is considered to be located in the relevant foreign country only if the asset was physically present in such country at the close of the acquisition date and for more time than in any other country during the testing period. All group assets must be valued consistently and on a gross basis (that is, not reduced by liabilities) using either the adjusted tax basis or fair market value determined in U.S. dollars translated, if necessary, at the spot rate determined under the principles of §1.988–1(d)(1), (2), and (4). Tangible personal property or real property that is rented by members of the expanded affiliated group from a person other than

a member of the expanded affiliated group is also treated as a group asset, provided such property is used in the active conduct of a trade or business and is being rented by members of the expanded affiliated group at the close of the acquisition date. For purposes of this section, a group asset that is rented is valued at eight times the net annual rent paid or accrued with respect to the property by members of the expanded affiliated group.

(6) The term *group employees* means employees of members of the expanded affiliated group. A group employee is considered to be based in the relevant foreign country only if the employee spent more time providing services in such country than in any other single country during the testing period.

(7) The term *group income* means gross income of members of the expanded affiliated group from transactions occurring in the ordinary course of business with customers that are not related persons. Group income is translated into U.S. dollars, if necessary, using the weighted average exchange rate (as defined in §1.989(b)–1) for the testing period. Group income is considered derived in the relevant foreign country only if it is derived from a transaction with a customer located in such country.

(8) The term *net annual rent* means the annual rent paid or accrued with respect to property, less any payments received or accrued from subleasing such property (or other similar arrangement).

(9) The term *related person* has the meaning specified in section 954(d)(3), except that section 954(d)(3) is applied by substituting "one or more members of the expanded affiliated group" for "a controlled foreign corporation" and "the controlled foreign corporation" each place they appear.

(10) The term *relevant foreign country* means the foreign country in which, or under the law of which, the foreign corporation was created or organized.

(11) The term *testing period* means the one-year period ending on the applicable date.

(e) *Treatment of partnerships*. For purposes of this section, if one or more members of the expanded affiliated group own, in the aggregate, more than 50 percent (by value) of the interests in a partnership, such partnership will be treated as a corporation that is a member of the expanded affiliated group. Thus, all items of such a partnership are taken into account for purposes of this section. No items of a partnership are taken into account for purposes of this section unless the partnership is treated as a member of the expanded affiliated group pursuant to this paragraph.

(f) *Effective/applicability and expiration dates*. Except as otherwise provided in this paragraph, this section shall apply to acquisitions that are completed on or after June 7, 2012. For acquisitions completed on or after June 7, 2012, that were either described in a filing with the Securities and Exchange Commission on or before June 7, 2012, or that were subject to a written agreement that was binding on June 7, 2012, and at all times thereafter, taxpayers may apply either the rules in §1.7874–2T(g), as contained in 26 CFR part 1 revised as of April 12, 2012, or the rules set forth in this section. The applicability of this section expires on June 5, 2015.

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

Approved June 4, 2012.

Emily S. McMahon,
Acting Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on June 7, 2012, 4:15 p.m., and published in the issue of the Federal Register for June 12, 2012, 77 F.R. 34785)

Part III. Administrative, Procedural, and Miscellaneous

Qualified Energy Conservation Bonds

Notice 2012–44

PURPOSE

This notice provides guidance concerning qualified energy conservation bonds under § 54D of the Internal Revenue Code (Qualified Energy Conservation Bonds). This notice addresses questions regarding qualified conservation purposes eligible for financing with these bonds, particularly (1) how to measure reductions of energy consumption in publicly-owned buildings by at least 20 percent under § 54D(f)(1)(A)(i) and (2) what constitutes a "green community program" under § 54D(f)(1)(A)(ii).

BACKGROUND

Section 301(a) of Title III of Division B, the Energy Improvement and Extension Act of 2008, Pub. L. 110–343, 122 Stat. 1365 (2008) (the "2008 Energy Act"), added new § 54D, which contains program provisions specific to Qualified Energy Conservation Bonds effective for obligations issued after October 3, 2008.

Section 54D(a) provides that the term Qualified Energy Conservation Bond means any bond issued as part of an issue if: (1) 100 percent of the available project proceeds of such issue are to be used for one or more "qualified conservation purposes;" (2) the bond is issued by a State or local government; and (3) the issuer designates such bond for purposes of § 54D. Section 54D(f) defines the term "qualified conservation purpose" to include, among other purposes, capital expenditures incurred for purposes of (i) reducing energy consumption in publicly-owned buildings by at least 20 percent, or (ii) implementing green community programs (including the use of loans, grants, or other repayment mechanisms to implement such programs). Section 54D(d) originally authorized a national bond volume cap of $800 million for Qualified Energy Conservation Bonds, and § 54D(e) generally provides rules for how this volume cap is to be allocated among the States.

Section 1112 of Division B of the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111–5, 123 Stat. 115 (2009) ("ARRA"), amended § 54D in several respects. ARRA increased the national bond volume cap for Qualified Energy Conservation Bonds from $800 million to $3.2 billion. ARRA also amended the provision on "green community programs" to what is in the statute today to clarify that these programs may include the use of loans, grants, or other repayment mechanisms to implement such programs. In addition, ARRA added § 54D(e)(4), which provides generally that bonds issued to provide loans, grants, or other repayment mechanisms for capital expenditures to implement green community programs are not treated as private activity bonds for purposes of the restriction under § 54D(e)(3) against using more than 30 percent of the bond volume cap for private activity bonds.

In Notice 2009–29, 2009–16 I.R.B. 849 (April 6, 2009), the Treasury Department and the IRS allocated the national bond volume cap for Qualified Energy Conservation Bonds to States, the District of Columbia, and possessions of the United States in proportion to population. Notice 2009–29 also provided interim guidance on certain general program requirements under § 54D.

Section 179D also provides tax benefits for reductions in energy consumption in government-owned buildings. Because of the difference in the rules and standards for determining the deduction for energy-efficient commercial buildings under § 179D as compared to the rules and standards for determining whether bonds are Qualified Energy Conservation Bonds under § 54D, this notice, including the rules for measuring the reduction of energy consumption in publicly-owned buildings, does not apply for purposes of § 179D. For guidance on § 179D, see Notice 2006–52, 2006–1 C.B. 1175, Notice 2008–40, 2008–1 C.B. 725, and Notice 2012–26, 2012–17 I.R.B. 847.

LEGISLATIVE HISTORY

The legislative history of the 2008 Energy Act includes the House of Representatives version of the 2008 Energy Act in a bill entitled the "Renewable Energy and Job Creation Act of 2008," H.R. 6049, 110th Cong. (2008) (H.R. 6049). The text of the House Bill is identical, in pertinent part, to the text of the statute that was enacted. House of Representatives Report No. 110–658 accompanied H.R. 6049 and indicates that the House intended the Qualified Energy Conservation Bond rules to be interpreted broadly to give State and local governments wide discretion on methods to conserve energy that may be financed with Qualified Energy Conservation Bonds. The House Report states the following reasons for enacting the Qualified Energy Conservation Bond provision:

Reasons for Change

The Committee believes that it is important to encourage energy conservation. The Committee believes that State and local governments often are in the best position to assess community needs and recognizes there are a number of approaches to energy conservation that State and local governments may wish to encourage. For example, the Committee recognizes that State and local governments may wish to encourage the development of combined heat and power systems, facilities that use thermal energy produced from renewable resources, smart electrical grids, the use of solar panels, mass transit, bicycle paths, or residential property that reduces peak-use of energy. In addition to these approaches, the Committee believes that State and local governments will develop numerous other approaches to energy conservation. Furthermore, the Committee recognizes that there is great potential for energy conservation in urban areas and the Committee believes that local officials should have the flexibility to develop their own approaches to energy conservation. Therefore, the Committee believes that it is appropriate to empower State and local governments by providing them with access to subsidized financing to help promote energy-efficient policies tailored to the needs of local communities.

H. R. Rep. No. 110–658, at 94 (2008).

The legislative history of ARRA gives further indication of the broad discretion

Congress intended to give State and local governments issuing Qualified Energy Conservation Bonds. The Conference Report, H. R. Rep. No. 111–16 (2009), provides:

Conference Agreement

In general

The provision expands the present-law qualified energy conservation bond program. . . . Also, the provision clarifies that capital expenditures to implement green community programs includes grants, loans and other repayment mechanisms to implement such programs. For example, this expansion will enable States to issue these tax credit bonds to finance retrofits of existing private buildings through loans and/or grants to individual homeowners or businesses, or through other repayment mechanisms. Other repayment mechanisms can include periodic fees assessed on a government bill or utility bill that approximates the energy savings of energy efficiency or conservation retrofits. Retrofits can include heating, cooling, lighting, water-saving, storm water-reducing, or other efficiency measures.

H. R. Rep. No. 111–16, at 627 (2009).

QUESTIONS AND ANSWERS

Numerous questions have arisen relating to Qualified Energy Conservation Bonds, particularly how to measure whether there have been reductions of energy consumption in publicly-owned buildings by at least 20 percent under § 54D(f)(1)(A)(i) and what constitutes a "green community program" under § 54D(f)(1)(A)(ii). Set forth below are questions and answers regarding certain of these interpretative issues. Issuers may rely upon these answers until further guidance, if any, is provided.

CAPITAL EXPENDITURES FOR CERTAIN QUALIFIED CONSERVATION PURPOSES

Q.–1. What are "capital expenditures" for purposes of § 54D(f)(1)(A), which provides in relevant part that qualified energy conservation purposes include, among other purposes, capital expenditures incurred for purposes of (i) reducing energy consumption in publicly-owned buildings by at least 20 percent, or (ii) implementing green community programs (including the use of loans, grants, or other repayment mechanisms to implement such programs)?

A–1. For purposes of the capital expenditures requirement in § 54D(f)(1)(A), the definition of a "capital expenditure" applicable to State and local governments for tax-exempt bond purposes in § 1.150–1(b) of the Income Tax Regulations applies. This definition provides that a "capital expenditure" means any cost of a type that is properly chargeable to capital account (or would be so chargeable with a proper election or with the application of the definition of placed in service under § 1.150–2(c)) under general Federal income tax principles. The determination of whether a particular expenditure is a capital expenditure is made when the expenditure is paid or incurred and future changes in law do not affect this determination.

20% REDUCTION IN ENERGY CONSUMPTION IN PUBLICLY-OWNED BUILDINGS

Q–2. What does the term "publicly-owned buildings" mean under § 54D(f)(1)(A)(i)?

A–2. The term "publicly-owned buildings" under § 54D(f)(1)(A)(i) means a building or buildings that are owned by a State or local government (as defined in § 1.103–1) or any instrumentality thereof for Federal tax purposes. If the "measurement unit" (as defined in Q&A 4 below) used to measure reductions in energy consumption is a unit other than a building or buildings, such as a building system component, the building or buildings encompassing the measurement unit must be a publicly-owned building or buildings.

Q–3. What standard applies to determine that available project proceeds are to be used to finance capital expenditures for the purpose of reducing energy consumption in publicly-owned buildings by at least 20 percent under § 54D(f)(1)(A)(i) (the "20 percent test")?

A–3. In general, a reasonable expectations standard (as defined for tax-exempt bond purposes under § 1.148–1(b)) applies for purposes of determining reductions in energy consumption under the 20 percent test. In particular, an issuer may determine that its available project proceeds are to be used in a manner that meets the 20 percent test if, as of the issue date of the issue of Qualified Energy Conservation Bonds, the issuer has reasonable expectations (as defined in § 1.148–1(b)) that the capital expenditures to be financed with the bond proceeds will result in a 20 percent or greater reduction in energy consumption for the selected building, buildings, or building system component(s) comprising the measurement unit for the selected measurement time period, and using a common energy unit. See Q & A 4 (regarding measurement units), Q & A 5 (regarding measurement methods), Q & A 6 (regarding measurement time periods), Q & A 7 (regarding reliance on certifications of independent experts), Q & A 8 (regarding certain available tools for measuring energy reductions), and Q & A 9 (regarding common energy units) below.

Q–4. What is the unit for which the issuer measures reductions in energy consumption for purposes of satisfying the 20 percent test?

A–4. For purposes of the 20 percent test, the issuer may measure the reduction in energy consumption using one of the following measurement units: (i) a single publicly-owned building, (ii) multiple publicly-owned buildings; (iii) one or more building system components of one or more publicly-owned buildings, or (iv) a combination of (i) or (ii) and (iii) above (the "measurement unit"), provided that measurement unit includes the publicly-owned building or buildings, or building system component or components, with respect to which the capital expenditures financed with Qualified Energy Conservation Bond proceeds are incurred. For this purpose, a building system includes a system that serves one of the following functions: heating, ventilation, and air conditioning ("HVAC"): hot water system; lighting; building envelope (*e.g.*, windows, roof, walls, insulation); or electricity "plug load" (*e.g.*, items plugged into electric outlets, such as computers and refrigerators).

Q–5. What methods may be used to measure energy savings attributable to capital expenditures with respect to a measurement unit for purposes of the 20 percent test?

A–5. A reasonable and consistently applied method must be used to measure energy savings attributable to capital expenditures with respect to a measurement unit for purposes of the 20 percent test.

Q–6. What time periods may an issuer use to measure reductions in energy consumption to meet the 20 percent test?

A–6. For purposes of the 20 percent test, the issuer may consider actual and expected energy consumption in the measurement unit during any reasonable and consistent time periods of not less than one year (the measurement time periods), with one such period ending immediately before, and one such period beginning immediately after, all capital expenditures to be financed by the Qualified Energy Conservation Bond proceeds in the measurement unit are to be incurred, using a consistent method of measuring energy use. For example, if the issuer selects measurement time periods of two years, the issuer must determine its energy consumption in the measurement unit during the two years immediately before the capital expenditures are to be incurred and compare it to the energy consumption in the measurement unit during the two years immediately after the capital expenditures are to be incurred (energy consumption during the construction period is not considered), using the same method for measuring energy consumption, to determine if it meets the 20 percent test.

Q–7. May an issuer rely on a certification of an independent expert to establish its reasonable expectations to meet the 20 percent test?

A–7. An issuer may rely on an independent expert to establish that it reasonably expects to meet the 20 percent test, if, no earlier than 60 days before the issue date of the issue, an independent, licensed professional engineer or other independent expert certifies under penalty of perjury that the capital expenditures to be incurred with respect to the measurement unit are reasonably expected to result in the reduction of energy consumption by 20 percent or greater in the measurement unit during the measurement time period. An issuer may rely on this certification only if the actual capital expenditures from the bond proceeds are substantially the same as the expected capital expenditures of such proceeds on which the certification was based.

An example of an engineer's certification for this purpose is attached as Appendix A to this Notice.

Q–8. What tools are available to estimate the energy savings attributable to capital expenditures for purposes of establishing that the issuer had reasonable expectations as of the issue date of the issue that the capital expenditures will result in reduction of energy consumption in publicly-owned buildings by at least 20 percent?

A–8. An issuer or an independent expert on whom an issuer relies may obtain energy savings estimates through an ASHRAE level 3 audit or through building energy use simulation techniques and estimating software, including the DOE (Department of Energy) 2 based Quick Energy Simulation Tool (eQUEST) or other qualified computer software for calculating commercial building energy and power cost savings that meet federal tax incentive requirements as listed by Department of Energy's Building Technology Program at: *http://apps1.eere.energy.gov/buildings/tools_directory/*. Further, an issuer or independent expert may rely on other tools to estimate energy savings, using reasonable and consistently applied methods.

An issuer is not required to subsequently measure the energy savings, but is encouraged to employ energy management and monitoring practices, such as use of the ENERGY STAR Portfolio Manager software to establish energy baselines and track whole building energy performance. *See http://www.energystar.gov/index.cfm?c=evaluate_performance.bus_portfoliomanager*.

Q–9. How does the issuer determine the reduction of energy consumed in the chosen measurement unit if more than one energy source affects the measurement unit and the energy reduction is computed with respect to different types of energy sources, such as electricity and natural gas?

A–9. If more than one energy source affects the measurement unit and thus is taken into account in computing the reduction in energy consumption, the amount of the consumed energy from each source before and after incurring the capital expenditures must be converted into a common energy unit such as, for example, a MMBtu (one million British thermal Units). In this circumstance, for purposes of the 20 percent test, the percentage reduction in energy consumption is based on the percentage reduction for the aggregate of the energy sources, using the common energy unit.

GREEN COMMUNITY PROGRAM

Q–10. What is a "green community program" under § 54D(f)(1)(A)(ii) for which capital expenditures may be incurred as one of the qualified conservation purposes eligible for financing with Qualified Energy Conservation Bonds?

A–10. In general, the term "green community program" means a program that meets the following two requirements:

(1) *Program Purpose*. The purpose of a green community program is to promote one or more of the purposes of energy conservation, energy efficiency, or environmental conservation initiatives relating to energy consumption, broadly construed. Eligible program purposes include, among others, promotion of energy savings through retrofitting initiatives for heating, cooling, lighting, water-saving, storm-water reducing, or other efficiency measures; distributed generation initiatives; or transportation initiatives that conserve energy and/or support alternative fuel infrastructure (which may include, for example, improvements to public bicycle paths or mass transit systems).

(2) *General Public Use or Broad Public Availability*. A green community program must: (i) involve property that is available for general public use (using standards similar to standards for distinguishing general public use from private business use under § 1.141–3(c)); or (ii) involve a loan (or other repayment mechanism) or grant program that is broadly available to members of the general public, including individuals or businesses. A green community program need not affect the entire geographical area or all the residents and businesses within the jurisdiction of the State or local governmental unit that implements the program, provided that the program broadly benefits the general public, residents, or businesses in the affected area of the State or local governmental unit. Examples of programs that are available for general public use include programs to make improvements to public infrastructure that enhances proximity and connectivity between commu-

nity assets and public transit in order to reduce motor vehicle use and promote energy conservation. An example of a loan or grant program that is broadly available to the general public would be a program for residential housing or private building energy efficiency initiatives that provides grants or loans that are broadly available for homeowners or businesses.

Q–11. What is an example of a green community program?

A–11. The following example illustrates the implementation of a green community program with proceeds of Qualified Energy Conservation Bonds. City, a large local government, plans a program to finance capital expenditures to replace existing public street lights located throughout the City with more energy-efficient lights within a 3-year period. City recognizes the program as a green community program and designates the bonds to finance the program as Qualified Energy Conservation Bonds under § 54D(a)(3). Specifically, City plans to use the bond proceeds to replace existing high-pressure luminaries with light emitting diode luminaries that consume substantially less electricity. City's independent experts estimate that the new streetlights will have a useful life of approximately 15 years. As of the issue date of the bonds, City expects that the program will result in substantial energy savings. City's program qualifies as a green community program that meets § 54D(f)(1)(A)(ii) for the following reasons:

1. The program furthers a qualified conservation purpose because it promotes energy conservation. The program calls for the replacement of existing street lights with more efficient street lights.

2. The program involves public streetlights that are available for general public use.

3. The proceeds of the bond will be used for capital expenditures within the meaning of § 1.150–1(b) to replace the street lights.

FURTHER INFORMATION

For further information regarding this notice, contact Zoran Stojanovic at (202) 622–3980 (not a toll-free call).

APPENDIX A

Qualified Energy Conservation Bonds Statement of Expected Savings and Signatures

Qualified Professional Engineer certifying reasonable expectation of 20% or greater savings using based on an ASHRAE Level 3 audit or through use of DOE-approved software tool.

Name: _____

Address: _____

Phone: _____

I certify that the expected percentage of energy savings from the capital expenditures financed with Qualified Energy Conservation Bonds for the measurement unit and measurement time specified by the issuer is at least 20 percent.

Address of the building(s) (and description of component(s), if applicable) to which the certification applies:

_____

_____

Qualified Professional Engineer must initial and complete one or more of the following statements:

_____ (1) I conducted an ASHRAE level 3 energy audit to estimate the expected savings from planned improvements that will be financed through the qualified energy conservation bond.

_____ (2) I used a qualified computer software for calculating commercial building energy and power cost savings that meet federal tax incentive requirements as listed by Department of Energy's Building Technology Program to estimate the expected savings from planned improvements that will be financed through the qualified energy conservation bond. The name and version of the software is: _____

Penalty of perjury statement to be signed by the Qualified Professional Engineer that performs field inspections and generates certification form using qualified computer software.

Under penalties of perjury, I declare that I have examined this certification, including supporting documents, and to the best of my knowledge and belief, the facts presented in support of this certification are true, correct, and complete.

Professional Engineer License # and State: _____

Signature of Professional Engineer: _____

Date Signed: _____

26 CFR 1.83–2: Election to include in gross income in year of transfer.

Rev. Proc. 2012–29

SECTION 1. PURPOSE

This revenue procedure contains sample language that may be used (but is not required to be used) for making an election under § 83(b) of the Internal Revenue Code. Additionally, this revenue procedure provides examples of the income tax consequences of making such an election.

SECTION 2. BACKGROUND

.01 Section 83(a) provides generally that if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of the fair market value of the property (determined without regard to any restriction other than a restriction which by its terms will never lapse) as of the first time that the transferee's rights in the property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over the amount (if any) paid for the property is included in the service provider's gross income for the taxable year which includes such time.

.02 Under § 1.83–3(f) of the Income Tax Regulations, property is transferred in connection with the performance of services if it is transferred to an employee or independent contractor (or beneficiary thereof) in recognition of the performance of services, or refraining from performance of services. The existence of other persons entitled to buy stock on the same terms and conditions as an employee, whether pursuant to a public or private offering may, however, indicate that in such circumstance a transfer to the employee is not in recognition of the performance of, or refraining from performance of, services. The transfer of property is subject to § 83 whether such transfer is in respect of past, present, or future services.

.03 Section 83(b) and § 1.83–2(a) permit the service provider to elect to include in gross income the excess (if any) of the fair market value of the property at the time of transfer over the amount (if any) paid for the property, as compensation for services.

.04 Under § 83(e)(3) and § 1.83–7(b), § 83 does not apply to the transfer of an option without a readily ascertainable fair market value at the time the option is granted. As a result, a § 83(b) election may only be made with respect to the transfer of an option that has a readily ascertainable fair market value (as defined in § 1.83–7(b)), at the time the option is granted and that is substantially nonvested

(as defined in § 1.83–3(b)). If substantially nonvested property is received upon exercise of an option without a readily ascertainable fair market value at grant, a service provider is permitted to make a § 83(b) election with respect to the transfer of such property upon the exercise of the option.

.05 Under § 83(b)(2), an election made under § 83(b) must be made in accordance with the regulations thereunder and must be filed with the Internal Revenue Service no later than 30 days after the date that the property is transferred to the service provider. In accordance with § 7503, if the thirtieth day following the transfer of property falls on a Saturday, Sunday or legal holiday, the election will be considered timely filed if it is postmarked by the next business day.

.06 Under § 1.83–2(c), an election under § 83(b) is made by filing a copy of a written statement with the Internal Revenue Service office with which the person who performed the service files his return. In addition, the person who performed the services is required to submit a copy of such statement with his or her income tax return for the taxable year in which such property was transferred. Section 1.83–2(d) requires that the person who performed the services also submit a copy of the § 83(b) election to the person for whom the services were performed.

.07 Under § 1.83–2(e), the statement must be signed by the person making the election and must indicate the election is being made under § 83(b). The statement must include the following information: the name, address and taxpayer identification number of the taxpayer; a description of each property with respect to which the election is being made; the date or dates on which the property was transferred and the taxable year for which such election is being made; the nature of the restriction or restrictions to which the property is subject; the fair market value at the time of transfer (determined without regard to any lapse restrictions, as defined in § 1.83–3(i)) of each property with respect to which the election is being made; the amount, if any, paid for such property; and a statement to the effect that copies have been furnished to other persons as provided in § 1.83–2(d).

.08 Under § 1.83–2(f), an election under § 83(b) may not be revoked except with the consent of the Commissioner. The regulations also provide that such consent will only be granted where the person filing the election is under a mistake of fact as to the underlying transaction and must be requested within 60 days of the date on which the mistake of fact first became known to the person who made the election. Neither a mistake as to the value (or decline in the value) of the property for which the election was made nor the failure of anyone to perform an act that was contemplated at the time of transfer of the property constitutes a mistake of fact for this purpose. See Rev. Proc. 2006–31, 2006–2 C.B. 32, for additional guidance with respect to revoking an election under § 83(b).

SECTION 3. SCOPE

This revenue procedure applies to taxpayers who receive substantially nonvested property in connection with the performance of services and wish to file an election under § 83(b).

SECTION 4. CONSEQUENCES OF ELECTIONS UNDER § 83(b)

.01 Under § 1.83–2(a), if property is transferred in connection with the performance of services, the person performing such services may elect to include in gross income under § 83(b) the excess (if any) of the fair market value of the property at the time of transfer (determined without regard to any lapse restriction, as defined in § 1.83–3(i)) over the amount (if any) paid for such property, as compensation for services. If this election is made, the substantial vesting rules of § 83(a) and the regulations thereunder do not apply with respect to such property, and except as otherwise provided in § 83(d)(2) and the regulations thereunder (relating to the cancellation of a nonlapse restriction), any subsequent appreciation in the value of the property is not taxable as compensation to the person who performed the services. Thus, the value of property with respect to which this election is made is included in gross income as of the time of transfer, even though such property is substantially nonvested (as defined in § 1.83–3(b)) at the time of transfer, and no compensation will be includible in gross income when such property becomes substantially vested.

.02 In computing the gain or loss from a subsequent sale or exchange of property for which a § 83(b) election was filed, § 1.83–2(a) provides that the basis of such property shall be the amount paid for the property (if any) increased by the amount included in gross income under § 83(b).

.03 If property for which a § 83(b) election was filed is forfeited while substantially nonvested, § 83(b)(1) provides that no deduction shall be allowed with respect to such forfeiture. Section 1.83–2(a) further provides that such forfeiture shall be treated as a sale or exchange upon which there is realized a loss equal to the excess (if any) of (1) the amount paid (if any) for such property, over (2) the amount realized (if any) upon such forfeiture. If such property is a capital asset in the hands of the taxpayer, such loss shall be a capital loss.

SECTION 5. EXAMPLES

The following examples illustrate the tax results that may occur depending on whether or not a § 83(b) election is made following the transfer of substantially nonvested stock in connection with the performance of services. The tax results in the examples do not depend on whether or not the stock transferred to the employee is traded on an established securities market.

Example 1. Company A is a privately held corporation and no stock in Company A is traded on an established securities market. On April 1, 2012, in connection with the performance of services, Company A transfers to E, its employee, 25,000 shares of substantially nonvested stock in Company A. In exchange for the stock, E pays Company A $25,000, representing the fair market value of the shares at the time of the transfer. The restricted stock agreement provides that if E ceases to provide services to Company A as an employee prior to April 1, 2014, Company A will repurchase the stock from E for the lesser of the then current fair market value or the original purchase price of $25,000. E's ownership of the 25,000 shares of stock will not be treated as substantially vested until April 1, 2014 and will only be treated as substantially vested if E continues to provide services to Company A as an employee until April 1, 2014. On April 1, 2012, E makes a valid election under § 83(b) with respect to the 25,000 shares of Company A stock. Because the excess of the fair market value of the property ($25,000) over the amount E paid for the property ($25,000) is $0, E includes $0 in gross income for 2012 as a result of the stock transfer and related § 83(b) election. The 25,000 shares of stock become substantially vested on April 1, 2014 when the fair market value of the shares is $40,000. No compensation is includible in E's gross income when the shares become substantially vested on April 1, 2014. In 2015, E sells the stock for $60,000. As a result

of the sale, E realizes $35,000 ($60,000 sale price - $25,000 basis) of gain, which is a capital gain.

Example 2. The facts are the same as in *Example 1* above, except that E does not make an election under § 83(b). Under § 83(a), E includes $0 in gross income in 2012 as a result of the transfer of stock from Company A because the stock is not substantially vested. When the shares become substantially vested on April 1, 2014, E includes $15,000 ($40,000 fair market value less $25,000 purchase price) of compensation in gross income. E's basis in the stock as of April 1, 2014 is $40,000 ($25,000 paid for the stock and $15,000 included in income under § 83(a)). As a result of the 2015 sale of the stock for $60,000, E realizes $20,000 ($60,000 sale price - $40,000 basis) of gain, which is a capital gain.

Example 3. The facts are the same as in *Example 1* above, except that E terminates employment with Company A on August 1, 2013 before the shares become substantially vested. Because the excess of the fair market value of the property ($25,000) over the amount E paid for the property ($25,000) is $0, E includes $0 in gross income for 2012 as a result of the stock transfer and related § 83(b) election. When E terminates employment on August 1, 2013, the fair market value of the stock is $30,000 but Company A purchases the stock from E for $25,000 pursuant to the terms of the restricted stock agreement. As a result of the 2013 sale of the stock for $25,000, E realizes $0 in gain ($25,000 sale price - $25,000 basis).

Example 4. Company B is a publicly held corporation and Company B stock is traded on an established securities market. On April 1, 2012, in connection with the performance of services, Company B transfers to F, its employee, 25,000 shares of substantially nonvested stock in Company B. At the time of the transfer, the shares have an aggregate fair market value of $25,000. F is not required to pay Company B any consideration in exchange for the stock. The restricted stock agreement provides that if F ceases to provide services to Company B as an employee prior to April 1, 2014, F will forfeit the stock back to Company B. F's ownership of the 25,000 shares of stock will not be treated as substantially vested until April 1, 2014 and will only be treated as substantially vested if F continues to provide services to Company B as an employee until April 1, 2014. On April 1, 2012, F makes a valid election under § 83(b) with respect to the 25,000 shares of Company B stock. Because the excess of the fair market value of the property ($25,000) over the amount F paid for the property ($0) is $25,000, F includes $25,000 of compensation in gross income for 2012 as a result of the stock transfer and related § 83(b) election. The 25,000 shares of stock become substantially vested on April 1, 2014 when the fair market value of the shares is $40,000. No compensation is includible in F's gross income when the shares become substantially vested on April 1, 2014. In 2015, F sells the stock for $60,000. As a result of the sale, F realizes $35,000 ($60,000 sale price - $25,000 basis) in gain, which is a capital gain.

Example 5. The facts are the same as in *Example 4* above, except that F does not make an election under § 83(b). Under § 83(a), F includes $0 in gross income in 2012 as a result of the transfer of stock from Company B because the stock is not substantially vested. When the shares become substantially vested on April 1, 2014, F includes $40,000 ($40,000 fair market value less $0 purchase price) of compensation in gross income. F's basis in the stock as of April 1, 2014 is $40,000 ($0 paid for the stock and $40,000 included in income under § 83(a)). As a result of the 2015 sale of the stock for $60,000, F realizes $20,000 ($60,000 sale price - $40,000 basis) of gain, which is a capital gain.

Example 6. The facts are the same as in *Example 4* above, except that F terminates employment with Company B on August 1, 2013 and forfeits the shares before the shares become substantially vested. Because the excess of the fair market value of the property ($25,000) over the amount F paid for the property ($0) is $25,000, F includes $25,000 of compensation in gross income for 2012 as a result of the stock transfer and related § 83(b) election. In the year F terminates employment, F forfeits the 25,000 shares back to Company B and such forfeiture is treated as a sale of the shares in exchange for no consideration. Pursuant to § 1.83–2(a), F realizes no loss as the result of such sale. F is not entitled to a deduction or credit for taxes paid as the result of filing the § 83(b) election or the subsequent forfeiture of the property.

SECTION 6. SAMPLE ELECTION

.01 The sample election in this section, if properly completed and executed by an individual taxpayer, would satisfy the requirements of § 1.83–2 regarding the required content of a § 83(b) election with respect to shares of common stock subject to a substantial risk of forfeiture. For the election to be valid, the service provider must in addition satisfy all other applicable requirements, including the requirements discussed above relating to the time for filing the election, filing the election with the Internal Revenue Service, attaching a copy of the election to the tax return, and providing a copy to the service recipient. An election under § 83(b) must contain all the information required by § 1.83–2(e), but need not use the exact format or language of the sample election set forth below. In the sample election below, bracketed items and blanks should be replaced with the applicable information for the taxpayer. An election with respect to property other than common stock should include an appropriate description of the property in item 2 and modifications to items 5 and 6 as necessary.

.02 The text of the sample election follows.

Section 83(b) Election

The undersigned taxpayer hereby elects, pursuant to § 83(b) of the Internal Revenue Code of 1986, as amended, to include in gross income as compensation for services the excess (if any) of the fair market value of the shares described below over the amount paid for those shares.

1. *The name, taxpayer identification number, address of the undersigned, and the taxable year for which this election is being made are:*

   TAXPAYER'S NAME: _____
   TAXPAYER'S SOCIAL SECURITY NUMBER: _____
   ADDRESS: _____
   *TAXABLE YEAR: Calendar Year 20*_____

2. *The property which is the subject of this election is* _____ *shares of common stock of* _____.

3. *The property was transferred to the undersigned on* ***[DATE].***

4. *The property is subject to the following restrictions:* ***[Describe applicable restrictions here.]***

5. *The fair market value of the property at the time of transfer (determined without regard to any restriction other than a nonlapse restriction as defined in § 1.83–3(h) of the Income Tax Regulations) is: $*_____ *per share x* _____ *shares = $*_____.

6. *For the property transferred, the undersigned paid $*_____ *per share x* _____ *shares = $*_____.

7. *The amount to include in gross income is $*_____. ***[The result of the amount reported in Item 5 minus the amount reported in Item 6.]***

The undersigned taxpayer will file this election with the Internal Revenue Service office with which taxpayer files his or her annual income tax return not later than 30 days after the date of transfer of the property. A copy of the election also will be furnished to the person for whom the services were performed. Additionally, the undersigned will include a copy of the election with his or her income tax return for the taxable year in which the property is transferred. The undersigned is the person performing the services in connection with which the property was transferred.

Dated: _____ _____
Taxpayer

SECTION 7: PAPERWORK REDUCTION ACT

.01 The collection of information contained in this revenue procedure has 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 1545–2018. 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.

.02 The collection of information in this revenue procedure is in Section 6. The use of the sample election language provided under Section 6 is voluntary, however, this information is required in order for a taxpayer to make a valid election under § 83(b) of the Code. This information on the § 83(b) elections filed by the taxpayers with the IRS will be used by the IRS for matching with the income tax returns filed by the taxpayers. The likely respondents are individuals and business or other for-profit institutions.

.03 The estimated total annual reporting and/or recordkeeping burden is 33,000 hours.

.04 The estimated annual burden per respondent/recordkeeper varies from 10 to 30 minutes, depending on individual circumstances, with an estimated average of 20 minutes.

.05 The estimated number of respondents and/or recordkeepers is 100,000.

.06 The estimated frequency of responses (used for reporting requirements only) is on occasion.

.07 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.

SECTION 8. EFFECTIVE DATE

This revenue procedure is effective June 25, 2012.

SECTION 9. DRAFTING INFORMATION

The principal author of this revenue procedure is Michael Hughes of the Office of Associate Chief Counsel (Tax Exempt & Government Entities). For further information regarding this revenue procedure contact Thomas Scholz or Michael Hughes at (202) 622–6030 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations

Substantial Business Activities

REG–107889–12

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 and the Treasury Department are issuing temporary regulations (T.D. 9592) regarding whether a foreign corporation has substantial business activities in a foreign country. These regulations affect certain domestic corporations and partnerships (and certain parties related thereto), and foreign corporations that acquire substantially all of the properties of such domestic corporations or partnerships. The text of the temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations and these proposed regulations.

DATES: Written or electronic comments and requests for a public hearing must be received by September 10, 2012.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–107889–12), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–107889–12), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC, or sent electronically via the Federal eRulemaking Portal at *www.regulations.gov* (IRS and REG–107889–12).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Mary W. Lyons, (202) 622–3860 and David A. Levine, (202) 622–3860; concerning submissions of comments or requests for a public hearing, Oluwafunmilayo (Funmi) Taylor, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Temporary regulations in this issue of the Bulletin amend the Income Tax Regulations (26 CFR part 1) relating to section 7874 of the Code. The temporary regulations provide guidance regarding whether a foreign corporation has substantial business activities in a foreign country for purposes of whether a foreign corporation is treated as a surrogate foreign corporation under section 7874(a)(2)(B). The text of those regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains these amendments.

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. These regulations do not impose a collection of information. Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that this regulation will not have a significant economic impact on a substantial number of small entities. The complexity and cost of a transaction to which section 7874 may apply make it unlikely that a substantial number of small entities will engage in such a transaction. In addition, any economic impact to entities affected by section 7874, large or small, is derived from the operation of the statute or its intended application, and not from the temporary regulations. Pursuant to section 7805(f) of the Code, these regulations have been 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 (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department specifically request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will 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 for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these proposed regulations are Mary W. Lyons and David A. Levine of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department 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 1.7874–3 is also issued under 26 U.S.C. 7874(c)(6) and (g).* * *

Par. 2. Section 1.7874–3 is added to read as follows:

§1.7874–3 Substantial Business Activities.

[The text of proposed §1.7874–3 is the same as the text of §1.7874–3T published elsewhere in this issue of the Bulletin].

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on June 7, 2012, 4:15 p.m., and published in the issue of the Federal Register for June 12, 2012, 77 F.R. 34887)

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations and Notice of Public Hearing

Portability of a Deceased Spousal Unused Exclusion Amount

REG–141832–11

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: In this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9593) that provide guidance on the estate and gift tax applicable exclusion amount, in general, as well as on the applicable requirements for electing portability of a deceased spousal unused exclusion (DSUE) amount to the surviving spouse and on the applicable rules for the surviving spouse's use of this DSUE amount. The text of the temporary regulations also serves as the text of the proposed regulations set forth in this notice of proposed rulemaking. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by September 17, 2012. Outlines of topics to be discussed at the public hearing scheduled for October 18, 2012, at 10 a.m., must be received by September 27, 2012.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG–141832–11), Room 5205, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–141832–11), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC; or sent electronically via the Federal eRulemaking Portal at *http://www.regulations.gov* (IRS-REG–141832–11). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, N.W., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Karlene Lesho at (202) 622–3090; concerning the submission of comments, the hearing, or to be placed on the building access list to attend the hearing, Oluwafunmilayo Taylor at (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 approved by the Office of Management and Budget, in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)), under Form 706, "*United States Estate (and Generation-Skipping Transfer) Tax Return*," and assigned control number 1545–0015.

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:M:S, Washington, DC 20224. Comments on the collection of information should be received by August 17, 2012. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

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

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

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

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

The collection of information in this proposed regulation is in proposed §§20.2010–2(a), 20.2010–2(a)(1), 20.2010–2(a)(3)(i), 20.2010–2(a)(7)(ii)(B), and 20.2010–2(b). The information in §§20.2010–2(a), 20.2010–2(a)(1), and 20.2010–2(b) as it affects estates not otherwise required to file an estate tax return under section 6018(a) is necessary in order for an executor of a decedent's estate to elect portability of a DSUE amount to the surviving spouse. The information in §20.2010–2(a)(3)(i) is necessary in order for an executor of a decedent's estate to signify that the estate is not electing portability of a DSUE amount to the surviving spouse. The information in §20.2010–2(a)(7)(ii)(B) is necessary in order to evaluate whether an estate qualifies for a special rule relating to applicable estate tax return requirements. The collection of information is voluntary to obtain a benefit. The likely respondents are executors of estates of decedents having a date of death in 2011 or 2012 or any subsequent period in which portability of a DSUE amount is in effect.

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 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

The temporary regulations in this issue of the Bulletin make additions to the Estate Tax Regulations (26 CFR part 20) under sections 2001 and 2010 of the Internal Revenue Code (Code) and Gift Tax Regulations (26 CFR part 25) under section 2505 of the Code. The temporary

regulations provide guidance on the estate and gift tax applicable credit amount under sections 2010 and 2505 of the Code. In addition, the temporary regulations provide guidance on the portability of a deceased spousal unused exclusion (DSUE) amount under section 2010(c) of the Code, including the applicable requirements for electing portability of a DSUE amount to the surviving spouse, for computing the deceased spouse's DSUE amount, and for the surviving spouse's use of the DSUE amount. The text of those regulations also serves as the text of these regulations. The preamble to the temporary regulations explains the temporary regulations and these proposed regulations.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS as prescribed in this preamble under the **ADDRESSES** heading. The IRS and the Treasury Department request comments on all aspects of the proposed rules. All comments will be available at *www.regulations.gov* or for public inspection and copying.

A public hearing has been scheduled for October 18, 2012, in the IRS auditorium, Internal Revenue Building, 1111 Constitution Avenue, N.W., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments (a signed original and eight (8) copies) and an outline of the topics to be discussed and the time to be devoted to each topic by September 27, 2012. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Karlene Lesho, Office of the Associate Chief Counsel (Passthroughs and Special Industries). Other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 20 and 25 are proposed to be amended as follows:

PART 20—ESTATE TAX; ESTATE OF DECEDENTS DYING AFTER AUGUST 16, 1954

Paragraph 1. The authority citation for part 20 is amended by adding entries in numerical order to read as follows:

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

Section 20.2010–0 also issued under 26 U.S.C. 2010(c)(6).

Section 20.2010–1 also issued under 26 U.S.C. 2010(c)(6).

Section 20.2010–2 also issued under 26 U.S.C. 2010(c)(6).

Section 20.2010–3 also issued under 26 U.S.C. 2010(c)(6). * * *

Par. 2. Section 20.2001–2 is added to read as follows:

§20.2001–2 Valuation of adjusted taxable gifts for purposes of determining the deceased spousal unused exclusion amount of last deceased spouse.

[The text of the proposed amendments to §20.2001–2(a) and (b) is the same as the text of §20.2001–2T(a) and (b) published elsewhere in this issue of the Bulletin].

Par. 3. Section 20.2010–0 is added to read as follows:

§20.2010–0 Table of contents.

[The entries in the table of contents for the proposed amendments to §20.2010–0 are the same as the entries in the table of contents for §20.2010–0T published elsewhere in this issue of the Bulletin].

Par. 4. Section 20.2010–1 is added to read as follows:

§20.2010–1 Unified credit against estate tax; in general.

[The text of the proposed amendments to §20.2010–1(a) through (e) is the same as the text of §20.2010–1T(a) through (e) published elsewhere in this issue of the Bulletin].

Par. 5. Section 20.2010–2 is added to read as follows:

§20.2010–2 Portability provisions applicable to estate of a decedent survived by a spouse.

[The text of the proposed amendments to §20.2010–2(a) through (e) is the same as the text of §20.2010–2T(a) through (e) published elsewhere in this issue of the Bulletin].

Par. 6. Section 20.2010–3 is added to read as follows:

§20.2010–3 Portability provisions applicable to the surviving spouse's estate.

[The text of the proposed amendments to §20.2010–3(a) through (f) is the same as the text of §20.2010–3T(a) through (f) published elsewhere in this issue of the Bulletin].

PART 25—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

Par. 7. The authority citation for part 25 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805.

Section 25.2505–2T also issued under 26 U.S.C. 2010(c)(6). * * *

Par. 8. Section 25.2505–0 is added to read as follows:

§25.2505–0 Table of contents.

[The entries in the table of contents for the proposed amendments to §25.2505–0 are the same as the entries in the table of contents for §25.2505–0T published elsewhere in this issue of the Buletin].

Par. 9. Section 25.2505–1 is added to read as follows:

§25.2505–1 Unified credit against gift tax; in general.

[The text of the proposed amendments to §25.2505–1(a) through (e) is the same as the text of §25.2505–1T(a) through (e) published elsewhere in this issue of the Bulletin].

Par. 10. Section 25.2505–2 is added to read as follows:

§25.2505–2 Gifts made by a surviving spouse having a DSUE amount available.

[The text of the proposed amendments to §25.2505–2(a) through (g) is the same as the text of §25.2505–2T(a) through (g) published elsewhere in this issue of the Bulletin].

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on June 15, 2012, 8:45 a.m., and published in the issue of the Federal Register for June 18, 2012, 77 F.R. 36229)

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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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2012–1 through 2012–26 is in Internal Revenue Bulletin 2012–26, dated June 25, 2012.

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REG-100276-97
Withdrawn by
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[1] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2012–1 through 2012–26 is in Internal Revenue Bulletin 2012–26, dated June 25, 2012.

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