Internal Revenue bulletin

Bulletin No. 2004-39
September 27, 2004

# 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. 2004–97, page 516.

**Section 7805(b); Rev. Rul. 2004–75.** This ruling grants insurance companies section 7805(b) relief from the retroactive application of Rev. Rul. 2004–75. Rev. Rul. 2004–75 will not be applied to payments made to nonresident alien individuals or *bona fide* residents of Puerto Rico under life insurance or annuity contracts issued by foreign or Puerto Rican branches of U.S. life insurance companies before January 1, 2005, provided such payments are made pursuant to binding life insurance or annuity contracts issued by such branches on or before July 12, 2004. Rev. Rul. 2004–75 amplified.

### T.D. 9150, page 514.

Final regulations under sections 141 and 142 of the Code finalize a portion of proposed regulations (REG–132483–03) that modify remedial action regulations. The regulations make one substantive change to the proposed regulations. This change provides an additional method for determining which bonds must be remediated for certain issuers with outstanding bonds. The regulations will generally apply to failures to properly use proceeds that occur on or after August 13, 2004.

### T.D. 9152, page 509.

Final regulations under section 121 of the Code provide rules relating to the reduced maximum exclusion of gain from the sale or exchange of property that the taxpayer has not owned and used as the taxpayer's principal residence for two of the preceding five years or when the taxpayer has excluded gain from the sale or exchange of a principal residence within the preceding two years. T.D. 9031 removed.

### T.D. 9153, page 517.
### REG–124872–04, page 533.

Final, temporary, and proposed regulations under section 7701 of the Code provide that some business entities may be recognized under state or foreign law as created or organized in more than one jurisdiction at the same time ("dually chartered entities"). These regulations provide clarification regarding how to determine the federal tax classification (*e.g.*, corporation, partnership, or an entity disregarded as separate from its owner) of a dually chartered entity and how to determine whether a dually chartered entity is domestic or foreign. A public hearing on the proposed regulations is scheduled for November 3, 2004.

### REG–149524–03, page 528.

Proposed regulations under section 1363 of the Code relate to LIFO recapture by corporations converting from C corporations to S corporations. The purpose of the regulations is to provide guidance on the LIFO recapture requirement when the corporation holds inventory accounted for under the last-in, first-out method (LIFO inventory) indirectly through a partnership. The regulations affect C corporations that own interests in partnerships holding LIFO inventory and that elect to be taxed as S corporations or that transfer such partnership interests to S corporations in nonrecognition transactions. The regulations also affect S corporations receiving such partnership interests from C corporations in nonrecognition transactions. A public hearing is scheduled for December 8, 2004.

**(Continued on the next page)**

**Finding Lists begin on page ii.**
**Index for July through September begins on page iv.**

Department of the Treasury
Internal Revenue Service

**REG–128767–04, page 534.**
Proposed regulations under section 752 of the Code provide rules for taking into account the net value of a disregarded entity owned by a partner or related person for purposes of allocating partnership liabilities. Specifically, the regulations provide that in determining the extent to which a partner bears the economic risk of loss for a partnership liability, payment obligations of a disregarded entity are taken into account only to the extent of the net value of the disregarded entity.

**REG–130863–04, page 538.**
Proposed regulations address the effect of transfers of the assets or the stock of parties to a reorganization pursuant to transactions intended to qualify as reorganizations within the meaning of section 368(a) of the Code.

**Notice 2004–58, page 520.**
This notice sets forth a method that the IRS will accept for determining whether subsidiary stock loss is disallowed and subsidiary stock basis is reduced under regulations section 1.337(d)–2T, and requests comments as to what method should be adopted in prospective regulations.

**Announcement 2004–69, page 542.**
This document withdraws proposed regulations (REG–165579–02, 2004–13 I.R.B. 651) that address the effect of transfers of the assets or the stock of parties to a reorganization pursuant to transactions intended to qualify as reorganizations within the meaning of section 368(a) of the Code.

## ESTATE TAX

**REG–145987–03, page 523.**
Proposed regulations under section 2642 of the Code provide guidance regarding the qualified severance of a trust for generation-skipping transfer (GST) tax purposes under section 2642(a)(3), which was added to the Code by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

## EXCISE TAX

**Announcement 2004–70, page 543.**
The Service will not assert the penalty under section 6715 of the Code for diesel fuel that has been delivered or sold in Florida by wholesale dealers to retail dealers for resale to highway users or directly to end users for highway use for the period September 2, 2004, through September 15, 2004.

## ADMINISTRATIVE

**Announcement 2004–73, page 543.**
This document changes the date of the public hearing on proposed regulations (REG–150562–03, 2004–32 I.R.B. 175) that relate to the application of section 1045 of the Code to partnerships and their partners.

# The IRS Mission

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

# Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

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

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

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

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



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

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

## Section 121.—Exclusion of Gain From Sale of Principal Residence

*26 CFR 1.121–3: Reduced maximum exclusion for taxpayers failing to meet certain requirements.*

## T.D. 9152

## DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

## Reduced Maximum Exclusion of Gain From Sale or Exchange of Principal Residence

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the exclusion of gain from the sale or exchange of a taxpayer's principal residence. The final regulations apply to a taxpayer who has not owned and used the property as the taxpayer's principal residence for two of the preceding five years or who has excluded gain from the sale or exchange of a principal residence within the preceding two years. The final regulations reflect changes to the law by the Taxpayer Relief Act of 1997, as amended by the Internal Revenue Service Restructuring and Reform Act of 1998, and the Military Family Tax Relief Act of 2003.

DATES: *Effective Date:* These final regulations are effective August 13, 2004.

*Applicability Date:* For dates of applicability, see §§1.121–3(h) and 1.121–5(e).

FOR FURTHER INFORMATION CONTACT: Sara Paige Shepherd, (202) 622–4960 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

**Background**

This document contains amendments to 26 CFR Part 1. On December 24, 2002, the IRS and Treasury Department published in the **Federal Register** a notice of proposed rulemaking (REG–138882–02, 2003–1 C.B. 522 [67 FR 78398]) by cross reference to temporary regulations (T.D. 9031, 2003–1 C.B. 504 [67 FR 78367]) under section 121(c) of the Internal Revenue Code (Code). The regulations relate to the exclusion of gain from the sale or exchange of the principal residence of a taxpayer who has not owned and used the property as the taxpayer's principal residence for two of the preceding five years or who has excluded gain on the sale or exchange of a principal residence within the preceding two years. Written and electronic comments were received. No public hearing was requested or held.

After considering all of the comments, the proposed regulations are adopted as amended by this Treasury decision, and the corresponding temporary regulations are removed.

**Explanation and Summary of Comments**

1. *Facts and Circumstances Test*

Under section 121(a), a taxpayer may exclude up to $250,000 ($500,000 for certain joint returns) of gain realized on the sale or exchange of the taxpayer's principal residence if the taxpayer owned and used the property as the taxpayer's principal residence for at least two years during the five-year period ending on the date of the sale or exchange. Section 121(b)(3) allows the taxpayer to apply the maximum exclusion to only one sale or exchange during the two-year period ending on the date of the sale or exchange. Section 121(c) provides that a taxpayer who fails to meet any of the conditions by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances, may be entitled to an exclusion in a reduced maximum amount.

The temporary regulations provide, as a general definition, that a sale or exchange is by reason of a change in place of employment, health, or unforeseen circumstances only if the taxpayer's primary reason for the sale or exchange is a change in place of employment, health, or unforeseen circumstances. The temporary regulations provide factors that may be relevant in determining the taxpayer's primary reason for the sale or exchange.

One commentator asserted that the factors are beyond Congressional intent, unnecessary, and overbroad. The final regulations retain the list of factors because it is helpful in determining the taxpayer's primary reason for the sale or exchange.

For each of the three grounds for claiming a reduced maximum exclusion, the temporary regulations provide a general definition and one or more safe harbors. Under the temporary regulations, if a safe harbor applies, the taxpayer's "primary reason" for the sale or exchange is deemed to be change in place of employment, health, or unforeseen circumstances. For greater simplicity, the final regulations delete the primary reason test from the safe harbors and provide that, if a safe harbor applies, the sale or exchange is deemed to be "by reason of" a change in place of employment, health, or unforeseen circumstances. If a safe harbor does not apply, the taxpayer may be eligible to claim a reduced maximum exclusion if the taxpayer establishes, based on the facts and circumstances, that the taxpayer's primary reason for the sale or exchange is a change in place of employment, health, or unforeseen circumstances.

2. *Unforeseen Circumstances*

The temporary regulations provide that a sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer does not anticipate before purchasing and occupying the residence. One commentator asserted that this definition is beyond Congressional intent and would allow any circumstance giving rise to the sale or exchange of property to qualify for a reduced maximum exclusion.

The final regulations revise the definition of a sale or exchange by reason of unforeseen circumstances from "an event that the taxpayer did not anticipate" to "an event that the taxpayer could not reasonably have anticipated" before purchasing and occupying the residence. Additionally, the final regulations clarify that a sale or exchange by reason of unforeseen circumstances (other than a sale or exchange within a safe harbor) does not qualify for the reduced maximum exclusion if the primary reason for the sale or exchange is a preference for a different residence or an improvement in financial circumstances. The final regulations provide additional examples illustrating the application of the reduced maximum exclusion rules to situations outside of the unforeseen circumstances safe harbors.

Under the temporary regulations, a taxpayer's primary reason for the sale or exchange is deemed to be unforeseen circumstances if one of the following safe harbor events occurs during the taxpayer's ownership and use of the property: (1) involuntary conversion of the residence, (2) a natural or man-made disaster or act of war or terrorism resulting in a casualty to the residence, and (3) in the case of a qualified individual, (a) death, (b) the cessation of employment as a result of which the individual is eligible for unemployment compensation, (c) a change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household, (d) divorce or legal separation under a decree of divorce or separate maintenance, (e) multiple births resulting from the same pregnancy, or (f) an event determined by the Commissioner to be an unforeseen circumstance. A taxpayer who does not qualify for a safe harbor may demonstrate that, under the facts and circumstances, the primary reason for the sale or exchange is unforeseen circumstances.

Commentators suggested that marriage, bankruptcy of the taxpayer's employer not resulting in the loss of the taxpayer's employment, and the adoption of a family member should be additional unforeseen circumstances safe harbors that qualify for the reduced maximum exclusion.

The final regulations do not adopt these comments. Marriage and adoption are voluntary events that typically lack the degree of unforeseeability common in the other unforeseen circumstances safe harbors, and bankruptcy of the taxpayer's employer unaccompanied by a change in employment status of the taxpayer does not impact the taxpayer's current ability to pay housing costs. However, these events may still qualify for the reduced maximum exclusion under the facts and circumstances test if, as a result of such an event, the taxpayer's primary reason for the sale or exchange is a change in place of employment, health, or unforeseen circumstances.

For purposes of the reduced maximum exclusion by reason of unforeseen circumstances, the temporary regulations provide that a *qualified individual* includes the taxpayer, the taxpayer's spouse, a co-owner of the residence, and a person whose principal place of abode is in the same household as the taxpayer.

A commentator suggested that the unforeseen circumstances exception should be limited to events involving only the taxpayer and the taxpayer's spouse. The commentator stated that, under this narrower exception, a safe harbor for death would be unnecessary because little, if any, gain would result as a consequence of the step-up in basis provisions of the Code. The commentator also asserted that the safe harbor for involuntary conversions is redundant and unnecessary because section 1033 already provides for non-recognition of gain in such circumstances.

The final regulations do not adopt these comments. The inclusion in the safe harbors of events affecting co-owners and co-inhabitants is appropriate because these events may affect the taxpayer's ability to pay housing costs. The involuntary conversion safe harbor is also appropriate, as both the non-recognition provisions of section 1033 and the exclusion provisions of section 121 may apply to a conversion of property. See section 121(d)(5).

The temporary regulations provide that unforeseen circumstances include events determined by the Commissioner to be unforeseen circumstances to the extent provided in published guidance of general applicability or in a ruling directed to a specific taxpayer. The final regulations clarify that taxpayers may rely on only those determinations made by the Commissioner in published guidance of general applicability. A ruling directed to a specific taxpayer does not establish a safe harbor of general applicability.

3. *Health Exception*

The temporary regulations provide that a sale or exchange of a residence is by reason of health if the primary reason for the sale or exchange is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual, or to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness, or injury. A sale or exchange that is merely beneficial to the general health or well-being of the individual is not a sale or exchange by reason of health. This definition is based on the definition of medical care under section 213.

A commentator suggested eliminating the term *diagnosis* from the definition of sale or exchange by reason of health because taxpayers rarely would sell a residence merely to obtain a diagnosis of a disease, illness, or injury. The final regulations do not adopt this suggestion because, while such sales are likely to be uncommon, they may occur. In addition, retaining *diagnosis* in the general definition of sale or exchange by reason of health maintains uniformity with the definition of medical care under section 213 and reduces complexity.

4. *Statute of Limitations*

A commentator suggested that the regulations should clarify that, under section 6501, the statute of limitations on assessments arising from the use of the exclusion begins to run from the filing date for the year of the sale or exchange. The final regulations do not address this issue because the issue is well-settled by statute and rules regarding the statute of limitations on assessments are outside the scope of these regulations.

5. *Military Exception*

Numerous commentators suggested that members of the uniformed services should be accorded a special exception to the use requirement because they are often required to be away from home for extended periods of time and unable to use a property as their principal residence for at least two years during the five-year period prior to a sale or exchange. The final regulations reflect enactment of the Military Family Tax Relief Act of 2003 Public Law 108–121, section 101 (117 Stat. 1335) (MFTRA). The MFTRA amends section 121 to provide that a taxpayer serving (or whose spouse is serving) on qualified official extended duty as a member of the uniformed services or Foreign Service may elect to suspend the running of the 5-year period for up to 10 years. The election may be made with respect to only one property at a time.

The taxpayer makes an election by filing a return for the taxable year of the sale or exchange of the taxpayer's principal residence that does not include the resulting gain in the taxpayer's gross income. A taxpayer who would qualify to exclude gain under section 121 as a result of the amendments made by the MFTRA but is barred by operation of any law or rule of law may nonetheless claim a refund or credit of an overpayment of tax if the taxpayer files the claim before November 11, 2004.

6. *Effective Dates*

Section 1.121–3 of the final regulations, relating to the reduced maximum exclusion, applies to sales and exchanges on or after August 13, 2004. For sales or exchanges before August 13, 2004, and on or after May 7, 1997, taxpayers may elect to apply the rules retroactively in accordance with §1.121–4(j) and will be afforded audit protection in accordance with §1.121–4(k). Section 1.121–5 of the final regulations, relating to the suspension of the 5-year period for certain members of the uniformed services and Foreign Service, applies to sales and exchanges on or after May 7, 1997.

**Special Analysis**

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

**Drafting Information**

The principal author of these regulations is Sara Paige Shepherd, Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in the development of the regulations.

* * * * *

**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 U.S.C. 7805 * * *

Par. 2. Section 1.121–3 is amended by:

1. Adding paragraphs (b), (c), (d), (e), and (f).

2. Removing paragraphs (h), (i), (j), and (k).

3. Redesignating paragraph (l) as paragraph (h) and revising it.

The revisions and additions read as follows:

*§1.121–3 Reduced maximum exclusion for taxpayers failing to meet certain requirements.*

* * * * *

(b) *Primary reason for sale or exchange*. In order for a taxpayer to claim a reduced maximum exclusion under section 121(c), the sale or exchange must be by reason of a change in place of employment, health, or unforeseen circumstances. If a safe harbor described in this section applies, a sale or exchange is deemed to be by reason of a change in place of employment, health, or unforeseen circumstances. If a safe harbor described in this section does not apply, a sale or exchange is by reason of a change in place of employment, health, or unforeseen circumstances only if the primary reason for the sale or exchange is a change in place of employment (within the meaning of paragraph (c) of this section), health (within the meaning of paragraph (d) of this section), or unforeseen circumstances (within the meaning of paragraph (e) of this section). Whether the requirements of this section are satisfied depends upon all the facts and circumstances. Factors that may be relevant in determining the taxpayer's primary reason for the sale or exchange include (but are not limited to) the extent to which—

(1) The sale or exchange and the circumstances giving rise to the sale or exchange are proximate in time;

(2) The suitability of the property as the taxpayer's principal residence materially changes;

(3) The taxpayer's financial ability to maintain the property is materially impaired;

(4) The taxpayer uses the property as the taxpayer's residence during the period of the taxpayer's ownership of the property;

(5) The circumstances giving rise to the sale or exchange are not reasonably foreseeable when the taxpayer begins using the property as the taxpayer's principal residence; and

(6) The circumstances giving rise to the sale or exchange occur during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence.

(c) *Sale or exchange by reason of a change in place of employment*—(1) *In general*. A sale or exchange is by reason of a change in place of employment if, in the case of a qualified individual described in paragraph (f) of this section, the primary reason for the sale or exchange is a change in the location of the individual's employment.

(2) *Distance safe harbor*. A sale or exchange is deemed to be by reason of a change in place of employment (within the meaning of paragraph (c)(1) of this section) if—

(i) The change in place of employment occurs during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence; and

(ii) The qualified individual's new place of employment is at least 50 miles farther from the residence sold or exchanged than was the former place of employment, or, if there was no former place of employment, the distance between the qualified individual's new place of employment and the residence sold or exchanged is at least 50 miles.

(3) *Employment*. For purposes of this paragraph (c), *employment* includes the commencement of employment with a new employer, the continuation of employment with the same employer, and the commencement or continuation of self-employment.

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

*Example 1*. A is unemployed and owns a townhouse that she has owned and used as her principal residence since 2003. In 2004 A obtains a job that is 54 miles from her townhouse, and she sells the townhouse. Because the distance between A's new place of employment and the townhouse is at least 50 miles, the sale is within the safe harbor of paragraph (c)(2) of this section and A is entitled to claim a reduced maximum exclusion under section 121(c)(2).

*Example 2*. B is an officer in the United States Air Force stationed in Florida. B purchases a house in Florida in 2002. In May 2003, B moves out of his house to take a 3-year assignment in Germany. B sells his house in January 2004. Because B's new place of employment in Germany is at least 50 miles farther from the residence sold than is B's former place of employment in Florida, the sale is within the safe harbor of paragraph (c)(2) of this section and B is entitled to claim a reduced maximum exclusion under section 121(c)(2).

*Example 3*. C is employed by Employer R at R's Philadelphia office. C purchases a house in February 2002 that is 35 miles from R's Philadelphia office. In May 2003, C begins a temporary assignment at R's Wilmington office that is 72 miles from C's house, and moves out of the house. In June 2005, C is assigned to work in R's London office. C sells her house in August 2005 as a result of the assignment to London. The sale of the house is not within the safe harbor of paragraph (c)(2) of this section by reason of the change in place of employment from Philadelphia to Wilmington because the Wilmington office is not 50 miles farther from C's house than is the Philadelphia office. Furthermore, the sale is not within the safe harbor by reason of the change in place of employment to London because C is not using the house as her principal residence when she moves to London. However, C is entitled to claim a reduced maximum exclusion under section 121(c)(2) because, under the facts and circumstances, the primary reason for the sale is the change in C's place of employment.

*Example 4*. In July 2003 D, who works as an emergency medicine physician, buys a condominium that is 5 miles from her place of employment and uses it as her principal residence. In February 2004, D obtains a job that is located 51 miles from D's condominium. D may be called in to work unscheduled hours and, when called, must be able to arrive at work quickly. Because of the demands of the new job, D sells her condominium and buys a townhouse that is 4 miles from her new place of employment. Because D's new place of employment is only 46 miles farther from the condominium than is D's former place of employment, the sale is not within the safe harbor of paragraph (c)(2) of this section. However, D is entitled to claim a reduced maximum exclusion under section 121(c)(2) because, under the facts and circumstances, the primary reason for the sale is the change in D's place of employment.

(d) *Sale or exchange by reason of health*—(1) *In general*. A sale or exchange is by reason of health if the primary reason for the sale or exchange is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual described in paragraph (f) of this section, or to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness, or injury. A sale or exchange that is merely beneficial to the general health or well-being of an individual is not a sale or exchange by reason of health.

(2) *Physician's recommendation safe harbor*. A sale or exchange is deemed to be by reason of health if a physician (as defined in section 213(d)(4)) recommends a change of residence for reasons of health (as defined in paragraph (d)(1) of this section).

(3) *Examples*. The following examples illustrate the rules of this paragraph (d):

*Example 1*. In 2003, A buys a house that she uses as her principal residence. A is injured in an accident and is unable to care for herself. A sells her house in 2004 and moves in with her daughter so that the daughter can provide the care that A requires as a result of her injury. Because, under the facts and circumstances, the primary reason for the sale of A's house is A's health, A is entitled to claim a reduced maximum exclusion under section 121(c)(2).

*Example 2*. H's father has a chronic disease. In 2003, H and W purchase a house that they use as their principal residence. In 2004, H and W sell their house in order to move into the house of H's father so that they can provide the care he requires as a result of his disease. Because, under the facts and circumstances, the primary reason for the sale of their house is the health of H's father, H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

*Example 3*. H and W purchase a house in 2003 that they use as their principal residence. Their son suffers from a chronic illness that requires regular medical care. Later that year their son begins a new treatment that is available at a hospital 100 miles away from their residence. In 2004, H and W sell their house so that they can be closer to the hospital to facilitate their son's treatment. Because, under the facts and circumstances, the primary reason for the sale is to facilitate the treatment of their son's chronic illness, H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

*Example 4*. B, who has chronic asthma, purchases a house in Minnesota in 2003 that he uses as his principal residence. B's doctor tells B that moving to a warm, dry climate would mitigate B's asthma symptoms. In 2004, B sells his house and moves to Arizona to relieve his asthma symptoms. The sale is within the safe harbor of paragraph (d)(2) of this section and B is entitled to claim a reduced maximum exclusion under section 121(c)(2).

*Example 5*. In 2003, H and W purchase a house in Michigan that they use as their principal residence. H's doctor tells H that he should get more outdoor exercise, but H is not suffering from any disease that can be treated or mitigated by outdoor exercise. In 2004, H and W sell their house and move to Florida so that H can increase his general level of exercise by playing golf year-round. Because the sale of the house is merely beneficial to H's general health, the sale of the house is not by reason of H's health. H and W are not entitled to claim a reduced maximum exclusion under section 121(c)(2).

(e) *Sale or exchange by reason of unforeseen circumstances*—(1) *In general*. A sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer could not reasonably have anticipated before purchasing and occupying the residence. A sale or exchange by reason of unforeseen circumstances (other than a sale or exchange deemed to be by reason of unforeseen circumstances under paragraph (e)(2) or (3) of this section) does not qualify for the reduced maximum exclusion if the primary reason for the sale or exchange is a preference for a different residence or an improvement in financial circumstances.

(2) *Specific event safe harbors*. A sale or exchange is deemed to be by reason of unforeseen circumstances (within the meaning of paragraph (e)(1) of this section) if any of the events specified in paragraphs (e)(2)(i) through (iii) of this section occur during the period of the taxpayer's ownership and use of the residence as the taxpayer's principal residence:

(i) The involuntary conversion of the residence.

(ii) Natural or man-made disasters or acts of war or terrorism resulting in a casualty to the residence (without regard to deductibility under section 165(h)).

(iii) In the case of a qualified individual described in paragraph (f) of this section—

(A) Death;

(B) The cessation of employment as a result of which the qualified individual is eligible for unemployment compensation (as defined in section 85(b));

(C) A change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household (including amounts for food, clothing, medical expenses, taxes, transportation, court-ordered payments, and expenses reasonably necessary to the production of income, but not for the maintenance of an affluent or luxurious standard of living);

(D) Divorce or legal separation under a decree of divorce or separate maintenance; or

(E) Multiple births resulting from the same pregnancy.

(3) *Designation of additional events as unforeseen circumstances*. The Commissioner may designate other events or situations as unforeseen circumstances in published guidance of general applicability and may issue rulings addressed to specific taxpayers identifying other events or situations as unforeseen circumstances with regard to those taxpayers (see §601.601(d)(2) of this chapter).

(4) *Examples*. The following examples illustrate the rules of this paragraph (e):

*Example 1*. In 2003, A buys a house in California. After A begins to use the house as her principal residence, an earthquake causes damage to A's house. A sells the house in 2004. The sale is within the safe harbor of paragraph (e)(2)(ii) of this section and A is entitled to claim a reduced maximum exclusion under section 121(c)(2).

*Example 2*. H works as a teacher and W works as a pilot. In 2003, H and W buy a house that they use as their principal residence. Later that year W is furloughed from her job for six months. H and W are unable to pay their mortgage and reasonable basic living expenses for their household during the period W is furloughed. H and W sell their house in 2004. The sale is within the safe harbor of paragraph (e)(2)(iii)(C) of this section and H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

*Example 3*. In 2003, H and W buy a two-bedroom condominium that they use as their principal residence. In 2004, W gives birth to twins and H and W sell their condominium and buy a four-bedroom house. The sale is within the safe harbor of paragraph (e)(2)(iii)(E) of this section, and H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

*Example 4*. In 2003, B buys a condominium in a high-rise building and uses it as his principal residence. B's monthly condominium fee is $X. Three months after B moves into the condominium, the condominium association replaces the building's roof and heating system. Six months later, B's monthly condominium fee doubles in order to pay for the repairs. B sells the condominium in 2004 because he is unable to afford the new condominium fee along with a monthly mortgage payment. The safe harbors of paragraph (e)(2) of this section do not apply. However, under the facts and circumstances, the primary reason for the sale, the doubling of the condominium fee, is an unforeseen circumstance because B could not reasonably have anticipated that the condominium fee would double at the time he purchased and occupied the property. Consequently, the sale of the condominium is by reason of unforeseen circumstances and B is entitled to claim a reduced maximum exclusion under section 121(c)(2).

*Example 5*. In 2003, C buys a house that he uses as his principal residence. The property is located on a heavily traveled road. C sells the property in 2004 because C is disturbed by the traffic. The safe harbors of paragraph (e)(2) of this section do not apply. Under the facts and circumstances, the primary reason for the sale, the traffic, is not an unforeseen circumstance because C could reasonably have anticipated the traffic at the time he purchased and occupied the house. Consequently, the sale of the house is not by reason of unforeseen circumstances and C is not entitled to claim a reduced maximum exclusion under section 121(c)(2).

*Example 6*. In 2003, D and her fiancé E buy a house and live in it as their principal residence. In 2004, D and E cancel their wedding plans and E moves out of the house. Because D cannot afford to make the monthly mortgage payments alone, D and E sell the house in 2004. The safe harbors of paragraph (e)(2) of this section do not apply. However, under the facts and circumstances, the primary reason for the sale, the broken engagement, is an unforeseen circumstance because D and E could not reasonably have anticipated the broken engagement at the time they purchased and occupied the house. Consequently, the sale is by reason of unforeseen circumstances and D and E are each entitled to claim a reduced maximum exclusion under section 121(c)(2).

*Example 7*. In 2003, F buys a small condominium that she uses as her principal residence. In 2005, F receives a promotion and a large increase in her salary. F sells the condominium in 2004 and purchases a house because she can now afford the house. The safe harbors of paragraph (e)(2) of this section do not apply. Under the facts and circumstances, the primary reason for the sale of the house, F's salary increase, is an improvement in F's financial circumstances. Under paragraph (e)(1) of this section, an improvement in financial circumstances, even if the result of unforeseen circumstances, does not qualify for the reduced maximum exclusion by reason of unforeseen circumstances under section 121(c)(2).

*Example 8*. In April 2003, G buys a house that he uses as his principal residence. G sells his house in October 2004 because the house has greatly appreciated in value, mortgage rates have substantially decreased, and G can afford a bigger house. The safe harbors of paragraph (e)(2) of this section do not apply. Under the facts and circumstances, the primary reasons for the sale of the house, the changes in G's house value and in the mortgage rates, are an improvement in G's financial circumstances. Under paragraph (e)(1) of this section, an improvement in financial circumstances, even if the result of unforeseen circumstances, does not qualify for the reduced maximum exclusion by reason of unforeseen circumstances under section 121(c)(2).

*Example 9*. H works as a police officer for City X. In 2003, H buys a condominium that he uses as his principal residence. In 2004, H is assigned to City X's K–9 unit and is required to care for the police service dog at his home. Because H's condominium association does not permit H to have a dog in his condominium, in 2004 he sells the condominium and buys a house. The safe harbors of paragraph (e)(2) of this section do not apply. However, under the facts and circumstances, the primary reason for the sale, H's assignment to the K–9 unit, is an unforeseen circumstance because H could not reasonably have anticipated his assignment to the K–9 unit at the time he purchased and occupied the condominium. Consequently, the sale of the condominium is by reason of unforeseen circumstances and H is entitled to claim a reduced maximum exclusion under section 121(c)(2).

*Example 10*. In 2003, J buys a small house that she uses as her principal residence. After J wins the lottery, she sells the small house in 2004 and buys a bigger, more expensive house. The safe harbors of paragraph (e)(2) of this section do not apply. Under the facts and circumstances, the primary reason for the sale of the house, winning the lottery, is an improvement in J's financial circumstances. Under paragraph (e)(1) of this section, an improvement in financial circumstances, even if the result of unforeseen circumstances, does not qualify for the reduced maximum exclusion under section 121(c)(2).

(f) *Qualified individual*. For purposes of this section, qualified *individual means*—

(1) The taxpayer;

(2) The taxpayer's spouse;

(3) A co-owner of the residence;

(4) A person whose principal place of abode is in the same household as the taxpayer; or

(5) For purposes of paragraph (d) of this section, a person bearing a relationship specified in sections 152(a)(1) through 152(a)(8) (without regard to qualification as a dependent) to a qualified individual described in paragraphs (f)(1) through (4) of this section, or a descendant of the taxpayer's grandparent.

* * * * *

(h) *Effective dates*. Paragraphs (a) and (g) of this section are applicable for sales and exchanges on or after December 24, 2002. Paragraphs (b) through (f) of this section are applicable for sales and exchanges on or after August 13, 2004.

**§1.121–3T [Removed]**

Par. 3. Section 1.121–3T is removed.

Par. 4. Section 1.121–5 is added to read as follows:

*§1.121–5 Suspension of 5-year period for certain members of the uniformed services and Foreign Service.*

(a) *In general*. Under section 121(d)(9), a taxpayer who is serving (or whose spouse is serving) on qualified official extended duty as a member of the uniformed services or Foreign Service of the United States may elect to suspend the running of the 5-year period of ownership and use during such service but for not more than 10 years. The election does not suspend the running of the 5-year period for any period during which the running of the 5-year period with respect to any other property of the taxpayer is suspended by an election under section 121(d)(9).

(b) *Manner of making election*. The taxpayer makes the election under section 121(d)(9) and this section by filing a return for the taxable year of the sale or exchange of the taxpayer's principal residence that does not include the gain in the taxpayer's gross income.

(c) *Application of election to closed years*. A taxpayer who would otherwise qualify under §§1.121–1 through 1.121–4 to exclude gain from a sale or exchange of a principal residence on or after May 7, 1997, may elect to apply section 121(d)(9) and this section for any years for which a claim for refund is barred by operation of any law or rule of law by filing an amended return before November 11, 2004.

(d) *Example*. The provisions of this section are illustrated by the following example:

*Example*. B purchases a house in Virginia in 2003 that he uses as his principal residence for 3 years. For 8 years, from 2006 through 2014, B serves on qualified official extended duty as a member of the Foreign Service of the United States in Brazil. In 2015, B sells the house. B did not use the house as his principal residence for 2 of the 5 years preceding the sale. Under section 121(d)(9) and this section, however, B may elect to suspend the running of the 5-year period of ownership and use during his 8-year period of service with the Foreign Service in Brazil. If B makes the election, the 8-year period is not counted in determining whether B used the house for 2 of the 5 years preceding the sale. Therefore, B may exclude the gain from the sale of the house under section 121.

(e) *Effective date*. This section is applicable for sales and exchanges on or after May 7, 1997.

Nancy Jardini,
*Acting Deputy Commissioner for Services and Enforcement.*

Approved July 29, 2004.

Gregory F. Jenner,
*Acting Assistant Secretary of the Treasury.*

(Filed by the Office of the Federal Register on August 13, 2004, 8:45 a.m., and published in the issue of the Federal Register for August 16, 2004, 69 F.R. 50302)

## Section 141.—Private Activity Bond; Qualified Bond

*26 CFR 1.141–16: Effective dates for qualified private activity bond provisions.*

## T.D. 9150

## DEPARTMENT OF THE TREASURY
## Internal Revenue Service
## 26 CFR Part 1

## Remedial Actions Applicable to Tax-Exempt Bonds Issued by State and Local Governments

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations on the exempt facility bond rules applicable to tax-exempt bonds issued by state and local governments. The regulations affect issuers of tax-exempt bonds and amend provisions in the current regulations permitting remedial actions for tax-exempt bonds issued by state and local governments.

DATES: *Effective Date:* These regulations are effective August 13, 2004.

*Applicability Date:* For dates of applicability, see §1.141–16(c) and (d) of these regulations.

FOR FURTHER INFORMATION CONTACT: Vicky Tsilas, (202) 622–3980 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

**Background**

This document amends 26 CFR part 1 under sections 141 and 142 of the Internal Revenue Code by amending rules pertaining to remedial actions (the final regulations). On July 21, 2003, the IRS published in the **Federal Register** a notice of proposed rulemaking (REG–132483–03, 2003–34 I.R.B. 410 [68 FR 43059]) (the proposed regulations). The proposed regulations would amend (1) the definition of nonqualified bonds in §1.141–12, (2) the rules in §§1.141–12 and 1.142–2, pertaining to the allocation of nonqualified bonds, and (3) the effective date provisions under §§1.141–15(e) and 1.141–16(c). A public hearing was scheduled for November 4, 2003. The public hearing was cancelled because no requests to speak were received. Written comments on the proposed regulations were received. After consideration of the written comments, the proposed regulations under §§1.141–16 and 1.142–2 are adopted as revised by this Treasury decision. The revisions are discussed below.

**Explanation of Provisions**

*A. Proposed Regulations*

The proposed regulations propose two changes to the remedial action rules contained in §§1.141–12 and 1.142–2. First, the proposed regulations would change the definition of nonqualified bonds under §1.141–12 to provide that the nonqualified bonds are a portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the date on which the deliberate action occurs, the remaining bonds would not satisfy the private business use test or private loan financing test, as applicable. For this purpose, the proposed regulations provide that the amount of private business use is the greatest percentage of private business use in any one-year period commencing with the deliberate action.

Second, the proposed regulations would amend the provisions of §1.141–12 (relating to redemption or defeasance) and §1.142–2 relating to allocations of nonqualified bonds. Under the proposed regulations, allocations of nonqualified bonds must be made on a *pro rata* basis, except that an issuer may treat any bonds of an issue as the nonqualified bonds so long as (i) the remaining weighted average maturity of the issue, determined as of the date on which the nonqualified bonds are redeemed or defeased (determination date), and excluding from the determination the nonqualified bonds redeemed or defeased by the issuer, is not greater than (ii) the remaining weighted average maturity of the issue, determined as of the determination date, but without regard to the redemption or defeasance of any bonds (including the nonqualified bonds) occurring on the determination date.

The proposed regulations also would amend §§1.141–15(e) and 1.141–16(c) to provide that for bonds issued before May 16, 1997, issuers may apply §§1.141–12 and 1.142–2 without regard to the 10½ year limitation on defeasances contained in those regulations.

*B. Final Regulations*

Public comments were received regarding the proposed regulations. These comments request that the amount of nonqualified bonds be determined in a manner consistent with the general measurement rules under § 1.141–3(g). Because of the interrelationship between the remedial action provisions of §1.141–12 and the allocation and accounting rules of §1.141–6 (which are currently reserved), the proposed regulations under §§1.141–12 and 1.141–15 are not being finalized at this time. It is anticipated that these proposed regulations will be finalized in connection with the provision of the allocation and accounting rules.

Commentators agreed with the proposed change that allows any bonds of an issue to be treated as the nonqualified bonds, provided that the redemption or defeasance does not have the effect of extending the weighted average maturity (WAM) of the issue. However, the commentators stated that under the bond indentures for certain fixed rate bonds, the redemption or defeasance of bonds with the longest maturities in an issue could result in an extension of the WAM of the issue. Under some bond indentures, optional redemptions of a portion of a term bond must be used first to reduce the earliest mandatory sinking fund payments on the bond. In this case, the redemption or defeasance of the longest bonds could result in an extension of the WAM. Commentators indicated that requiring an issuer to use the *pro rata* allocation method in these circumstances is inappropriate and recommended that the regulations be revised to permit the longer bonds to be treated as the nonqualified bonds, which is permitted under the existing regulations. The IRS and Treasury Department agree that additional flexibility should be provided for outstanding bonds with bond indentures that prevent compliance with the WAM rule, but believe that extensions of the WAM should not be permitted on a prospective basis. As a result, the final regulations provide that for purposes of §1.142–2(e)(2), in addition to the allocation methods permitted in §1.142–2(e)(2), an issuer may treat bonds with the longest maturities (determined on a bond-by-bond basis) as the nonqualified bonds, but only with respect to failures to properly use proceeds that occur on or after May 14, 2004, with respect to bonds sold before August 13, 2004.

Other comments were received that are beyond the scope of this project. The IRS and Treasury Department continue to consider these comments.

**Effective Dates**

The final regulations apply to failures to properly use proceeds that occur on or after August 13, 2004, and may be applied by issuers to failures to properly use proceeds that occur on or after May 14, 2004, provided that the bonds are subject to §1.142–2. The final regulations that amend §1.141–16(c) apply to bonds issued before May 16, 1997, that are subject to §1.142–2, for purposes of failures to properly use proceeds that occur on or after April 21, 2003.

**Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the rule does not impose a collection of information on small entities, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply. Pursuant to section 7805(f) of the Internal Revenue Code, 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 authors of these regulations are Rebecca L. Harrigal and Vicky Tsilas, Office of Associate Chief Counsel (Tax-Exempt and Government Entities), IRS. However, other personnel from the IRS and 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 U.S.C. 7805 * * *

Par. 2. Section 1.141–0 is amended by adding an entry to the table for §1.141–16(d) to read as follows:

*§1.141–0 Table of contents.*

* * * * *

*§1.141–16 Effective dates for qualified private activity bond provisions.*

* * * * *

(d) Certain remedial actions.
(1) General rule.
(2) Special rule for allocations of nonqualified bonds.

* * * * *

Par. 3. Section 1.141–16 is amended by revising paragraph (c) and adding paragraph (d) to read as follows:

*§1.141–16 Effective dates for qualified private activity bond provisions.*

* * * * *

(c) *Permissive application*. The regulations designated in paragraph (a) of this section may be applied by issuers in whole, but not in part, to bonds outstanding on the effective date. For this purpose, issuers may apply §1.142–2 without regard to paragraph (c)(3) thereof to failures to properly use proceeds that occur on or after April 21, 2003.

(d) *Certain remedial actions*—(1) *General rule*. The provisions of §1.142–2(e) apply to failures to properly use proceeds that occur on or after August 13, 2004, and may be applied by issuers to failures to properly use proceeds that occur on or after May 14, 2004, provided that the bonds are subject to §1.142–2.

(2) *Special rule for allocations of nonqualified bonds*. For purposes of §1.142–2(e)(2), in addition to the allocation methods permitted in §1.142–2(e)(2), an issuer may treat bonds with the longest maturities (determined on a bond-by-bond basis) as the nonqualified bonds, but only with respect to failures to properly use proceeds that occur on or after May 14, 2004, with respect to bonds sold before August 13, 2004.

Par. 4. Section 1.142–0 is amended by revising the entry to the table for §1.142–2 paragraph (e) to read as follows:

*§1.142–0 Table of contents*

* * * * *

*§1.142–2 Remedial actions.*

* * * * *

(e) * * *

(1) Amount of nonqualified bonds.

(2) Allocation of nonqualified bonds.

* * * * *

Par. 5. Section 1.142–2 is amended by revising paragraph (e) to read as follows:

*§1.142–2 Remedial actions*

* * * * *

(e) *Nonqualified bonds*—(1) *Amount of nonqualified bonds*. For purposes of this section, the nonqualified bonds are a portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the date on which the failure to properly use the proceeds occurs, at least 95 percent of the net proceeds of the remaining bonds would be used to provide an exempt facility. If no proceeds have been spent to provide an exempt facility, all of the outstanding bonds are nonqualified bonds.

(2) *Allocation of nonqualified bonds*. Allocations of nonqualified bonds must be made on a *pro rata* basis, except that an issuer may treat any bonds of an issue as the nonqualified bonds so long as—

(i) The remaining weighted average maturity of the issue, determined as of the date on which the nonqualified bonds are redeemed or defeased (determination date), and excluding from the determination the nonqualified bonds redeemed or defeased by the issuer to meet the requirements of paragraph (c) of this section, is not greater than

(ii) The remaining weighted average maturity of the issue, determined as of the determination date, but without regard to the redemption or defeasance of any bonds (including the nonqualified bonds) occurring on the determination date.

Nancy Jardini,
*Acting Deputy Commissioner of Internal Revenue.*

Approved July 18, 2004.

Gregory Jenner,
*Acting Assistant Secretary of the Treasury.*

(Filed by the Office of the Federal Register on August 12, 2004, 8:45 a.m., and published in the issue of the Federal Register for August 13, 2004, 69 F.R. 50065)

## Section 861.—Income From Sources Within the United States

*(Also § 7805(b), Rev. Rul. 2004–75.)*

**Section 7805(b); Rev. Rul. 2004–75.** This ruling grants insurance companies section 7805(b) relief from the retroactive application of Rev. Rul. 2004–75. Rev. Rul. 2004–75 will not be applied to payments made to nonresident alien individuals or *bona fide* residents of Puerto Rico under life insurance or annuity contracts issued by foreign or Puerto Rican branches of U.S. life insurance companies before January 1, 2005, provided such payments are made pursuant to binding life insurance or annuity contracts issued by such branches on or before July 12, 2004. Rev. Rul. 2004–75 amplified.

## Rev. Rul. 2004–97

Rev. Rul. 2004–75, 2004–31 I.R.B. 109, issued on July 12, 2004, addresses the U.S. tax treatment of certain payments made to nonresident alien individuals or *bona fide* residents of Puerto Rico under life insurance or annuity contracts issued by foreign or Puerto Rican branches of U.S. life insurance companies. Revenue Ruling 2004–75 holds that income as determined under section 72 of the Internal Revenue Code received by nonresident alien individuals under life insurance or annuity contracts issued by a foreign branch of a U.S. life insurance company is U.S.-source fixed or determinable annual or periodical income that is subject to 30-percent tax and withholding under sections 871(a) and 1441. The revenue ruling also holds that income as determined under section 72 received by *bona fide* residents of Puerto Rico under life insurance or annuity contracts issued by a Puerto Rican branch of a U.S. life insurance company is U.S.-source income that is subject to the tax imposed by section 1.

Pursuant to the authority contained in section 7805(b) of the Internal Revenue Code, Rev. Rul. 2004–75 will not be applied to payments that are made to nonresident alien individuals or *bona fide* residents of Puerto Rico under life insurance or annuity contracts issued by foreign or Puerto Rican branches of U.S. life insurance companies, as described in Rev. Rul. 2004–75, before January 1, 2005, provided that such payments are made pursuant to binding life insurance or annuity contracts issued by such branches on or before July 12, 2004. The Internal Revenue Service will carefully review the treatment of payments to which Rev. Rul. 2004–75, as amplified by this ruling, does not apply, including, in particular, payments on life insurance or annuity contracts that are issued by a U.S. life insurance company without the substantial involvement of a foreign or Puerto Rican branch (which involvement is contemplated by Rev. Rul. 2004–75).

### EFFECT ON OTHER REVENUE RULING(S)

Rev. Rul. 2004–75 is amplified.

### DRAFTING INFORMATION

The principal author of this revenue ruling is Gregory A. Spring of the Office of Associate Chief Counsel (International). For further information regarding this revenue ruling, contact Mr. Spring at (202) 622–3870 (not a toll-free call).

## Section 7701.—Definitions

*26 CFR 301.7701–2: Business entities; definitions.*

## T.D. 9153

## DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 301

## Clarification of Definitions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations providing clarification of the definitions of a corporation and a domestic entity in circumstances where the business entity is considered to be created or organized in more than one jurisdiction. These regulations will affect business entities that are created or organized under the laws of more than one jurisdiction. The final regulations consist of technical revisions to reflect the issuance of the temporary regulations and to correct a cross-reference in §301.7701–3. The text of the temporary regulations also serves as the text of the proposed regulations (REG–124872–04) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective August 12, 2004.

*Applicability Dates:* For the dates of applicability of these regulations, see §301.7701–2T(f) and §301.7701–5T(c).

FOR FURTHER INFORMATION CONTACT: Thomas Beem, (202) 622–3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

**Background**

Several jurisdictions have recently enacted provisions (generally referred to as either continuance or domestication statutes) that make it possible for a business entity to be treated as created or organized under the laws of more than one jurisdiction at the same time (a dually chartered entity). A dually chartered entity and the interest holders in the entity must determine for Federal tax purposes (1) the entity's classification (*e.g.*, corporation or partnership) and (2) whether the entity is foreign or domestic. The regulations contained in this document are intended to clarify the rules for these determinations.

Section 7701(a)(3) of the Internal Revenue Code of 1986 (Code) provides that the term *corporation* includes associations, joint stock companies, and insurance companies. The definition of a corporation under the tax statutes has not changed since the Revenue Act of 1918, Public Law 65–254 (40 Stat. 1057, section 1). Final regulations (T.D. 8697, 1997–1 C.B. 215) providing rules for the classification of business entities were published in the **Federal Register** on December 18, 1996 (61 FR 66584 (1996)). Those entity classification rules identify certain entities that are always treated as corporations and are not eligible to elect their entity classification.

Section 7701(a)(4) of the Code provides that the term *domestic* when applied to a corporation or partnership means "created or organized in the United States or under the law of the United States or of any State unless, in the case of a partnership, the Secretary provides otherwise by regulations." Section 7701(a)(5) of the Code provides that the term *foreign* when applied to a corporation or partnership means a "corporation or partnership that is not domestic." This definition is significantly different than the definition of foreign entity that preceded it. The Revenue Act of 1918 used the term foreign to mean a corporation or partnership "created or organized outside the United States." Thus, under that definition, a dually chartered entity that was organized in the United States and in a foreign jurisdiction would have met the definitions of both a domestic entity and a foreign entity, creating uncertainty as to the entity's status. The Revenue Act of 1924, Public Law 68–176 (43 Stat. 253) eliminated that potential for uncertainty by providing the definition of a foreign entity that is currently reflected in section 7701(a)(5). This definition of a foreign entity as "a corporation or partnership that is not domestic" makes it impossible for an entity to meet the definitions of both a domestic entity and a foreign entity for Federal tax purposes at the same time. As a result, a dually chartered entity that is organized both in the United States and in a foreign jurisdiction is a domestic entity.

Final regulations providing further guidance on the definitions of domestic and foreign business entities were published in the **Federal Register** on November 17, 1960 (25 FR 10928 (1960)).

**Explanation of Provisions**

Under the existing rules, the characterization of a business entity for Federal tax purposes is established in two separate and independent steps. The first involves a determination of whether the entity is a corporation or a non-corporate entity (*e.g.*, a partnership). The second involves a determination of whether the entity is foreign or domestic.

The determination of whether a business entity is classified as a corporation is made by applying the definition in §301.7701–2(b). If the entity is not a corporation under that definition, then it is a partnership if it has more than one owner and it is a disregarded entity if it has only a single owner. The temporary regulations in this document clarify that this same definition applies to dually chartered entities. Thus, to determine whether a dually chartered entity is a corporation, it must first be determined if the entity's organization in any of the jurisdictions in which it is organized would cause it to be treated as a corporation under the rules of §301.7701–2(b). If the entity would be treated as a corporation as a result of its formation in any of the jurisdictions in which it is organized, it is treated as a corporation for Federal tax purposes even though its organization in the other jurisdiction or jurisdictions would not have caused it to be treated as a corporation.

Once the classification of a business entity has been determined, a determination will generally need to be made regarding whether it is a domestic or foreign entity. It is a domestic entity if it is created or organized in the United States or under the laws of the United States or of any state. It is a foreign entity only if it is not domestic. The temporary regulations in this document revise §301.7701–5 to clarify that a dually chartered entity is domestic if it is organized as any form of entity in the

United States, regardless of how it is organized in any foreign jurisdiction. An entity that is classified as a corporation because of its form of organization in a foreign country is considered a domestic corporation if it is also organized as some form of entity in the United States, regardless of what form the entity takes in the United States (*e.g.*, corporation, limited liability company, or partnership).

These temporary regulations also remove from §301.7701–5 the definitions of resident foreign corporation, nonresident foreign corporation, resident partnership and nonresident partnership because these terms have become obsolete due to statutory changes since the final regulations were published in 1960.

These regulations clarify current law and do not change the outcome that would result under a proper application of the existing rules as they apply to dually chartered entities. For example, the temporary regulations are consistent with the result in Rev. Rul. 88–25, 1988–1 C.B. 116. These regulations are also not intended to affect the result under existing rules regarding whether an organization is a separate entity for Federal tax purposes (*e.g.*, whether, in a particular case, two sets of organizational documents constitute different facets of a single entity or the foundations of two separate entities). In addition, if a business entity undertakes a continuance, domestication, or other transaction that, upon application of these rules, changes its entity classification or changes its foreign or domestic status, the tax effects of that transaction are determined under the regular tax principles that apply to such changes. Finally, the regulations contained in this document do not determine an entity's place of residence for the purpose of applying the provisions of a tax treaty.

Section 7701(a)(4) of the Code provides regulatory authority to define a domestic partnership other than based on where the partnership is created or organized. The Treasury and the IRS are continuing to explore whether, and under what circumstances, a different definition may be appropriate. If any change to the definition of a domestic partnership were to be proposed, it would apply only to partnerships created or organized after the issuance of regulations or other guidance substantially describing the change in definition.

**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 also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the Special Analyses section of the preamble to the notice of proposed rulemaking published in this issue of the Bulletin. Pursuant to section 7806(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact.

**Drafting Information**

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

* * * * *

**Amendments to the Regulations**

Accordingly, 26 CFR part 301 is amended as follows:

PART 301 — PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read, in part, as follows:

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

Par. 2. In §301.7701–1, paragraph (d) is revised to read as follows:

*§301.7701–1 Classification of organizations for federal tax purposes.*

* * * * *

(d) *Domestic and foreign business entities*. [Reserved]. For further guidance, see §301.7701–1T.

* * * * *

Par 3. Section 301.7701–1T is added to read as follows:

*§301.7701–1T Classification of organizations for federal tax purposes (temporary).*

(a) through (c) [Reserved]. For further guidance, see §301.7701–1(a) through (c).

(d) *Domestic and foreign entities*. See §301.7701–5T for the rules that determine whether a business entity is domestic or foreign.

(e) through (f) [Reserved].

Par. 4. In §301.7701–2, paragraph (b)(9) is added to read as follows:

*§301.7701–2 Business entities; definitions.*

* * * * *

(b) * * *

(9) [Reserved]. For further guidance, see §301.7701–2T(b)(9).

* * * * *

Par. 5. Section 301.7701–2T is added to read as follows:

*§301.7701–2T Business entities; definitions (temporary).*

(a) through (b)(8) [Reserved] For further guidance, see §301.7701–2 (a) through (b)(8).

(b)(9) *Entities with multiple charters*. (i) An entity created or organized under the laws of more than one jurisdiction if the rules of this section would treat it as a corporation as a result of its formation in any one of the jurisdictions in which it is created or organized. (The determination of a business entity's classification is made independently of the determination whether the entity is domestic or foreign. See §301.7701–5T for the rules that determine whether a business entity is domestic or foreign.)

(ii) *Examples*. The following examples illustrate the rule of this paragraph (b)(9):

*Example 1*. (i) *Facts*. X is an entity with a single owner organized under the laws of Country A as an entity that is specifically mentioned in paragraph (b)(8)(i) of this section. Under the rules of this section, such an entity generally is a corporation for Federal tax purposes. Several years after its formation, X files a certificate of domestication in State B as a limited liability company (LLC). Under the laws of State B, X is considered to be created or organized in State B as a LLC upon the filing of the certificate of domestication and is therefore subject to the laws of State B. Under the rules of this section and §301.7701–3, a LLC with a single owner organized only in State B is disregarded as an entity separate from its owner for Federal tax purposes (absent an election to be treated as an association). Neither Country A nor State B law requires X to terminate its charter in Country A as a result of the domestication, and in fact X does not terminate its charter in Country A. Consequently, X is now organized in more than one jurisdiction.

(ii) *Result*. X remains organized under the laws of Country A as an entity that is specifically mentioned in §301.7701–2(b)(8)(i), and as such, it is an entity that generally is treated as a corporation under the rules of this section. Therefore, X is a corporation for Federal tax purposes because the rules of this section would treat X as a corporation as a result of its formation in one of the jurisdictions in which it is created or organized.

*Example 2*. (i) *Facts*. Y is an entity that is incorporated under the laws of State A and that has two shareholders. Under the rules of this section, an entity incorporated under the laws of State A is a corporation for Federal tax purposes. Several years after its formation, Y files a certificate of continuance in Country B as an unlimited company. Under the laws of Country B, upon filing a certificate of continuance, Y is treated as organized in Country B. Under the rules of this section and §301.7701–3, an unlimited company organized only in Country B that has more than one owner is treated as a partnership for Federal tax purposes (absent an election to be treated as an association). Neither State A nor Country B law requires Y to terminate its charter in State A as a result of the continuance, and in fact Y does not terminate its charter in State A. Consequently, Y is now organized in more than one jurisdiction.

(ii) *Result*. Y remains organized in State A as a corporation, an entity that is treated as a corporation under the rules of this section. Therefore, Y is a corporation for Federal tax purposes because the rules of this section would treat Y as a corporation as a result of its formation in one of the jurisdictions in which it is created or organized.

*Example 3*. (i) *Facts*. Z is an entity that has more than one owner and that is recognized under the laws of Country A as an unlimited company organized in Country A. Under the rules of this section and §301.7701–3, an unlimited company organized only in Country A with more than one owner is treated as a partnership for Federal tax purposes (absent an election to be treated as an association). At the time Z was formed, it was also organized as a public limited company under the laws of Country B. Under the rules of this section, a public limited company organized only in Country B generally is treated as a corporation for Federal tax purposes.

(ii) *Result*. Z is organized in Country B as a public limited company, an entity that generally is treated as a corporation under the rules of this section. Therefore, Z is a corporation for Federal tax purposes because the rules of this section would treat Z as a corporation as a result of its formation in one of the jurisdictions in which it is created or organized.

(c) through (e) [Reserved]. For further guidance, see §301.7701–2(c) through (e).

(f) *Special effective date*. The rules of this section apply as of August 12, 2004, to all business entities existing on or after that date.

Par. 6. In §301.7701–3, the last sentence of paragraph (b)(3)(i) is revised to read as follows:

*§301.7701–3 Classification of certain business entities.*

* * * * *

(b) * * *

(3) * * * (i) * * *For special rules regarding the classification of such entities prior to the effective date of this section, see paragraph (h)(2) of this section.

* * * * *

Par. 7. Section 301.7701–5 is revised to read as follows:

*§301.7701–5 Domestic and foreign business entities*. [Reserved]. For further guidance, see §301.7701–5T.

Par. 8. Section 301.7701–5T is added to read as follows:

*§301.7701–5T Domestic and foreign business entities (temporary)*

(a) *Domestic and foreign entities*. A business entity (including an entity that is disregarded as separate from its owner) is domestic if it is created or organized as any type of entity (including, but not limited to, a corporation, unincorporated association, general partnership, limited partnership, and limited liability company) in the United States, or under the law of the United States or of any State. Accordingly, a business entity that is created or organized both in the United States and in a foreign jurisdiction is a domestic entity. A business entity (including an entity that is disregarded as separate from its owner) is foreign if it is not domestic. (The determination of whether an entity is domestic is made independently of the determination of its classification for Federal tax purposes. See §§301.7701–2, 301.7701–2T, and 301.7701–3 for the rules governing the classification of entities.)

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

*Example 1*. (i) *Facts*. Y is an entity that is created or organized under the laws of Country A as a public limited company. It is also an entity that is organized as a limited liability company (LLC) under the laws of State B. Y has been classified as a corporation for Federal tax purposes under the rules of §§301.7701–2, 301.7701–2T, and 301.7701–3.

(ii) *Result*. Y is a domestic corporation because it is an entity that is classified as a corporation and it is organized as an entity under the laws of State B.

*Example 2*. (i) *Facts*. P is an entity with more than one owner organized under the laws of Country A as an unlimited company. It is also an entity that is organized as a general partnership under the laws of State B. P has been classified as a partnership for Federal tax purposes under the rules of §§301.7701–2, 301.7701–2T, and 301.7701–3.

(ii) *Result*. P is a domestic partnership because it is an entity that is classified as a partnership and it is organized as an entity under the laws of State B.

(c) *Effective date*. The rules of this section apply as of August 12, 2004, to all business entities existing on or after that date.

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

Approved July 21, 2004.

Gregory Jenner,
*Acting Assistant Secretary of the Treasury.*

(Filed by the Office of the Federal Register on August 11, 2004, 8:45 a.m., and published in the issue of the Federal Register for August 12, 2004, 69 F.R. 49809)

## Section 7805(b).—Retroactivity of Regulations

A revenue ruling provides relief from the retroactive application of Rev. Rul. 2004–75. See Rev. Rul. 2004-97, page 516.

# Part III. Administrative, Procedural, and Miscellaneous

## Subsidiary Stock Loss Under Section 1.337(d)–2T

## Notice 2004–58

### I. Purpose

This notice sets forth a method that the Internal Revenue Service will accept for determining whether subsidiary stock loss is disallowed and subsidiary stock basis is reduced under § 1.337(d)–2T of the Income Tax Regulations. This notice also requests comments regarding the method that should be adopted in prospective regulations to ensure that the policies underlying the repeal of *General Utilities* are not circumvented through the operation of the consolidated return provisions.

### II. Background

Section 1.337(d)–2T(a)(1) generally provides that no loss is allowed with respect to the disposition of subsidiary stock by a member of a consolidated group. Section 1.337(d)–2T(b)(1) generally requires the basis of a share of subsidiary stock to be reduced to its value immediately before a deconsolidation of the share. An exception to these general rules is found in § 1.337(d)–2T(c)(2), which provides that loss is not disallowed and basis is not reduced to the extent the taxpayer establishes that the loss or basis "is not attributable to the recognition of built-in gain on the disposition of an asset." Section 1.337(d)–2T(c)(2) defines the term "built-in gain" as gain that is "attributable, directly or indirectly, in whole or in part, to any excess of value over basis that is reflected, before the disposition of the asset, in the basis of the share, directly or indirectly, in whole or in part".

In addition to other methods that may be appropriate, the IRS will accept the basis disconformity method described in Section III of this notice as a method for determining the extent to which loss or basis is attributable to the recognition of built-in gain on the disposition of an asset for purposes of applying the exception of § 1.337(d)–2T(c)(2). A consolidated group is not required to adopt the same method for each disposition or deconsolidation of a share of subsidiary stock.

### III. Basis Disconformity Method

The basis disconformity method disallows loss on a disposition of subsidiary stock and reduces basis (but not below value) on a deconsolidation of subsidiary stock in an amount equal to the least of the "gain amount," the "disconformity amount," and the "positive investment adjustment amount." For this purpose, the gain amount is the sum of all gains (net of directly related expenses) recognized on asset dispositions of the subsidiary that are allocable to the share while the subsidiary is a member of the group. The disconformity amount is the excess, if any, of the share's basis over the share's proportionate interest in the subsidiary's "net asset basis." A subsidiary's net asset basis is the excess of (a) the sum of the subsidiary's money, basis in assets (other than stock of consolidated subsidiaries), loss carryforwards that would be carried to a separate return year of the subsidiary under the principles of § 1.1502–21, and deductions that have been recognized but deferred, over (b) the subsidiary's liabilities that have been taken into account for tax purposes. Both the gain amount and the disconformity amount include the subsidiary's allocable share of corresponding amounts of a subsidiary the items of which directly or indirectly adjust the basis of the subsidiary's stock. The positive investment adjustment amount is the excess, if any, of the sum of the positive adjustments made to the share under § 1.1502–32 over the sum of the negative adjustments made to the share under § 1.1502–32, excluding adjustments for distributions under § 1.1502–32(b)(2)(iv).

### IV. Other Methods

As indicated above, the IRS will accept methods other than the basis disconformity method for determining the amount of stock loss or basis that is not attributable to the recognition of built-in gain on the disposition of an asset, including a tracing approach. Thus, a taxpayer generally may use tracing to establish that stock loss is not attributable to the recognition of built-in gain, and stock loss is not disallowed to that extent. Under a tracing approach, events subsequent to the acquisition of a share of subsidiary stock that create or alter the disconformity between the basis of the share and the share's interest in the aggregate basis of assets the disposition of which would adjust the basis of the share (for example, the acquisition by a subsidiary of stock of another corporation that joins the consolidated group, an intra-group spin-off under section 355, or a contribution of property to a subsidiary under section 351) may need to be taken into account to determine the extent to which stock loss or basis is attributable to the recognition of built-in gain on the disposition of an asset.

### V. Reliance on Notice, Related Relief Provisions

The IRS and Treasury Department are publishing temporary regulations concurrently with this notice that permit taxpayers to make, amend, or revoke elections under § 1.1502–20T(i) (regarding the method to determine allowable loss and basis reduction upon certain dispositions and deconsolidations of subsidiary stock). Under those regulations, a taxpayer that was permitted to make an election under § 1.1502–20T(i), but did not previously make such an election, may make an election to apply either § 1.1502–20 without regard to the duplicated loss factor of the loss disallowance formula, or § 1.337(d)–2T. The regulations also permit a taxpayer that previously made an election to apply § 1.1502–20 without regard to the duplicated loss factor to revoke the election and apply § 1.1502–20 in its entirety, or to amend the election in order to apply § 1.337(d)–2T. Finally, the regulations permit a taxpayer that previously made an election to apply § 1.337(d)–2T to revoke the election and apply § 1.1502–20 in its entirety or to amend the election in order to apply § 1.1502–20 without regard to the duplicated loss factor.

### VI. Approaches Under Consideration

The IRS and Treasury Department are studying various approaches to implement the repeal of *General Utilities* in the consolidated return context pursuant to the mandate of section 337(d) and intend to promulgate regulations that will prescribe a single set of rules. Among the approaches that the IRS and Treasury Department are considering are a number of tracing regimes and a basis disconformity approach described below. The IRS and Treasury Department recognize that differing interpretations of what is necessary to implement the policies underlying the repeal of *General Utilities* in the consolidated return context may suggest differing approaches for regulations under section 337(d). It is clear that, in enacting section 337(d), Congress intended that the consolidated return regulations would not facilitate the circumvention of the recognition of corporate level gain on a corporation's sale or distribution of appreciated property. While some might argue that this concern was limited to stock losses created by the recognition of asset gain that existed when the stock or asset was acquired by the group, others might argue that this concern extended to losses created by any gain or income recognized.

*Tracing Regimes*

The IRS and Treasury Department recognize that there are a variety of ways to implement a tracing regime. Some of those regimes might disallow loss based on the recognition of gain that is actually reflected in the share's basis, as under § 1.337(d)–2T. Others might disallow loss solely by reference to the appreciation in an asset when the asset is introduced into the group, presuming such appreciation is reflected in the share's basis, as under a built-in items approach described below. In addition, a tracing regime could be implemented that operates not only to disallow loss, but also to increase stock gain by reducing the share's basis to the extent of recognized built-in gain, even below value. A tracing regime also could employ irrebuttable presumptions for determining whether recognized gain is built-in, to address administrability concerns inherent in rebuttable presumptions.

Under one type of a built-in items approach, the basis of a share of subsidiary stock would be reduced immediately prior to a disposition or deconsolidation of that share (but not below its value) in an amount equal to the "extraordinary disposition amount." The extraordinary disposition amount is the excess, if any, of the sum of the gain over the sum of the loss that is allocated to the share from asset dispositions. For this purpose, the gain or loss that is allocated to a share from an asset disposition is taken into account only to the extent that it does not exceed the "unrealized built-in gain" (UBIG) or "unrealized built-in loss" (UBIL) that is attributable to the asset disposed of and that is properly allocable to the share. The UBIG or UBIL attributable to an asset is generally measured on the first date that the asset is introduced into the group (the measurement date). For example, if an asset is held by a corporation at the time that all of the stock of that corporation is acquired by a group member, the UBIG (or UBIL) attributable to that asset is the excess of the asset's value over its basis (or, in the case of UBIL, the excess of the asset's basis over its value) immediately after the stock acquisition. In addition, if an asset is acquired by a corporation the stock of which is already wholly owned by group members, the UBIG (or UBIL) attributable to that asset is the excess of the asset's value over its basis (or, in the case of UBIL, the excess of the asset's basis over its value) immediately after the asset acquisition.

Under one variation of this type of a built-in items approach, all recognized gains would be presumed to be UBIG and all recognized losses would be presumed not to be UBIL unless the taxpayer established the contrary with clear and convincing evidence. Under another variation of the built-in items approach, the presumption that all recognized gains are UBIG and all recognized losses are not UBIL would be irrebutable. However, the aggregate amount of gains that could be treated as UBIG would be limited to the sum of the gain, if any, inherent in each of the assets on the measurement date.

*Basis Disconformity Approach*

The IRS and Treasury Department are considering a version of the basis disconformity method described in Section III of this notice. That version, however, would not distinguish between the recognition of gain and income and, therefore, would determine disallowed loss without regard to the gain amount factor described in Section III. Therefore, the stock loss disallowed or basis reduced would equal the lesser of the disconformity amount and the positive investment adjustment amount. This basis disconformity approach is based on the view that corporate tax is avoided whenever stock basis is increased under the investment adjustment rules of § 1.1502–32 for items of gain or income when the group already has enough stock basis to prevent a second tax on a disposition of the stock.

The rationale for the basis disconformity approach can be illustrated by the following example. Assume that P purchases the stock of S for $100, the value of the S stock is $100 at all relevant times, and S holds one asset with a basis of $0 on the date of its acquisition. If S recognizes $100 of income, regardless of the source of that income (for example, gain on the disposition of the original asset, or on the disposition of any after-acquired assets, or income produced in the consumption of the original or any after-acquired asset), P's $100 basis in the S stock is sufficient to protect P from further tax on a disposition of the S stock. Increasing P's basis in its S stock when the $100 of income is recognized would allow that $100 of income to be offset by a stock loss, thereby eliminating the corporate tax on the $100 of income.

**VII. Request for Comments**

The IRS and Treasury Department request comments regarding the appropriate scope of regulations implementing the mandate of section 337(d) and the specific approach that such regulations should adopt. In addition, the IRS and Treasury Department request comments on the treatment of lower tier entities, including partnerships and foreign subsidiaries, under future regulations and the need, if any, for transitional rules. Comments should refer to Notice 2004–58, and should be submitted to:

Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044
Attn: CC:PA:LPD:PR
Room 5203

or electronically via the Service internet site at: *Notice.Comments@irscounsel.treas.gov* (the Service comments e-mail address).

All comments will be available for public inspection and copying.

DRAFTING INFORMATION:

The principal authors of this notice are Theresa Abell and Martin Huck of the Office of Associate Chief Counsel (Corporate). For further information regarding this notice, contact Ms. Abell at (202) 622–7700 or Mr. Huck at (202) 622–7750 (not toll-free numbers).

# Part IV. Items of General Interest

## Notice of Proposed Rulemaking

## Qualified Severance of a Trust for Generation-Skipping Transfer (GST) Tax Purposes

## REG–145987–03

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: These proposed regulations provide guidance regarding the qualified severance of a trust for generation-skipping transfer (GST) tax purposes under section 2642(a)(3) of the Internal Revenue Code, which was added to the Code by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). The regulations will affect trusts that are subject to the GST tax.

DATES: Written or electronic comments and requests for a public hearing must be received by November 22, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–145987–03), 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–145987–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the IRS Internet site at *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS — REG–145987–03).

FOR FURTHER INFORMATION CONTACT: Mayer R. Samuels, (202) 622–3090 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

**Paperwork Reduction Act**

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by October 25, 2004. 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 (see below);

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

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

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

The collection of information in this proposed regulation is in §26.2642–6(b). This collection of information is required by the IRS to identify whether a trust is exempt from the GST. This information will be used to determine whether the amount of tax has been calculated correctly. The collection of information is required in order to have a qualified severance. The respondents are trustees of trusts that are being severed.

Estimated total annual reporting burden: 12,500 hours.

Estimated average annual burden hours per respondent: 30 minutes.

Estimated number of respondents: 25,000.

Estimated annual frequency of responses: on occasion.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget. Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

**Background**

Section 2642(a)(3) was added to the Internal Revenue Code by EGTRRA, Public Law 107–16 (115 Stat. 38 (2001)). Under section 2642(a)(3), if a trust is divided into two or more trusts in a "qualified severance," the resulting trusts will be recognized as separate trusts for GST tax purposes. In many cases, a qualified severance of a trust will facilitate the most efficient and effective use of the transferor's GST tax exemption. The GST tax exemption is the lifetime exemption applicable in determining the inclusion ratio with respect to the trust, which in turn determines the amount of GST tax imposed on any generation-skipping transfer made from the trust.

Section 2642(a)(3) expands the options for trustees wishing to sever trusts by providing more time to make the severance, providing that severances may occur for more trusts, and providing a uniform system for severance. Section 2642(a)(3) was intended to supercede and replace §26.2654–1(b) of the Generation-Skipping Transfer Tax Regulations, which authorizes the recognition of severed trusts for GST tax purposes in limited situations involving testamentary trusts or *inter vivos* trusts that are included in the transferor's gross estate for estate tax purposes. That regulation does not apply to irrevocable *inter vivos* trusts that are not includible in the decedent's gross estate. Further, under that regulation, a severance is recognized only if commenced within a prescribed time period, and only if specifically authorized under the terms of the governing instrument or local law.

Section 2642(a)(3)(B)(i) provides a general rule that a qualified severance is defined as the division of a single trust and the creation of two or more trusts if: (1) the single trust is divided on a fractional basis; and (2) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust. Under section 2642(a)(3)(B)(ii), if a trust has an inclusion ratio that is greater than zero and less than one, the trust must be severed in a specified manner that produces one trust that is wholly exempt from GST tax, and one trust that is wholly subject to GST tax. Each of the two new trusts created may be further divided into two or more trusts under section 2642(a)(3)(B)(i). Under section 2642(a)(3)(C), a trustee may elect to sever a trust in a qualified severance at any time, and the manner in which the qualified severance is to be reported is to be specified by regulation. Section 2642(a)(3) is applicable for severances of trusts occurring after December 31, 2000.

**Explanation of Provisions**

I. *Division on a Fractional Basis*

Under section 2642(a)(3), in order to constitute a qualified severance, the single trust must be divided on a fractional basis. Under the proposed regulations, each new trust must receive assets with a value equal to a fraction or percentage of the total value of the trust assets. Thus, for example, the severance of a single trust on the basis that one trust is to be funded with 30% of the trust assets and that the other trust is to be funded with the remaining 70% of the trust assets would satisfy this requirement. Similarly, a severance stated in terms of a fraction of the trust assets such that one trust is to receive, for example, that fraction of the trust assets the numerator of which is $1,500,000 and the denominator of which is the fair market value of the trust assets on a specified date and the second trust is to receive the remaining fraction, would also satisfy this requirement. However, the severance of a trust based on a pecuniary amount (for example, severance of a single trust on the basis that one trust is to be funded with $1,500,000, and the other trust is to be funded with the balance of the trust corpus) would not satisfy this requirement.

The proposed regulations provide that each separate trust need not be funded with a *pro rata* portion of each asset held by the original trust. Rather, the separate trusts may be funded on a non *pro rata* basis (that is, where each resulting trust does not receive a *pro-rata* portion of each asset) provided that funding is based on the total fair market value of the assets on the date of funding. This avoids the necessity of dividing each and every asset on a fractional basis to fund the severed trusts.

II. *New Trusts Must Provide for the Same Succession of Interests*

Under section 2642(a)(3)(B)(i)(II), the new trusts created as a result of the qualified severance must provide in the aggregate for the same succession of interests of beneficiaries as provided in the original trust. Under the regulations, the beneficiaries of each separate trust resulting from the severance need not be identical to those of the original trust. In the case of trusts that grant the trustee the discretionary power to make non *pro rata* distributions to beneficiaries, the separate trusts will be considered to have the same succession of interests of beneficiaries if the terms of the separate trusts are the same as the terms of the original trust, the severance does not shift a beneficial interest in the trust to any beneficiary in a lower generation (as determined under section 2651) than the person or persons who held the beneficial interest in the original trust, and the severance does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. This rule for discretionary trusts is intended to facilitate the severance of trusts along family lines.

In this regard, the Treasury Department and the IRS recognize that in many cases involving discretionary trusts, when the members of two or more families are beneficiaries, the parties may desire to divide the trust along family lines so that one trust is established exclusively for the benefit of one family and one trust is established exclusively for the benefit of another family. If the inclusion ratio of the trust is between zero and one, section 2642(a)(3)(B)(ii) would ordinarily, as a practical matter, preclude the division of the trust along family lines because the section requires that the severance result in one trust with an inclusion ratio of zero and one trust with an inclusion ratio of one. However, under the proposed regulations, a similar result may be accomplished through a series of severances; that is, first a division of the trust based on the inclusion ratio, and then a division of each resulting trust along family lines.

Finally, §26.2601–1(b)(4) of the regulations contains rules for determining when certain actions with respect to a non-chapter 13 trust (a trust that was irrevocable on or before September 25, 1985) will not cause the trust to lose its exempt status. In particular, under §26.2601–1(b)(4)(i)(D)(1), a modification (including a severance) of a non-chapter 13 trust will not cause the trust to be subject to the provisions of chapter 13 if the modification does not (1) shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the modification or (2) extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

Under the proposed regulations, the rules in §26.2601–1(b)(4) will continue to apply to severances (and other actions) with respect to trusts created on or before September 25, 1985. However, the post–2000 severance of a trust created after September 25, 1985, will be governed by section 2642(a)(3) and the applicable regulations.

III. *Reporting Requirements*

The proposed regulations provide that a qualified severance is to be reported by filing a Form 706–GS(T), *"Generation-Skipping Transfer Tax Return for Terminations,"* or such other form that may be published by the IRS in the future that is specifically designated to be utilized to report qualified severances. When Form 706–GS(T) is utilized, the filer should write "Qualified Severance" in red at the top of the return and attach a Notice of Qualified Severance to the return that clearly identifies the trust that is being severed and the new trusts created as a result of the severance. The notice must also provide the inclusion ratio of the trust that was severed and the inclusion ratios of the new trusts resulting from the severance. The return and attached notice must be filed even if the severance does not result in a taxable termination. A transition rule applies in the case of severances occurring before the date of publication of the final regulations.

IV. *Income Tax Consequences of Severance under the Proposed Regulations*

The proposed regulations provide that a qualified severance will not constitute an exchange of property for other property differing materially either in kind or in extent, for purposes of section 1001, provided that: (1) an applicable state statute or the governing instrument authorizes the trustee to sever the trust; and (2) if the separate trusts created by the severance are funded on a non *pro rata* basis, as discussed in Section I above, an applicable state statute or the governing instrument authorizes the trustee to fund the separate trusts on a non *pro rata* basis. If section 1001 does not apply in accordance with this standard, then under section 1015, the basis of the trust assets will be the same after the severance as the basis of those assets before the severance, and under section 1223, the holding periods of the assets distributed to the new trusts will include the holding period of the assets in the original trust.

V. *Proposed Effective Date*

Section 2642(a)(3) supercedes the regulatory rules contained in §26.2654–1(b). Accordingly, under the proposed regulations, the applicability of §26.2654–1(b) is limited to severances occurring on or before December 31, 2000. The regulations under section 2642(a)(3), as proposed, apply to severances occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations. In the case of severances occurring after December 31, 2000, and before publication of final regulations, taxpayers may rely on any reasonable interpretation of section 2642(a)(3) as long as reasonable notice concerning the severance and identification of the trusts involved has been given to the IRS.

The regulations under section 1001, as proposed, apply to severances occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations. However, taxpayers may apply the proposed regulations under section 1001 to severances occurring after August 24, 2004, and before publication of final 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 these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the collection of information imposed by this regulation is not significant as reflected in the estimated burden of information collection for, which is 0.5 hours per respondent, and that few trustees are likely to be small entities. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

**Comments and Requests for Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the substance of the proposed regulations, as well as on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

**Drafting Information**

The principal author of these proposed regulations is Mayer R. Samuels, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. If you have any questions concerning these proposed regulations, please contact Mayer R. Samuels at (202) 622–3090. Other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

**Proposed Amendments to the Regulations**

Accordingly, 26 CFR parts 1 and 26 are proposed to be amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. In §1.1001–1, paragraph (h) is added to read as follows:

*§1.1001–1 Computation of gain or loss.*

* * * * *

(h) *Qualified severances of trusts*—(1) *In general*. A severance of a trust that meets the requirements of §26.2642–6 is not an exchange of property for other property differing materially either in kind or in extent if—

(i) An applicable state statute or the governing instrument authorizes the trustee to sever the trust; and

(ii) If the separate trusts created by the severance are funded on a non *pro rata* basis as provided in §26.2642–6(b)(3), an applicable state statute or the governing instrument authorizes the trustee to fund the separate trusts on a non *pro rata* basis.

(2) *Effective date*. This paragraph (h) applies to severances occurring on or after the date these regulations are published as final regulations in the **Federal Register**. Taxpayers may apply this paragraph (h) to severances occurring on or after August 24, 2004, and before the date these regulations are published as final regulations in the **Federal Register**.

PART 26 — GENERATION-SKIPPING TRANSFER TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1986

Par. 3. The authority citation for part 26 is amended by adding an entry in numerical order to read, in part, as follows:

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

Section 26.2642–6 also issued under 26 U.S.C. 2642. * * *

Par. 4. In §26.2600–1, the table is amended as follows.

1. An entry for §26.2642–6 is added.

2. The entry for §26.2654–1(b) introductory text is revised.

3. An entry for §26.2654–1(c) is added.

The revision and additions read as follows:

*§26.2600–1 Table of contents.*

* * * * *

*§26.2642–6 Qualified severance.*

(a) In general.

(b) Requirements for a qualified severance.

(c) Time for making a qualified severance.

(d) Irrevocable trusts.

(e) Examples.

(f) Effective date.

* * * * *

*§26.2654–1 Certain trusts treated as separate trusts.*

* * * * *

(b) Division of a trust included in the gross estate occurring on or before December 31, 2000.

* * * * *

(c) Qualified severance occurring after December 31, 2000.

Par. 5. Section 26.2642–6 is added to read as follows:

*§26.2642–6 Qualified severance*

(a) *In general*. If a trust is severed into two or more trusts, the separate trusts resulting from the severance will be treated as separate trusts for generation-skipping transfer tax purposes only if the severance is a qualified severance. In general, the rules in this section are applicable only for purposes of the generation-skipping transfer tax and are not applicable in determining, for example, whether the severance may result in a gift subject to gift tax, cause the trust to be included in the gross estate of a beneficiary, or result in a realization of gain for purposes of section 1001. See §1.1001–1(h) for rules relating to whether a qualified severance will constitute an exchange of property for other property differing materially either in kind or in extent.

(b) *Requirements for a qualified severance*. For purposes of this section, a qualified severance is a division of a single trust into two or more trusts that meets each of the following requirements:

(1) The single trust is severed pursuant to the terms of the governing instrument, or pursuant to applicable local law.

(2) The severance is effective under local law.

(3) The single trust is severed on a fractional basis, such that each new trust is funded with a fraction or percentage of the entire trust. For this purpose, the fraction or percentage may be determined by means of a formula (for example, that fraction of the trust the numerator of which is equal to transferor's unused GST tax exemption, and the denominator of which is the fair market value of the trust assets on the date of severance). The severance of a trust based on a pecuniary amount does not satisfy this requirement. For example, the severance of a trust would not be a qualified severance if the trust was divided into two trusts, with one trust to be funded with $1,500,000 and the other trust to be funded with the balance of the original trust assets. For purposes of this paragraph, the separate trusts resulting from the severance may be funded with the appropriate fraction, percentage, or *pro rata* portion of each asset held by the undivided trust, or on a non pro rata basis. However, if funded on a non *pro rata* basis, each resulting trust must be funded by applying the appropriate fraction or percentage to the total fair market value of the trust assets as of the date of funding.

(4) The terms of the new trusts must provide, in the aggregate, for the same succession of interests of beneficiaries as are provided in the original trust. This requirement will be satisfied if the beneficiaries of the separate trusts and the interests of the beneficiaries with respect to the separate trusts, when the separate trusts are viewed collectively, are identical to the beneficiaries and their respective beneficial interests with respect to the original trust before severance. With respect to trusts from which discretionary distributions may be made to any one or more beneficiaries on a non *pro rata* basis, this requirement will be satisfied if the terms of each of the separate trusts are the same as the terms of the original trust (even though each permissible distributee of the original trust might be a beneficiary of only one of the separate trusts), the severance does not shift a beneficial interest in the trust to any beneficiary in a lower generation (as determined under section 2651) than the person or persons who held the beneficial interest in the original trust, and the severance does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

(5) In the case of a severance after GST tax exemption has been allocated to the trust as a result of an allocation, deemed allocation, or automatic allocation pursuant to the rules contained in section 2632, if the trust has an inclusion ratio as defined in §26.2642–1 that is greater than zero and less than one, then the trust may be severed initially only into two trusts. One separate trust must receive that fractional share of the total value of all trust assets as of the date of funding equal to the applicable fraction, as defined in §26.2642–1(b) and (c), with respect to the single trust immediately before the severance. The other separate trust must receive the balance of the trust assets. The trust receiving the fractional share equal to the applicable fraction shall have an inclusion ratio of zero, and the other trust shall have an inclusion ratio of one. If the applicable fraction with respect to the original trust is .50, then with respect to the two equal trusts resulting from the severance, the Trustee may designate which of the resulting trusts will have an inclusion ratio of zero and which will have an inclusion ratio of one. Each separate trust resulting from the severance may be further divided in accordance with the rules of this section.

(6) The severance is reported by filing Form 706–GS(T), "*Generation-Skipping Transfer Tax Return for Terminations*," or such other form that may be published by the IRS that is specifically designated to be utilized to report qualified severances. When Form 706–GS(T) is utilized, the filer should write "Qualified Severance" in red at the top of the return and attach a Notice of Qualified Severance to the return. The notice must contain: a statement identifying the trust that is severed, the name of the transferor of the trust, the date of creation, the tax identification number,

and the inclusion ratio with respect to the trust before severance; and a statement identifying each of the new trusts created as a result of the severance, the name and tax identification number of each new trust, the fraction of trust assets received by each new trust, other details explaining the basis for funding each new trust (a fraction of the total fair market value of the assets on the date of funding or a fraction of each asset), and the inclusion ratio of each new trust. The return and attached notice must be filed by April 15th of the year immediately following the year during which the severance occurred or the last day of the period covered by an extension of time, if an extension of time is granted.

(c) *Time for making a qualified severance*. A trust may be severed in a qualified severance at any time prior to the termination of the trust. Thus, provided that the separate trusts resulting from the severance continue in existence after the severance, a trust may be severed in a qualified severance either before or after: GST tax exemption has been allocated to the trust; a taxable event has occurred with respect to the trust; or an addition has been made to the trust. A qualified severance is effective at the time the trust is divided into two or more separate trusts. Thus, a qualified severance has no effect on a taxable termination as defined in section 2612(a) or a taxable distribution as defined in section 2612(b) that occurred prior to the effective date of the qualified severance.

(d) *Irrevocable trusts*. See §26.2601–1(b)(4) for rules regarding severances and other actions with respect to trusts that were irrevocable on September 25, 1985.

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

*Example 1. Formula severance*. T's will establishes a testamentary marital trust (Trust) that qualifies as qualified terminable interest property (QTIP) under section 2056(b)(7). Trust provides that all trust income is to be paid to T's spouse for life. On the spouse's death, the trust corpus is to be held in further trust for the benefit of T's then-living descendants. On T's date of death in January of 2004, T's unused GST tax exemption is $1,200,000, $200,000 of which T's executor will allocate to bequests to T's grandchildren. Prior to the due date for filing the Form 706, "*United States Estate (and Generation-Skipping Transfer) Tax Return*," for T's estate, and thus, prior to the allocation of any GST tax exemption with respect to Trust, T's executor, pursuant to applicable state law, divides Trust into two separate trusts, Trust 1 and Trust 2. Trust 1 is to be funded with that fraction of the Trust assets, the numerator of which is $1,000,000, and the denominator of which is the value of the Trust assets as finally determined for federal estate tax purposes. Trust 2 is to be funded with the balance of the Trust assets. On the Form 706 filed for the estate, T's executor makes a QTIP election under section 2056(b)(7) with respect to Trust 1 and Trust 2 and a "reverse" QTIP election under section 2652(a)(3) with respect to Trust 1. Further, T's executor allocates T's available GST tax exemption to Trust 1. If the requirements of section 2642(a)(3) are otherwise satisfied, the severance constitutes a qualified severance. Accordingly, Trust 1 and Trust 2 are treated as separate trusts, and the GST tax elections and GST tax exemption allocation are recognized and effective for generation-skipping transfer tax purposes.

*Example 2. Severance of single trust with one income beneficiary*. T's will establishes a testamentary trust providing that income is to be paid to T's sister, S, for her life. On S's death, one-half of the corpus is to be paid to T's child, C, or to C's estate if C fails to survive S and one-half of the corpus is to be paid to T's grandchild, GC, or to GC's estate if GC fails to survive S. Prior to the due date for filing the Form 706, T's executor, pursuant to applicable state law, divides the testamentary trust into two separate trusts, Trust 1 and Trust 2, with each trust receiving 50 percent of the current value of the assets of the original trust. Trust 1 provides that trust income is to be paid to S for life with remainder to C or C's estate, and Trust 2 provides that trust income is to be paid to S for life with remainder to GC or GC's estate. Because Trust 1 and Trust 2 provide for the same succession of interests in the aggregate as provided in the original trust, the severance will constitute a qualified severance if the requirements of section 2642(a)(3) are otherwise satisfied. On the Form 706, T's executor may allocate T's available GST tax exemption to Trust 2.

*Example 3. Severance of discretionary trust*. T's will establishes a testamentary trust (Trust) providing that income is to be paid from time to time in such amounts as the trustee deems advisable to T's children, A and B, and to their respective descendants. In addition, the trustee may distribute corpus to any trust beneficiary in such amounts as the trustee deems advisable. On the death of the last to die of A and B, the trust is to terminate and the corpus is to be distributed in two equal shares, one share to the descendants of each child, per stirpes. Prior to the due date for filing the Form 706, T's executor, pursuant to applicable state law, divides Trust into two separate trusts, Trust 1 and Trust 2. Trust 1 provides that income is to be paid in such amounts as the trustee deems advisable to A and A's descendants. In addition, the trustee may distribute corpus to any trust beneficiary in such amounts as the trustee deems advisable. On the death of A, Trust 1 is to terminate and the corpus is to be distributed to the descendants of A, per stirpes, but if A dies with no living descendants, the principal will be added to Trust 2. Trust 2 contains identical provisions, except that B and B's descendants are the trust beneficiaries and, if B dies with no living descendants, the principal will be added to Trust 1. Because Trust 1 and Trust 2 provide for the same beneficiaries and the same succession of interests in the aggregate as provided in Trust, and because the severance does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation than the person or persons who held the beneficial interest in Trust, the severance constitutes a qualified severance if the requirements of section 2642(a)(3) are otherwise satisfied.

*Example 4. Severance of single trust with two income beneficiaries*. T's will establishes a testamentary trust (Trust) providing that Trust income is to be paid to T's children, A and B, for their joint lives. Upon the death of the first to die of A and B, the income will be paid to the survivor. At the death of the survivor of A and B, the corpus is to be distributed equally to T's grandchildren, W and X (with any then-deceased grandchild's share being paid to that grandchild's estate). W is A's child and X is B's child. Prior to the due date for filing Form 706, T's executor divides the testamentary trust equally into two separate trusts, Trust 1 and Trust 2. Trust 1 provides that trust income is to be paid to A for life and, on A's death, the remainder is to pass to W. Trust 2 provides that trust income is to be paid to B for life and the remainder on B's death to X. Because Trust 1 and Trust 2 do not provide A and B with contingent survivor income interests as provided under the terms of the original trust, Trust 1 and Trust 2 do not provide for the same succession of interests in the aggregate as provided in Trust. Therefore, the division is not a qualified severance, and Trust 1 and Trust 2 are treated as one trust. If, however, in this example, Trust 1 instead provides that trust income is to be paid to A for life and then to B (if B survives A), with remainder to W, and if Trust 2 instead provides that trust income is to be paid to B for life and then to A (if A survives B), with remainder to X, then Trust 1 and Trust 2 would provide for the same succession of interests in the aggregate as provided in Trust, and the severance would constitute a qualified severance.

*Example 5. Severance of a trust with a 50% inclusion ratio*. On September 1, 2004, T transfers $100,000 to a trust for the benefit of T's grandchild, GC. On a timely filed Form 709, "*United States Gift (and Generation-Skipping Transfer) Tax Return*," reporting the transfer, T allocates all of T's remaining GST tax exemption ($50,000) to the trust. As a result of the allocation, the applicable fraction with respect to the trust is .50 [$50,000 (the amount of GST tax exemption allocated to the trust) divided by $100,000 (the value of the property transferred to the trust)]. The inclusion ratio with respect to the trust is .50 [1 — .50]. In 2006, pursuant to authority granted under applicable state law, the trustee severs the trust into two trusts, Trust 1 and Trust 2, each of which receives a 50 percent fractional share of the total value of all trust assets at that time. Because the applicable fraction with respect to the original trust is .50 and the trust was severed into two equal trusts, the trustee may designate which trust has an inclusion ratio of one, and which trust has an inclusion ratio of zero. Accordingly, in the Notice of Qualified Severance reporting the severance, the trustee designates Trust 1 as having an inclusion ratio of zero, and Trust 2 as having an inclusion ratio of one.

*Example 6. Funding of severed trusts on a non pro rata basis*. T's will establishes a testamentary trust (Trust) for the benefit of T's descendants, to be funded with T's stock in Corporation A and Corporation B. T dies on May 1, 2004, at which time the Corporation A stock included in T's gross estate has a fair market value of $100,000 and the stock of Corporation B included in T's gross estate has a fair market value of $200,000. On a timely filed Form 706, T's executor allocates all of T's remaining GST tax exemption ($270,000) to Trust. As a result of the allocation, the applicable fraction with respect to Trust is .90 [$270,000 (the amount of GST tax exemption allocated to the trust) divided by $300,000 (the value of the property transferred to the trust)]. The inclusion ratio with respect to Trust is .10 [1 — .90]. On August 1, 2008, when the value of the Trust assets totals $500,000, consisting of Corporation A stock worth $450,000 and Corporation B stock worth $50,000, the trustee severs Trust into two identical trusts, Trust 1 and Trust 2. The terms of the instrument severing Trust provides that Trust 1 is to be funded on a non *pro rata* basis with assets having a fair market value on the date of funding equal to 90% of the value of the Trust assets on that date, and Trust 2 is to be funded with assets having a fair market value on the date of funding equal to 10% of the value of the Trust assets on that date. Also on August 1, 2008, the trustee funds Trust 1 with all of the Corporation A stock and funds Trust 2 with all of the Corporation B stock. Accordingly, Trust 1 is funded with assets having a value equal to 90% of the value of Trust as of the date of funding, August 1, 2008, and Trust 2 is funded with assets having a value equal to 10% of the value of Trust as of the date of funding. Therefore, if the requirements of section 2642(a)(3) are otherwise satisfied, the severance constitutes a qualified severance. Trust 1 will have an inclusion ratio of zero and Trust 2 will have an inclusion ratio of one.

*Example 7. Severance of a trust along family lines*. T dies on October 1, 2004. T's will establishes a testamentary trust (Trust) to be funded with $1,000,000. Trust income is to be paid to T's child, S, for S's life. On S's death, Trust is to terminate and the assets are to be divided equally among T's three grandchildren, GC1, GC2, and GC3 (or their respective descendants, per stirpes). On a timely filed Form 706, T's executor allocates all of T's remaining GST tax exemption ($300,000) to Trust. As a result of the allocation, the applicable fraction with respect to the trust is .30 [$300,000 (the amount of GST tax exemption allocated to the trust) divided by $1,000,000 (the value of the property transferred to the trust)]. The inclusion ratio with respect to the trust is .70 [1 — .30]. On June 1, 2007, the trustee determines that it is in the best interest of the beneficiaries to sever Trust to provide a separate trust for each of T's three grandchildren and their respective families. The trustee severs Trust into two identical trusts, Trust 1 and Trust 2, each trust providing that trust income is to be paid to S, for life, and on S's death, the trust is to terminate and the assets are to be divided equally among GC1, GC2, and GC3 (or their respective descendants, per stirpes). The terms of the instrument severing Trust provide that Trust 1 is to receive 30% of the Trust assets and Trust 2 is to receive 70% of the Trust assets. Further, each trust is to be funded with a *pro rata* portion of each asset held in Trust. The trustee then severs Trust 1 into three equal trusts, Trust GC1, Trust GC2, and Trust GC3. Each trust is named for a grandchild of T and provides that trust income is to be paid to S for life, and on S's death, the trust is to terminate and the trust proceeds distributed to the respective grandchild for whom the trust is named. If that grandchild has predeceased the termination date, the trust proceeds are to be distributed to that grandchild's then-living descendants, per stirpes, or, if none, to the other grandchildren (or their respective then-living descendants, per stirpes). Each trust is to be funded with a *pro rata* portion of each Trust 1 asset. The trustee also severs Trust 2 in a similar manner, into Trust GC1(2), Trust GC2(2), and Trust GC3(2). If the requirements of section 2642(a)(3) are otherwise satisfied, the severance of Trust into Trust 1 and Trust 2, the severance of Trust 1 into Trust GC1, Trust GC2, Trust GC3, and the severance of Trust 2 into Trust GC1(2), Trust GC2(2) and Trust GC3(2), constitute qualified severances. Trust GC1, Trust GC2, Trust GC3 will each have an inclusion ratio of zero and Trust GC1(2), Trust GC2(2) , and Trust GC3(2) will each have an inclusion ratio of one.

(f) *Effective date*. (1) This section applies to severances occurring on or after the date that this document is published in the **Federal Register** as final regulations.

(2) *Transition rule*. In the case of severances occurring after December 31, 2000, and before the date that this document is published in the **Federal Register** as a final regulation, taxpayers may rely on any reasonable interpretation of section 2642(a)(3) as long as reasonable notice concerning the severance and identification of the trusts involved has been given to the IRS. For this purpose, these proposed regulations are treated as a reasonable interpretation of the statute. For purposes of the notification requirement contained in §26.2642–6(b)(6), notification will be deemed timely if mailed by April 15th of the year immediately following the year during which the severance occurred or the last day of the period covered by an extension of time, if an extension of time is granted. For severances occurring between December 31, 2000, and January 1, 2004, notification will be deemed timely if mailed by November 22, 2004.

Par. 6. Section 26.2654–1 is amended as follows:

1. The paragraph heading for (b) and the introductory text of paragraph (b)(1) are revised.

2. Paragraph (c) is added.

The revision and addition reads as follows:

*§26.2654–1 Certain trusts treated as separate trusts.*

* * * * *

(b) *Division of a trust included in the gross estate occurring on or before December 31, 2000*—(1) *In general*. If a trust that is included in the transferor's gross estate (or created under the transferor's will) is severed on or before December 31, 2000, into two or more trusts, the severance is recognized for purposes of chapter 13 if—

* * * * *

(c) *Qualified severance occurring after December 31, 2000*. For rules applicable to the severance of a trust for GST tax purposes occurring after December 31, 2000, see §26.2642–6.

Deborah M. Nolan,
*Acting Deputy Commissioner for Services and Enforcement.*

(Filed by the Office of the Federal Register on August 23, 2004, 8:45 a.m., and published in the issue of the Federal Register for August 24, 2004, 69 F.R. 51967)

---

# Notice of Proposed Rulemaking and Notice of Public Hearing

# LIFO Recapture Under Section 1363(d)

# REG–149524–03

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations regarding LIFO recapture by corporations converting from C corporations to S corporations. The purpose of the proposed regulations is to provide guidance on the LIFO recapture requirement when the corporation holds inventory accounted for under the last-in, first-out (LIFO) method (LIFO inventory) indirectly through a partnership. The proposed regulations affect C corporations that own interests in partnerships holding LIFO inventory and that elect to be taxed as S corporations or that transfer such partnership interests to S corporations in nonrecognition transactions. The proposed regulations also affect S corporations receiving such partnership interests from C corporations in nonrecognition transactions.

DATES: Written or electronic comments must be received by November 12, 2004. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for Wednesday, December 8, 2004, must be received by Wednesday, November 17, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–149524–03), 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–149524–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or submitted electronically via the IRS Internet site at: *http://www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS and REG–149524–03).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Pietro Canestrelli, 202–622–3060, or Martin Schäffer, 202–622–3070; concerning submissions, Robin Jones, 202–622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

**Paperwork Reduction Act**

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by October 12, 2004. Comments are specifically requested concerning:

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

The accuracy of the estimated burden associated with the proposed collection of information (see below);

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

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

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

The collection of information in this proposed regulation is in §1.1363–2(e)(3). This information is required to inform the IRS of partnerships electing to increase the basis of inventory to reflect any amount included in a partner's income under section 1363(d). Thus, the collection of information is required to obtain a benefit. The likely respondents are businesses or other for-profit institutions.

The burden for the collection of information in §1.1363–2(e)(3) is reflected on Form 1065, "*U.S. Return of Partnership Income*."

The estimated burden for the collection of information in §1.1363–2(e)(3) is as follows:

Estimated total annual reporting burden: 200 hours.

The estimated annual burden per respondent varies from 1 to 3 hours, depending on individual circumstances, with an estimated average of 2 hours.

Estimated number of respondents: 100.

Estimated annual frequency of responses: On occasion.

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 assigned by the Office of Management and Budget.

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

**Background**

This document contains proposed amendments to 26 CFR Part 1 under section 1363(d) of the Internal Revenue Code (Code). Section 1363(d)(1) provides that a C corporation that owns LIFO inventory and that elects under section 1362(a) to be taxed as an S corporation must include in its gross income for its final tax year as a C corporation the LIFO recapture amount. Under section 1363(d)(3), the LIFO recapture amount is the excess of the inventory amount of the inventory using the first-in, first-out (FIFO) method (the FIFO value) over the inventory amount of the inventory using the LIFO method (the LIFO value) at the close of the corporation's final tax year as a C corporation (essentially, the amount of income the corporation has deferred by using the LIFO method rather than the FIFO method).

Final regulations (T.D. 8567, 1994–2 C.B. 199) under section 1363(d) were published in the **Federal Register** on October 7, 1994 (59 FR 51105) to describe the recapture of LIFO benefits when a C corporation that owns LIFO inventory elects to become an S corporation or transfers LIFO inventory to an S corporation in a nonrecognition transaction. The final regulations do not explicitly address the indirect ownership of inventory through a partnership. These proposed regulations provide guidance for situations in which a C corporation that owns LIFO inventory through a partnership (or through tiered partnerships) converts to an S corporation or transfers its partnership interest to an S corporation in a nonrecognition transaction.

Section 1374, modified as part of the repeal of the *General Utilities* doctrine, see *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935), imposes a corporate level tax on certain income or gain recognized by an S corporation to the extent the income or gain is attributable to appreciation that occurred while the assets were held by a C corporation. Specifically, section 1374 imposes a corporate level tax on an S corporation's net recognized built-in gain attributable to assets that it held on the date it converted from a C corporation to an S corporation. The tax is imposed only during the 10-year period beginning on the first day the corporation is an S corporation. In addition, section 1374 imposes a corporate level tax on an S corporation's net recognized built-in gain attributable to assets that the S corporation acquires if the S corporation's bases in such assets are determined (in whole or in part) by reference to the bases of such assets (or any other property) in the hands of a C corporation. This tax is imposed only during the 10-year period beginning on the date that the S corporation acquires the assets.

In Announcement 86–128, 1986–51 I.R.B. 22, the IRS stated that, for purposes of section 1374(d)(2)(A), the inventory method used by a taxpayer for tax purposes (FIFO, LIFO, etc.) shall be used in determining whether goods disposed of following a conversion from C corporation to S corporation status were held by the corporation at the time of conversion. After the issuance of this announcement, Congress became concerned that taxpayers owning LIFO inventory might avoid the built-in gain rules of section 1374. Congress believed that taxpayers owning LIFO inventory, who have enjoyed the deferral benefits of the LIFO method during their status as a C corporation, should not be treated more favorably than their FIFO counterparts. To eliminate this potential disparity in treatment, Congress enacted section 1363(d) in 1987, requiring a taxpayer owning LIFO inventory to recapture the benefits of using the LIFO method. H.R. Rep. No. 100–391 (Parts 1 and 2), 1098 (1987).

In *Coggin Automotive Corp. v. Commissioner*, 292 F.3d 1326 (11th Cir. 2002), *rev'g* 115 T.C. 349 (2000), a holding company owned majority interests in several subsidiaries that operated automobile dealerships owning LIFO inventory. As part of a restructuring, each subsidiary contributed its assets (including its LIFO inventory) to a different partnership. The subsidiaries were then merged into the holding company, which elected to be taxed as an S corporation. The court of appeals held that the holding company's S corporation election did not trigger LIFO recapture under section 1363(d) because it was the partnerships in which the holding company held interests, and not the holding company itself, that used the LIFO method.

Section 337(d)(1) authorizes the Secretary to prescribe regulations to prevent the circumvention of the purposes of the repeal of the *General Utilities* doctrine through the use of any provision of law or regulations. The Treasury Department and the IRS believe that these proposed regulations are necessary to implement *General Utilities* repeal. Congress enacted section 1363(d) because the use of the LIFO method by a C corporation that converts to S corporation status creates the potential for the permanent avoidance of corporate level tax on the built-in gain reflected in the LIFO reserve. This avoidance possibility is present regardless of whether the converting corporation owns inventory directly or indirectly through a partnership or tiered partnerships. Accordingly, the Treasury Department and the IRS believe it is appropriate to require the recapture of a converting corporation's share of the LIFO reserves of partnerships in which it participates. Such an approach is consistent with the regulations under section 1374, which generally adopt a lookthrough approach to partnerships.

**Explanation of Provisions**

The proposed regulations provide that a C corporation that holds an interest in a partnership owning LIFO inventory must include the lookthrough LIFO recapture amount in its gross income where the corporation either elects to be an S corporation or transfers its interest in the partnership to an S corporation in a nonrecognition transaction. The proposed regulations define the lookthrough LIFO recapture amount as the amount of income that would be allocated to the corporation, taking into account section 704(c) and §1.704–3, if the partnership sold all of its LIFO inventory for the FIFO value. A corporate partner's lookthrough LIFO recapture amount must be determined, in general, as of the day before the effective date of the S corporation election or, if the recapture event is a transfer of a partnership interest to an S corporation, the date of the transfer (the recapture date). The proposed regulations provide that, if a partnership is not otherwise required to determine inventory values on the recapture date, the lookthrough LIFO recapture amount may be determined based on inventory values of the partnership's opening inventory for the year that includes the recapture date.

The proposed regulations provide that a corporation owning LIFO inventory through a partnership must increase its basis in its partnership interest by the lookthrough LIFO recapture amount. The proposed regulations also allow the partnership through which the LIFO inventory is owned to adjust the basis of partnership inventory (or lookthrough partnership interests held by that partnership) to account for LIFO recapture. This adjustment to basis is to be patterned in manner and effect after the adjustment in section 743(b). Thus, the basis adjustment constitutes an adjustment to the basis of the LIFO inventory (or lookthrough partnership interests held by that partnership) with respect to the corporate partner only; no adjustment is made to the partnership's common basis. The IRS and the Treasury Department request comments on whether the partnership should be required, in some or all circumstances, to increase the basis of partnership assets by the lookthrough LIFO recapture amount attributable to those assets.

Under §1.1374–4(i)(1), an S corporation's distributive share of partnership items is not taken into account in determining the S corporation's share of net recognized built-in gain or loss if the S corporation's partnership interest represents less than 10 percent of the partnership capital and profits and has a fair market value of less than $100,000. This exception reduces the burden on the S corporation and the partnership of tracking built-in gain assets that are relatively small in amount.

The burden of looking through a partnership interest under section 1374 is greater than the burden of looking through a partnership interest under section 1363(d). Under section 1374, partnership assets must be tracked for a 10-year period. No such tracking problem exists under section 1363 because recapture generally occurs on the date of the S election. Accordingly, the proposed regulations do not contain an exception for partnership interests that are smaller than a specified threshold.

**Proposed Effective Date**

These regulations are proposed to apply to S elections and transfers made on or after August 13, 2004. No inference is intended as to the tax consequences of S elections and transfers made before the effective date of these regulations.

**Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866; therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that few corporations engage in the type of transactions that are subject to these regulations (the conversion from C corporation to S corporation status while holding an interest in a partnership that owns LIFO inventory or the transfer of an interest in such a partnership by a C corporation to an S corporation in a nonrecognition transaction). Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

**Comments and 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 Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Wednesday, December 8, 2004, beginning at 10:00 a.m. in the auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW, 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 area 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 and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by Wednesday, November 17, 2004. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

**Drafting Information**

The principal authors of these regulations are Martin Schäffer and Pietro Canestrelli, Office of Associate Chief Counsel (Passthroughs and Special Industries). 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 is amended by adding an entry in numerical order to read as follows:

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

Section 1.1363–2 also issued under 26 U.S.C. 337(d). * * *

Par. 2. Section 1.1363–2 is amended by:

1. Redesignating paragraphs (b), (c), and (d) as paragraphs (d), (e), and (g), respectively.

2. Adding paragraphs (b), (c), (f), and (g)(3).

3. Revising newly designated paragraphs (d) and (e).

The revisions and additions read as follows:

*§1.1363–2 Recapture of LIFO benefits.*

* * * * *

(b) *LIFO inventory held indirectly through partnership*. A C corporation must include the lookthrough LIFO recapture amount (as defined in paragraph (c)(2) of this section) in its gross income—

(1) In its last taxable year as a C corporation if, on the last day of the corporation's last taxable year before its S corporation election becomes effective, the corporation held a lookthrough partnership interest (as defined in paragraph (c)(1) of this section); or

(2) In the year of transfer by the C corporation to an S corporation of a lookthrough partnership interest if the corporation transferred its lookthrough partnership interest to the S corporation in a nonrecognition transaction (within the meaning of section 7701(a)(45)) in which the transferred interest constitutes transferred basis property (within the meaning of section 7701(a)(43)).

(c) *Definitions*—(1) *Lookthrough partnership interest*. A partnership interest is a lookthrough partnership interest if the partnership owns (directly or indirectly through one or more partnerships) assets accounted for under the last-in, first-out (LIFO) method (LIFO inventory).

(2) *Lookthrough LIFO recapture amount*. For purposes of this section, a corporation's lookthrough LIFO recapture amount is the amount of income that would be allocated to the corporation, taking into account section 704(c) and §1.704–3, if the partnership sold all of its LIFO inventory for the inventory's FIFO value. For this purpose, the FIFO value of inventory is the inventory amount of the inventory assets under the first-in, first-out method of accounting authorized by section 471. The lookthrough LIFO recapture amount generally shall be determined as of the end of the recapture date. However, if the partnership is not otherwise required to determine the inventory amount of the inventory using the LIFO method (the LIFO value) on the recapture date, the partnership may determine the lookthrough LIFO recapture amount as though the FIFO and LIFO values of the inventory on the recapture date equaled the FIFO and LIFO values of the opening inventory for the partnership's taxable year that includes the recapture date. For this purpose, the opening inventory includes inventory contributed by a partner to the partnership on or before the recapture date and excludes

inventory distributed by the partnership to a partner on or before the recapture date.

(3) *Recapture date*. In the case of a transaction described in paragraph (b)(1) of this section, the recapture date is the day before the effective date of the S corporation election. In the case of a transaction described in paragraph (b)(2) of this section, the recapture date is the date of the transfer of the partnership interest to the S corporation (but only the portion of that date that precedes the transfer).

(d) *Payment of tax*. Any increase in tax caused by including the LIFO recapture amount or the lookthrough LIFO recapture amount in the gross income of the C corporation is payable in four equal installments. The C corporation must pay the first installment of this payment by the due date of its return, determined without regard to extensions, for the last taxable year it operated as a C corporation if paragraph (a)(1) or (b)(1) of this section applies, or for the taxable year of the transfer if paragraph (a)(2) or (b)(2) of this section applies. The three succeeding installments must be paid—

(1) For a transaction described in paragraph (a)(1) or (b)(1) of this section, by the corporation that made the election under section 1362(a) to be an S corporation, on or before the due date for the corporation's returns (determined without regard to extensions) for the succeeding three taxable years; and

(2) For a transaction described in paragraph (a)(2) or (b)(2) of this section, by the transferee S corporation on or before the due date for the transferee corporation's returns (determined without regard to extensions) for the succeeding three taxable years.

(e) *Basis adjustments*—(1) *General rule*. Appropriate adjustments to the basis of inventory are to be made to reflect any amount included in income under paragraph (a) of this section.

(2) *LIFO inventory owned through a partnership*—(i) *Basis of corporation's partnership interest*. Appropriate adjustments to the basis of the corporation's lookthrough partnership interest are to be made to reflect any amount included in income under paragraph (b) of this section.

(ii) *Basis of partnership assets*. A partnership directly holding LIFO inventory that is taken into account under paragraph (b) may elect to adjust the basis of that LIFO inventory. In addition, a partnership that holds, through another partnership, LIFO inventory that is taken into account under paragraph (b) may elect to adjust the basis of that partnership interest. Any adjustment under this paragraph (e)(2) to the basis of inventory held by the partnership is equal to the amount of LIFO recapture attributable to the inventory. Likewise, any adjustment under this paragraph (e)(2) to the basis of a lookthrough partnership interest held by the partnership is equal to the amount of LIFO recapture attributable to the interest. A basis adjustment under this paragraph (e)(2) is treated in the same manner and has the same effect as an adjustment to the basis of partnership property under section 743(b). See §1.743–1(j).

(3) *Election*. A partnership elects to adjust the basis of its inventory and any lookthrough partnership interest that it owns by attaching a statement to its original or amended income tax return for the first taxable year ending on or after the date of the S corporation election or transfer described in paragraph (b) of this section. This statement shall state that the partnership is electing under §1.1363–2(e)(3) and must include the names, addresses, and taxpayer identification numbers of any corporate partner liable for tax under paragraph (d) of this section and of the partnership, as well as the amount of the adjustment and the portion of the adjustment that is attributable to each pool of inventory or lookthrough partnership interest that is held by the partnership.

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

*Example 1*. (i) G is a C corporation with a taxable year ending on June 30. GH is a partnership with a calendar year taxable year. G has a 20 percent interest in GH. The remaining 80 percent interest is owned by an individual. On April 25, 2005, G contributed inventory that is LIFO inventory to GH, increasing G's interest in the partnership to 50 percent. GH holds no other LIFO inventory. G elects to be an S corporation effective July 1, 2005. The recapture date is June 30, 2005, under paragraph (c)(3) of this section. GH determines that the FIFO and LIFO values of the opening inventory for GH's 2005 taxable year, including the inventory contributed by G, are $200 and $120, respectively.

(ii) Under paragraph (c)(1) of this section, GH is not required to determine the FIFO and LIFO values of the inventory on the recapture date. Instead, GH may determine the lookthrough LIFO recapture amount as though the FIFO and LIFO values of the inventory on the recapture date equaled the FIFO and LIFO values of the opening inventory for the partnership's taxable year (2005) that includes the recapture date. For this purpose, under paragraph (c)(2) of this section, the opening inventory includes the inventory contributed by G. The amount by which the FIFO value ($200) exceeds the LIFO value ($120) in GH's opening inventory is $80. Thus, if GH sold all of its LIFO inventory for $200, it would recognize $80 of income. G's lookthrough LIFO recapture amount is $80, the amount of income that would be allocated to G, taking into account section 704(c) and §1.704–3, if GH sold all of its LIFO inventory for the FIFO value. Under paragraph (b)(1) of this section, G must include $80 in income in its taxable year ending on June 30, 2005. Under paragraph (e)(2) of this section, G must increase its basis in its interest in GH by $80. Under paragraphs (e)(2) and (3) of this section, and in accordance with section 743(b) principles, GH may elect to increase the basis (with respect to G only) of its LIFO inventory by $80.

*Example 2*. (i) J is a C corporation with a calendar year taxable year. JK is a partnership with a calendar year taxable year. J has a 30 percent interest in the partnership. JK owns LIFO inventory that is not section 704(c) property. J elects to be an S corporation effective January 1, 2005. The recapture date is December 31, 2004, under paragraph (c)(3) of this section. JK determines that the FIFO and LIFO values of the inventory on December 31, 2004, are $240 and $140, respectively.

(ii) The amount by which the FIFO value ($240) exceeds the LIFO value ($140) on the recapture date is $100. Thus, if JK sold all of its LIFO inventory for $240, it would recognize $100 of income. J's lookthrough LIFO recapture amount is $30, the amount of income that would be allocated to J if JK sold all of its LIFO inventory for the FIFO value (30 percent of $100). Under paragraph (b)(1) of this section, J must include $30 in income in its taxable year ending on December 31, 2004. Under paragraph (e)(2) of this section, J must increase its basis in its interest in JK by $30. Under paragraphs (e)(2) and (3) of this section, and in accordance with section 743(b) principles, JK may elect to increase the basis (with respect to J only) of its inventory by $30.

(g) *Effective dates*. * * *

(3) The provisions of paragraphs (b), (c), (e)(2), (e)(3), and (f) of this section apply to S elections and transfers made on or after August 13, 2004.

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

(Filed by the Office of the Federal Register on August 12, 2004, 8:45 a.m., and published in the issue of the Federal Register for August 13, 2004, 69 F.R. 50109)

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

## Clarification of Definitions

## REG–124872–04

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This issue of the Bulletin contains temporary regulations (T.D. 9153) that provide clarification of the definitions of a corporation and a domestic entity in circumstances where the business entity is considered to be created or organized in more than one jurisdiction. These regulations will affect business entities that are created or organized under the laws of more than one jurisdiction. The text of those temporary regulations also serves as the text of these proposed regulations. This document also provides a notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments and must be received by November 10, 2004. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for November 3, 2004, must be received by October 15, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–124872–04), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may also be hand-delivered Monday through Friday (excluding Federal holidays) between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–124872–04), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via either the IRS internet site at *www.irs.gov/regs* or the Federal eRulemaking Portal at *www.regulations.gov* (IRS and REG–124872–04). The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Thomas Beem, (202) 622–3860; concerning submissions of comments or the public hearing, Sonya Cruse, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

### Background and Explanation of Provisions

Temporary regulations in this issue of the Bulletin amend 26 CFR part 301 relating to section 7701 of the Internal Revenue Code of 1986 (Code). The temporary regulations provide guidance as to the definitions of a corporation and of domestic and foreign entities in circumstances in which an entity is created or organized under the laws of more than one jurisdiction (a dually chartered entity). The text of those regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains both 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 these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7806(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact.

### Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 3, 2004, at 10:00 a.m. in the Auditorium of the Internal Revenue building, 1111 Constitution Avenue, NW, 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 area earlier than 30 minutes prior to the start of the hearing. 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 this hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time devoted to each topic (signed original and eight (8) copies) by October 15, 2004. A period of ten minutes will be allotted to each person for making comments. An agenda showing the scheduling of 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.

### Proposed Effective Date

The regulations proposed in this document would apply on August 12, 2004, to all business entities existing on or after that date.

### Drafting Information

The principal author of these proposed regulations is Thomas Beem of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

### Proposed Amendments to the Regulations

Accordingly, 26 CFR part 301 is proposed to be amended as follows:

PART 301 — PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read, in part, as follows:

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

Par. 2. In §301.7701–1, paragraph (d) is revised to read as follows:

*§301.7701–1 Classification of organizations for federal tax purposes.*

* * * * *

(d) [The text of the proposed amendment revising §301.7701–1(d) is the same as the text of §301.7701–1T(d) published elsewhere in this issue of the Bulletin.]

* * * * *

Par. 3. In §301.7701–2 paragraph (b)(9) is added to read as follows:

*§301.7701–2 Business entities; definitions.*

* * * * *

(b) * * *

(9) [The text of the proposed amendment adding §301.7701–2(b)(9) is the same as the text of §301.7701–2T(b)(9) published elsewhere in this issue of the Bulletin.]

* * * * *

Par. 4. Section 301.7701–5 is revised to read as follows:

*§301.7701–5 Domestic and foreign business entities.*

[The text of the proposed amendment revising §301.7701–5 is the same as the text of §301.7701–5T published elsewhere in this issue of the Bulletin.]

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

(Filed by the Office of the Federal Register on August 11, 2004, 8:45 a.m., and published in the issue of the Federal Register for August 12, 2004, 69 F.R. 49840)

---

# Notice of Proposed Rulemaking

## Treatment of Disregarded Entities Under Section 752

## REG–128767–04

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: The proposed regulations provide rules under section 752 for taking into account certain obligations of a business entity that is disregarded as separate from its owner under sections 856(i), 1361(b)(3), or §§301.7701–1 through 301.7701–3 (disregarded entity) for purposes of characterizing and allocating partnership liabilities. The rules affect partnerships with partnership debt and partners in those partnerships. These proposed regulations clarify the existing regulations concerning when a partner may be treated as bearing the economic risk of loss for a partnership liability based upon an obligation of a disregarded entity.

DATES: Written or electronic comments and requests for a public hearing must be received by November 11, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–128767–04), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may also be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG–128767–04), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the IRS Internet site at: *www.irs.gov/regs*, or via the Federal eRulemaking Portal at: *www.regulations.gov* (IRS-REG–128767–04).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Michael J. Goldman, (202) 622–3070; concerning submissions of the comments and the public hearing, Robin Jones, (202) 622–3521 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

**Paperwork Reduction Act**

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by October 12, 2004. Comments are specifically requested concerning:

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

The accuracy of the estimated burden associated with the proposed collection of information (see below);

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

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

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

The collection of information in this proposed regulation is in §1.752–2(k). This information is required to ensure proper allocations of partnership liabilities. This information will be used to determine the extent to which certain partners or related persons bear the economic risk of loss with respect to partnership liabilities. The collection of information is mandatory. The likely reporters are individuals and small businesses or organizations.

Estimated total annual reporting burden: 500 hours.

The estimated annual burden per respondent varies from 6 minutes to 2 hours, depending on individual circumstances, with an estimated average of 1 hour.

Estimated number of respondents: 500.

Estimated frequency of responses: On occasion.

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

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

**Background**

Under section 752, a partner's basis in its partnership interest includes the partner's share of partnership liabilities. The Income Tax Regulations under section 752 provide rules relating to the determination of a partner's share of partnership liabilities. Those rules differ depending upon whether the liability is characterized as recourse or nonrecourse for purposes of section 752. Section 1.752–1(a) provides that a partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss for that liability under §1.752–2. Section 1.752–1(a) also provides that a partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability under §1.752–2.

In general, a partner bears the economic risk of loss for a partnership liability under §1.752–2 to the extent that the partner or a related person (as defined in §1.752–4(b)) has an obligation to make a payment to any person, including a contribution to the partnership, that is recognized under §1.752–2(b)(3) on account of the partnership liability if the partnership were to constructively liquidate as described in §1.752–2(b) (payment obligation). As provided in §1.752–2(b)(3) and (5), all statutory and contractual obligations relating to the partnership liability and reimbursement rights are taken into account in determining whether a partner or related person has a payment obligation under §1.752–2(b). Moreover, for purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss for a partnership liability, §1.752–2(b)(6) provides that it is presumed that all partners and related persons who have obligations to make payments actually perform those obligations, irrespective of their actual net worth (presumption of deemed satisfaction), unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.

These proposed regulations clarify the existing regulations concerning when a partner may be treated as bearing the economic risk of loss for a partnership liability based upon a payment obligation of a business entity that is disregarded as separate from its owner under sections 856(i), 1361(b)(3), or §§301.7701–1 through 301.7701–3 of this chapter (disregarded entity). Because a disregarded entity and its owner are treated as a single entity, the presumption of deemed satisfaction of obligations undertaken by the owner arguably should include payment obligations undertaken by the disregarded entity. However, because of statutory limitations on liability, the owner of a disregarded entity may have no obligation to satisfy payment obligations undertaken by the disregarded entity. The current regulations consider such limitations on the payment obligations of a partner or related person to be relevant in determining the extent to which the partner or related person is treated as bearing the economic risk of loss for a partnership liability. The IRS and Treasury Department believe that because only the assets of a disregarded entity may be available to satisfy payment obligations undertaken by the disregarded entity, a partner should be treated as bearing the economic risk of loss for a partnership liability as a result of those payment obligations only to the extent of the net value of the disregarded entity's assets.

**Explanation of Provisions**

The proposed regulations provide that in determining the extent to which a partner bears the economic risk of loss for a partnership liability, payment obligations of a disregarded entity are taken into account for purposes of section 752 only to the extent of the net value of the disregarded entity as of the date on which the partnership determines the partner's share of partnership liabilities pursuant to §§1.752–4(d) and 1.705–1(a). However, the proposed regulations do not apply to an obligation of a disregarded entity to the extent that the owner of the disregarded entity otherwise is required to make a payment (that satisfies the requirements of §1.752–2(b)(1)) with respect to such obligation of the disregarded entity.

Under the proposed regulations, the net value of a disregarded entity equals the fair market value of all assets owned by the disregarded entity that may be subject to creditors' claims under local law, including the disregarded entity's enforceable rights to contributions from its owner but excluding the disregarded entity's interest in the partnership (if any) and the fair market value of property pledged to secure a partnership liability (which is already taken into account under §1.752–2(h)(1)), less obligations of the disregarded entity that do not constitute, and are senior or of equal priority to, payment obligations of the disregarded entity. After the net value of a disregarded entity is initially determined under the rules of the proposed regulations, the net value of the disregarded entity is not redetermined unless the obligations of the disregarded entity that do not constitute, and are senior or of equal priority to, payment obligations of the disregarded entity change by more than a *de minimis* amount or there is more than a *de minimis* contribution to or distribution from the disregarded entity. The IRS and Treasury Department request comments on whether other events (such as a sale of substantially all of a disregarded entity's assets) should be specified as revaluation events and whether a partner should be able to make an election to revalue a disregarded entity annually regardless of the occurrence of a revaluation event. An election to revalue annually would be revocable only with the Commissioner's consent.

The proposed regulations also provide that the net value of a disregarded entity is determined by taking into account a subsequent reduction in the net value of the entity if the subsequent reduction is anticipated and is part of a plan that has as one of its principal purposes creating the appearance that a partner bears the economic risk of loss for a partnership liability. In addition, under the proposed regulations, if one or more disregarded entities have payment obligations with respect to one or more partnership liabilities, or liabilities of more than one partnership, the partnership must allocate the net value of each disregarded entity among partnership liabilities in a reasonable and consistent manner, taking into account priorities among partnership liabilities.

To facilitate the partnership's determination of the net value of a disregarded entity, the proposed regulations provide that a partner that may be treated as bearing the economic risk of loss for a partnership liability based upon a payment obligation of a disregarded entity must provide information as to the entity's tax classification and net value to the partnership on a timely basis.

The IRS and Treasury Department are considering and request comments regarding whether the rules of the proposed regulations should be extended to the payment obligations of other entities, such as entities that are capitalized with nominal equity.

The proposed regulations also include conforming changes to §1.704–2(f)(2), (g)(3) and (i)(4). Section 1.704–2 includes rules that apply when the character of partnership debt under section 752 changes as a result of a guarantee, lapse of a guarantee, conversion, refinancing or other change in the debt instrument. Under the proposed regulations, those rules would apply upon any change in the character of partnership debt under section 752, whether as a result of the circumstances specified in the current regulations or as a result of changes under the rules of the proposed regulations.

Finally, the proposed regulations clarify that the pledge rules of the regulations under §1.752–2(h) refer to the net fair market value of property pledged to secure a partnership liability. The IRS and Treasury Department are considering and request comments regarding whether partners should be able to make an election, revocable only with the Commissioner's consent, to revalue pledged assets annually.

### Proposed Effective Date

The regulations are proposed to apply to liabilities incurred or assumed by a partnership on or after the date the regulations are published as final regulations in the **Federal Register**, other than liabilities incurred or assumed by a partnership pursuant to a written binding contract in effect prior to that date.

### Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the amount of time necessary to report the required information will be minimal. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and 8 copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules, how they can be made easier to understand and the administrability of the rules in the proposed regulations. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by any person who timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place of the public hearing will be published in the **Federal Register**.

### Drafting Information

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

* * * * *

### Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.704–2 is amended as follows:

1. Paragraph (f)(2) is revised.

2. The first sentence of paragraph (g)(3) is revised.

3. The third sentence of paragraph (i)(4) is revised.

4. Paragraph (l)(1)(iv) is added.

The revisions and addition read as follows:

*§1.704–2 Allocations attributable to nonrecourse liabilities.*

* * * * *

(f) * * *

(2) *Exception for certain conversions and refinancings*. A partner is not subject to the minimum gain chargeback requirement to the extent the partner's share of the net decrease in partnership minimum gain is caused by a recharacterization of nonrecourse partnership debt as partially or wholly recourse debt or partner nonrecourse debt, and the partner bears the economic risk of loss (within the meaning of §1.752–2) for the liability.

* * * * *

(g) * * *

(3) *Conversions of recourse or partner nonrecourse debt into nonrecourse debt*. A partner's share of minimum gain is increased to the extent provided in this paragraph (g)(3) if a recourse or partner nonrecourse liability becomes partially or wholly nonrecourse. * * *

* * * * *

(i) * * *

(4) * * * A partner is not subject to this minimum gain chargeback, however, to the extent the net decrease in partner

nonrecourse debt minimum gain arises because a partner nonrecourse liability becomes partially or wholly a nonrecourse liability. * * *

* * * * *

(l) * * * (1) * * *

(iv) Paragraph (f)(2), the first sentence of paragraph (g)(3), and the third sentence of paragraph (i)(4) of this section apply to liabilities incurred or assumed by a partnership on or after the date the regulations are published as final regulations in the **Federal Register**, other than liabilities incurred or assumed by a partnership pursuant to a written binding contract in effect prior to that date. Otherwise, the rules applicable to liabilities incurred or assumed (or subject to a binding contract in effect) prior to the date the regulations are published as final regulations in the **Federal Register** are contained in §1.704–2 in effect prior to the date the regulations are published as final regulations in the **Federal Register**, (see 26 CFR part 1 revised as of April 1, 2004).

* * * * *

Par. 3. Section 1.752–2 is amended as follows:

1. Paragraph (a) is revised.

2. The last sentence of paragraph (b)(6) is revised.

3. Paragraph (h)(3) is revised.

4. Paragraphs (k) and (l) are added.

The revisions and additions read as follows:

*§1.752–2 Partner's share of recourse liabilities.*

(a) *In general*. A partner's share of a recourse partnership liability equals the portion of that liability, if any, for which the partner or related person bears the economic risk of loss. The determination of the extent to which a partner bears the economic risk of loss for a partnership liability is made under the rules in paragraphs (b) through (k) of this section.

(b) * * *

(6) * * * See paragraphs (j) and (k) of this section.

* * * * *

(h) * * *

(3) *Valuation*. The extent to which a partner bears the economic risk of loss for a partnership liability as a result of a direct pledge described in paragraph (h)(1) of this section or an indirect pledge described in paragraph (h)(2) of this section is limited to the net fair market value of the property at the time of the pledge or contribution. For purposes of this paragraph, if property is subject to one or more other obligations that are senior or of equal priority to the partnership liability, those obligations must be taken into account in determining the net fair market value of pledged property.

* * * * *

(k) *Effect of a disregarded entity*—(1) *In general*. In determining the extent to which a partner bears the economic risk of loss for a partnership liability, obligations of a business entity that is disregarded as an entity separate from its owner under sections 856(i) or 1361(b)(3) or §§301.7701–1 through 301.7701–3 of this chapter (disregarded entity), that may be taken into account under paragraph (b)(1) of this section, are taken into account only to the extent of the net value of the disregarded entity (as determined under paragraph (k)(2) of this section) as of the date on which the partnership determines the partner's share of partnership liabilities pursuant to §§1.752–4(d) and 1.705–1(a) that is allocated to the liability under paragraph (k)(4) of this section. The rules of this paragraph (k) do not apply to an obligation of a disregarded entity to the extent that the owner of the disregarded entity otherwise is required to make a payment (that satisfies the requirements of paragraph (b)(1) of this section) with respect to such obligation of the disregarded entity.

(2) *Net value of a disregarded entity*. For purposes of paragraph (k)(1) of this section, the net value of a disregarded entity equals the fair market value of all assets owned by the entity that may be subject to creditors' claims under local law, including the entity's enforceable rights to contributions from its owner but excluding the entity's interest in the partnership (if any) and the fair market value of property pledged to secure a partnership liability under paragraph (h)(1) of this section, less obligations of the disregarded entity that do not constitute, and are senior or of equal priority to, obligations of the disregarded entity that may be taken into account under paragraph (b)(1) of this section. After the net value of a disregarded entity is initially determined for purposes of paragraph (k)(1) of this section, the net value of the disregarded entity is not redetermined unless the obligations of the disregarded entity that are described in the preceding sentence change by more than a *de minimis* amount or there is more than a *de minimis* contribution to or distribution from the disregarded entity of property other than property pledged to secure a partnership liability under paragraph (h)(1) of this section.

(3) *Reduction in net value of a disregarded entity*. For purposes of paragraph (k)(2) of this section, the net value of a disregarded entity is determined by taking into account a subsequent reduction in the net value of the disregarded entity if at the time the net value of the disregarded entity is determined it is anticipated that the net value of the disregarded entity will subsequently be reduced and the reduction is part of a plan that has as one of its principal purposes creating the appearance that a partner bears the economic risk of loss for a partnership liability.

(4) *Allocation of net value*. If one or more disregarded entities have obligations that may be taken into account under paragraph (b)(1) of this section with respect to one or more partnership liabilities, or liabilities of more than one partnership, the partnership must allocate the net value of each disregarded entity among partnership liabilities in a reasonable and consistent manner, taking into account priorities among partnership liabilities.

(5) *Information to be provided by the owner of a disregarded entity*. A partner that may be treated as bearing the economic risk of loss for a partnership liability based upon an obligation of a disregarded entity that may be taken in account under paragraph (b)(1) of this section must provide information as to the entity's tax classification and net value to the partnership on a timely basis.

(6) The following examples illustrate the rules of this paragraph (k):

*Example 1. Disregarded entity with net value of zero*. (i) In 2005, *A* forms a wholly owned domestic limited liability company, *LLC*, with a contribution of $100,000. *A* has no liability for *LLC's* debts, and *LLC* has no enforceable right to contribution from *A*. *A* files no election with respect to *LLC* under §301.7701–3 of this chapter. Also in 2005, *LLC* contributes $100,000 to *LP*, a limited partnership with a calendar year taxable year, in exchange for a general partnership interest in *LP*, and *B* and

*C* each contributes $100,000 to *LP* in exchange for a limited partnership interest in *LP*. The partnership agreement provides that only *LLC* is required to make up any deficit in its capital account. On January 1, 2006, *LP* borrows $300,000 from a bank and uses $600,000 to purchase nondepreciable property. The $300,000 debt is secured by the property and is also a general obligation of *LP*. *LP* makes payments of only interest on its $300,000 debt during 2006. Under §§1.752–4(d) and 1.705–1(a), *LP* determines its partners' shares of the $300,000 debt at the end of its taxable year, December 31, 2006. As of that date, *LLC* holds no assets other than its interest in *LP*.

(ii) Under §301.7701–3(b)(1)(ii) of this chapter, *LLC* is a disregarded entity. Because *LLC* is a disregarded entity, *A* is treated as the partner in *LP* for federal tax purposes. Only *LLC* has an obligation to make a payment on account of the $300,000 debt if *LP* were to constructively liquidate as described in paragraph (b)(1) of this section. Therefore, under paragraph (k) of this section, *A* is treated as bearing the economic risk of loss for *LP's* $300,000 debt only to the extent of *LLC's* net value. Because that net value is $0 on December 31, 2006, when *LP* determines its partners' shares of its $300,000 debt, *A* is not treated as bearing the economic risk of loss for any portion of *LP's* $300,000 debt. As a result, *LP's* $300,000 debt is characterized as nonrecourse under §1.752–1(a) and is allocated as required by §1.752–3.

*Example 2*. *Disregarded entity with positive net value*. (i) The facts are the same as in *Example 1* except that on January 1, 2007, *A* contributes $250,000 to *LLC* and *LLC* shortly thereafter uses the $250,000 to purchase unimproved land. *LP* makes payments of only interest on its $300,000 debt during 2007. Under §§1.752–4(d) and 1.705–1(a), *LP* again determines its partners' shares of the $300,000 debt at the end of its taxable year, December 31, 2007. As of that date, *LLC* holds its interest in *LP* and the land, the value of which has declined to $175,000.

(ii) *A's* contribution of $250,000 to *LLC* on January 1, 2007, constitutes a more than *de minimis* contribution of property to *LLC*. Accordingly, under paragraph (k)(2) of this section, *LLC's* value is redetermined on December 31, 2007, when *LP* determines its partners' shares of its $300,000 debt. As of that date, *LLC's* net value is $175,000. Therefore, under paragraph (k) of this section, *A* is treated as bearing the economic risk of loss for $175,000 of *LP's* $300,000 debt. As a result, $175,000 of *LP's* $300,000 debt is recharacterized as recourse under §1.752–1(a) and is allocated to *A* under this section, and the remaining $125,000 of *LP's* $300,000 debt remains characterized as nonrecourse under §1.752–1(a) and is allocated as required by §1.752–3.

*Example 3*. *Allocation of net value among partnership liabilities*. (i) The facts are the same as in *Example 2* except that on January 1, 2008, *A* forms another wholly owned domestic limited liability company, *LLC2*, with a contribution of $120,000. Shortly thereafter, *LLC2* uses the $120,000 to purchase stock in *X* corporation. *A* has no liability for *LLC2's* debts, and *LLC2* has no enforceable right to contribution from *A*. *A* files no election with respect to *LLC2* under §301.7701–3 of this chapter. On July 1, 2008, *LP* borrows $100,000 from a bank and uses the $100,000 to purchase nondepreciable property. The $100,000 debt is secured by the property and is also a general obligation of *LP*. The $100,000 debt is senior in priority to *LP's* existing $300,000 debt. Also on July 1, 2008, *LLC2* agrees to guarantee both *LP's* $100,000 and $300,000 debts. *LP* makes payments of only interest on both its $100,000 and $300,000 debts during 2008. Under §§1.752–4(d) and 1.705–1(a), *LP* determines its partners' shares of its $100,000 and $300,000 debts at the end of its taxable year, December 31, 2008. As of that date, *LLC* holds its interest in *LP* and the land, and *LLC2* holds the *X* corporation stock which has appreciated in value to $140,000.

(ii) Under §301.7701–3(b)(1)(ii) of this chapter, *LLC2* is a disregarded entity. Both *LLC* and *LLC2* have obligations to make a payment on account of *LP's* debts if *LP* were to constructively liquidate as described in paragraph (b)(1) of this section. Therefore, under paragraph (k) of this section, *A* is treated as bearing the economic risk of loss for *LP's* $100,000 and $300,000 debts only to the extent of the net values of *LLC* and *LLC2*, as allocated among those debts in a reasonable manner pursuant to paragraph (k)(4) of this section.

(iii) No events have occurred that would allow a revaluation under paragraph (k)(2) of this section. Therefore, *LLC's* net value remains $175,000. *LLC2's* net value on December 31, 2008, when *LP* determines its partners' shares of its liabilities, is $140,000. Under paragraph (k)(4) of this section, *LP* must allocate the net values of *LLC* and *LLC2* between its $100,000 and $300,000 debts in a reasonable and consistent manner. Because the $100,000 debt is senior in priority to the $300,000 debt, *LP* first allocates the net values of *LLC* and *LLC2*, *pro rata*, to its $100,000 debt. Thus, *LP* allocates $56,000 of *LLC's* net value and $44,000 of *LLC2's* net value to its $100,000 debt, and *A* is treated as bearing the economic risk of loss for all of *LP's* $100,000 debt. As a result, all of *LP's* $100,000 debt is characterized as recourse under §1.752–1(a) and is allocated to *A* under this section. *LP* then allocates the remaining $119,000 of *LLC's* net value and *LLC2's* $96,000 net value to its $300,000 debt, and *A* is treated as bearing the economic risk of loss for a total of $215,000 of the $300,000 debt. As a result, $215,000 of *LP's* $300,000 debt is characterized as recourse under §1.752–1(a) and is allocated to *A* under this section, and the remaining $85,000 of *LP's* $300,000 debt is characterized as nonrecourse under §1.752–1(a) and is allocated as required by §1.752–3. This example illustrates one reasonable method for allocating net values of disregarded entities among multiple partnership liabilities.

(l) *Effective dates*. Paragraphs (a), (b)(6), (h)(3), and (k) of this section apply to liabilities incurred or assumed by a partnership on or after the date the regulations are published as final regulations in the **Federal Register**, other than liabilities incurred or assumed by a partnership pursuant to a written binding contract in effect prior to that date. Otherwise, the rules applicable to liabilities incurred or assumed (or subject to a binding contract in effect) prior to the date the regulations are published as final regulations in the **Federal Register** are contained in §§1.752–2 and 1.752–3 in effect prior to the date the regulations are published as final regulations in the **Federal Register**, (see 26 CFR part 1 revised as of April 1, 2004).

Nancy Jardini,
*Acting Deputy Commissioner for Services and Enforcement.*

(Filed by the Office of the Federal Register on August 11, 2004, 8:45 a.m., and published in the issue of the Federal Register for August 12, 2004, 69 F.R. 49832)

---

## Notice of Proposed Rulemaking

## Corporate Reorganizations; Transfers of Assets or Stock Following a Reorganization

## REG–130863–04

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide guidance regarding the effect of certain transfers of assets or stock on the qualification of certain transactions as reorganizations under section 368(a). This document also contains proposed regulations that provide guidance on the continuity of business enterprise requirement and the definition of a party to a reorganization. These regulations affect corporations and their shareholders.

DATES: Written or electronic comments must be received by November 15, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–130863–04), 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–130863–04), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the IRS Internet site at *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS — REG–130863–04).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Jeffrey B. Fienberg, (202) 622–7770; concerning submissions and the hearing, LaNita Van Dyke, (202) 622–3215 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

**Background and Explanation of Provisions**

On March 2, 2004, the IRS and Treasury Department published in the **Federal Register** (69 FR 9771) a notice of proposed rulemaking (REG–165579–02, 2004–13 I.R.B. 651) that would amend §1.368–2(k) to provide that a reorganization otherwise qualifying under section 368(a) will not be disqualified as a result of the transfer or successive transfers to one or more corporations controlled in each transfer by the transferor corporation of part or all of (i) the assets of any party to the reorganization or (ii) the stock of any party to the reorganization other than the issuing corporation (hereinafter the March 2004 proposed regulations). The March 2004 proposed regulations also include amendments to the continuity of business enterprise (COBE) regulations under §1.368–1(d) and the definition of a party to a reorganization under §1.368–2(f).

While the March 2004 proposed regulations address transfers of assets and stock to corporations controlled by the transferor corporation, they do not address whether a transaction that otherwise qualifies as a reorganization continues to qualify when, pursuant to the plan of reorganization, assets or stock of the acquired corporation is distributed to a corporation or partnership following the reorganization. In addition, they do not provide guidance on whether a transaction that otherwise qualifies as a reorganization continues to qualify when, pursuant to the plan of reorganization, acquired assets are transferred to a partnership in which the transferor owns an interest. These proposed regulations expand the March 2004 regulations to address these situations.

The IRS and Treasury Department received comments regarding the March 2004 proposed regulations. Comments not addressed in this document are still being considered.

A. *Distributions*

These proposed regulations provide that a transaction otherwise qualifying as a reorganization under section 368(a) will not be disqualified as a result of a subsequent distribution of the acquired assets or stock if (i) no transferee receives substantially all of the acquired assets, substantially all of the assets of the acquired or surviving corporation in a transaction otherwise qualifying as a reorganization under section 368(a)(1)(B) or section 368(a)(1)(A) by reason of section 368(a)(2)(E), or stock constituting control of the acquired corporation, (ii) the transferee is either a member of the qualified group (as defined in §1.368–1(d)(4)(ii)) or a partnership the business of which is treated as conducted by a member of the qualified group under §1.368–1(d)(4)(iii), and (iii) the COBE requirement is satisfied. For this purpose, the term substantially all as used in this regulation has the same meaning as in section 368(a)(1)(C). The IRS and Treasury Department believe that the types of asset and stock distributions described in these proposed regulations are consistent with the policies underlying the reorganization provisions, which are intended to apply to transactions that effect readjustments of continuing interests in the reorganized business in modified corporate form. See §1.368–1(b); see also H.R. Rep. No. 83–1337, at A134 (1954) (stating that a corporation may not acquire assets with the intention of transferring them to a stranger).

In the course of developing these proposed regulations, the IRS and Treasury Department considered adopting a rule that would permit a distribution of the acquiring, acquired, or surviving corporation's assets as long as the distribution did not cause that corporation to be treated as liquidating for Federal income tax purposes. However, the IRS and Treasury Department are concerned that such a rule might produce inappropriate results. For example, if a pre-existing acquiring subsidiary in a transaction otherwise qualifying under section 368(a) by reason of section 368(a)(2)(D) distributes all of the acquired assets to the issuing corporation and retains all of the previously held assets, the distribution may not constitute either an actual or *de facto* liquidation, even though none of the acquired assets remain in the acquiring corporation. It could be argued that this transaction should be treated as a direct acquisition of the acquired assets by the issuing corporation. See, *e.g.*, Rev. Rul. 72–405, 1972–2 C.B. 217.

The IRS and Treasury Department request comments regarding whether a transaction should continue to qualify as a reorganization under section 368(a) if the distribution, including a distribution to which section 355 applies, is to a person that is not a member of the qualified group (as defined in §1.368–1(d)(4)(ii)) or a partnership the business of which is not treated as conducted by a member of the qualified group under §1.368–1(d)(4)(iii).

B. *Contributions to Partnerships*

Currently, the operative rules of §1.368–2(k) are silent on the effect of a post-transaction transfer of assets or stock to a partnership on a transaction otherwise qualifying as a reorganization. However, *Example 3* of that regulation involves a transfer of acquired stock to a partnership. In the example, P owns 80 percent of the stock of S–1, S–1 owns 80 percent of the stock of S–2, and S–2 owns 80 percent of the stock of S–3. Pursuant to a plan of reorganization, S–1 acquires the stock of T solely in exchange for P voting stock, S–1 transfers the T stock to S–2, and S–2 transfers the T stock to S–3. Also as part of the plan, S–2 and S–3 form PRS, a partnership, and S–3 transfers the T stock to PRS in exchange for an 80 percent partnership interest. The example states that because this transfer to PRS is not described in §1.368–2(k), the characterization of the transaction must be determined under the relevant provisions of law, including the step transaction doctrine. The transaction therefore fails to qualify as a reorganization under section 368(a)(1)(B) because the acquiring corporation does not have control of T immediately after the acquisition.

The IRS and Treasury Department are studying whether, in the transaction described in *Example 3* of the current §1.368–2(k), S–1 should be treated as having control of T immediately after the acquisition. Consequently, *Example 3* is not included in these proposed regulations. However, the IRS and Treasury Department recognize that certain transfers to partnerships would cause a transaction to fail the COBE requirement. For example, under the facts of *Example 3* of the current §1.368–2(k), because T is not a member of the qualified group after the stock transfer to PRS, the transaction would not satisfy the COBE requirement. Comments are requested on whether and how the COBE regulations should be amended to permit stock transfers to partnerships.

C. *Effective Date*

These regulations are proposed to apply to transactions that occur after the date that these regulations are published as final regulations in the **Federal Register**.

## Special Analyses

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

## Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

## Drafting Information

The principal author of these proposed regulations is Jeffrey B. Fienberg of the Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and 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 * * *

Par. 2. Section 1.368–1 is amended as follows:

1. The text of paragraph (d)(4)(i) is redesignated as paragraph (d)(4)(i)(A) and a paragraph heading is added for (d)(4)(i)(A).

2. Paragraph (d)(4)(i)(B) is added.

3. The text of paragraph (d)(5) is redesignated as paragraph (d)(5)(i), and revised.

4. In newly designated paragraph (d)(5)(i), *Examples 7* through *12* are redesignated as *Examples 8* through *13*, respectively.

5. In newly designated paragraph (d)(5)(i), a new *Example 7* is added.

6. In newly designated paragraph (d)(5)(i), paragraph (i) in resdesignated *Example 9*, paragraph (i) in redesignated *Example 10*, and the first sentence in paragraph (i) in redesignated *Example 12* are revised.

7. Paragraph (d)(5)(ii) is added.

The revisions and additions read as follows:

*§1.368–1 Purpose and scope of exception of reorganization exchanges.*

* * * * *

(d) * * *

(4) * * *

(i) *Business and assets of members of a qualified group*—(A) *In general*. * * *

(B) *Special rule*. The issuing corporation is treated as holding all of the businesses and assets of the surviving corporation after a reorganization that otherwise satisfies the requirements of a reverse triangular merger (as defined in §1.358–6(b)(2)(iii)), the acquired corporation after a reorganization that otherwise satisfies the requirements of section 368(a)(1)(B), and the acquiring corporation after a reorganization that otherwise satisfies the requirements of a forward triangular merger (as defined in §1.358–6(b)(2)(i)), a triangular B reorganization (as defined in §1.358–6(b)(2)(iv)), a triangular C reorganization (as defined in §1.358–6(b)(2)(ii)), or a reorganization under section 368(a)(1)(G) by reason of section (a)(2)(D), provided that members of the qualified group own, in the aggregate, stock of the surviving, acquired, or acquiring corporation meeting the requirements of section 368(c). This paragraph (d)(4)(i)(B) applies to transactions occurring after the date these regulations are published as final in the **Federal Register**.

* * * * *

(5) *Examples*. (i) The following examples illustrate this paragraph (d). All the corporations have only one class of stock outstanding:

* * * * *

*Example 7*. (i) *Facts*. The facts are the same as *Example 6*, except that, instead of P acquiring the assets of T, HC acquires all of the outstanding stock of T in exchange solely for voting stock of P. In addition, as part of the plan of reorganization, HC transfers 10 percent of the stock of T to each of subsidiaries S–1 through S–10. T will continue to operate an auto parts distributorship. Without regard to whether the transaction satisfies the COBE requirement, the transaction qualifies as a triangular B reorganization.

(ii) *Continuity of business enterprise*. Under paragraph (d)(4)(i)(B) of this section, P is treated as holding the assets and conducting the business of T because S–1 through S–10, members of the qualified group, together own stock of T meeting the requirements of section 368(c). The COBE requirement of paragraph (d)(1) of this section is satisfied because P is treated as continuing T's business.

* * * * *

*Example 9*. * * * (i) *Facts*. The facts are the same as *Example 8*, except that S–3 transfers the historic T business to PRS in exchange for a 1 percent interest in PRS.

(ii) * * *

*Example 10*. * * * (i) *Facts*. The facts are the same as *Example 8*, except that S–3 transfers the historic T business to PRS in exchange for a 33$^{1}/_{3}$ percent interest in PRS, and no member of P's qualified group performs active and substantial management functions for the ski boot business operated in PRS.

* * * * *

*Example 12*. * * * (i) *Facts*. The facts are the same as *Example 11*, except that S–1 transfers all the T assets to PRS, and P and X each transfers cash to PRS in exchange for partnership interests. * * *

* * * * *

(ii) *Effective dates*. Paragraph (d)(5) *Example 6* and *Example 8* through *Example 13* apply to transactions occurring after January 28, 1998, except that they do not apply to any transaction occurring pursuant to a written agreement that is binding on January 28, 1998, and at all times thereafter. Paragraph (d)(5) *Example 7* applies to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

Par. 3. Section 1.368–2 is amended by:

1. Adding three sentences at the end of paragraph (f).

2. Revising paragraphs (j)(3)(ii) and (iv).

3. Removing the first sentence of paragraph (j)(3)(iii) and adding two new sentences.

4. Revising paragraph (k).

The additions and the revision read as follows:

*§1.368–2 Definition of terms.*

* * * * *

(f) * * * If a transaction otherwise qualifies as a reorganization under section 368(a)(1)(B) or as a reverse triangular merger (as defined in §1.358–6(b)(2)(iii)), the target corporation (in the case of a transaction that otherwise qualifies as a reorganization under section 368(a)(1)(B)) or the surviving corporation (in the case of a transaction that otherwise qualifies as a reverse triangular merger) remains a party to the reorganization even though its stock or assets are transferred in a transaction described in paragraph (k) of this section. If a transaction otherwise qualifies as a forward triangular merger (as defined in §1.358–6(b)(2)(i)), a triangular B reorganization (as defined in §1.358–6(b)(2)(iv)), a triangular C reorganization (as defined in §1.358–6(b)(2)(ii)), or a reorganization under section 368(a)(1)(G) by reason of section 368(a)(2)(D), the acquiring corporation remains a party to the reorganization even though its stock is transferred in a transaction described in paragraph (k) of this section. The two preceding sentences apply to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

(j) * * *

(3) * * *

(ii) Except as provided in paragraph (k) of this section, the controlling corporation must control the surviving corporation immediately after the transaction.

(iii) After the transaction, the surviving corporation must hold substantially all of its own properties and substantially all of the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction). The issuing corporation may transfer such properties as provided in paragraph (k) of this section. * * *

* * * * *

(iv) Paragraph (j)(3)(ii) and the first two sentences of paragraph (j)(3)(iii) of this section apply to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**. The remainder of paragraph (j)(3)(iii) of this section applies to transactions occurring after January 28, 1998, except that it does not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter.

* * * * *

(k) *Certain transfers of assets or stock in reorganizations*—(1) *General rule*. A transaction otherwise qualifying as a reorganization under section 368(a) shall not be disqualified as a result of a subsequent transfer (or successive transfers) of assets or stock if—

(i) The transfer is of part or all of—

(A) The assets of any party to the reorganization; or

(B) The stock of any party to the reorganization other than the issuing corporation (as defined in §1.368–1(b)); and

(ii) Either—

(A) In such subsequent transfer or transfers, a person is not the transferee of—

(*1*) substantially all (within the meaning of section 368(a)(1)(C)) of the acquired assets;

(*2*) substantially all (within the meaning of section 368(a)(1)(C)) of the assets of the acquired corporation immediately after a transaction otherwise qualifying as a reorganization under section 368(a)(1)(B);

(*3*) substantially all (within the meaning of section 368(a)(1)(C)) of the assets of the surviving corporation immediately after a transaction otherwise qualifying as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E); or

(*4*) control of the stock of the acquired corporation; or

(B) The transfer is to one or more corporations controlled in each transfer by the transferor corporation or to a partnership in which the transferor has an ownership interest immediately after the transfer; and

(iii) The transferee is either a member of the qualified group (as defined in §1.368–1(d)(4)(ii)) or a partnership the business of which is treated as conducted by a member of the qualified group under §1.368–1(d)(4)(iii); and

(iv) The requirements of §1.368–1(d) are satisfied.

(2) Control is defined under section 368(c).

(3) *Examples*. The following examples illustrate the application of this paragraph (k). Except as otherwise noted, P is the issuing corporation, and T is the target corporation. T operates a bakery that supplies delectable pastries and cookies to local retail stores. The acquiring corporate group produces a variety of baked goods for nationwide distribution. P owns 80 percent of the stock of S–1 and 80 percent of the stock of S–4. S–1 owns 80 percent of the stock of S–2. S–2 owns 80 percent of the stock of S–3, which also makes and supplies pastries and cookies. S–4 owns 80 percent of the stock of S–5. The examples are as follows:

*Example 1. Contributions of acquired assets to controlled corporations after a reorganization under section 368(a)(1)(C).* (i) *Facts*. Pursuant to a plan of reorganization, T transfers all of its assets to S–1 solely in exchange for P stock, which T distributes to its shareholders. In addition, pursuant to the plan of reorganization, S–1 transfers all of the T assets to S–2, and S–2 transfers all of the T assets to S–3.

(ii) *Analysis*. Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(C), is not disqualified by the successive transfers of all of the T assets to S–2 and from S–2 to S–3 because, in each transfer, the transferee corporation is controlled by the transferor corporation, S–2 and S–3 are members of the qualified group, and the transaction satisfies the requirements of §1.368–1(d).

*Example 2. Distribution of acquired assets to the issuing corporation after a reorganization under section 368(a)(1)(C).* (i) *Facts*. Pursuant to a plan of reorganization, T transfers all of its assets to S–1 solely in exchange for P stock, which T distributes to its shareholders. In addition, pursuant to the plan of reorganization, S–1 transfers less than substantially all of the T assets to P. T does not have any liabilities.

(ii) *Analysis*. Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(C), is not disqualified by the transfer of T assets from S–1 to P because P is transferred less than substantially all of the T assets, P is a member of the qualified group, and the transaction satisfies the requirements of §1.368–1(d).

*Example 3. Contributions of acquired assets to controlled corporations after a reorganization under section 368(a)(1)(D).* (i) *Facts*. P owns 100 percent of the stock of T. Pursuant to a plan of reorganization, T transfers all of its assets to S–1 solely in exchange for S–1 stock, which T distributes to P. In addition, pursuant to the plan of reorganization, S–1 transfers all of the T assets to S–2, and S–2 transfers all of the T assets to S–3.

(ii) *Analysis*. Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(D), is not disqualified by the successive transfers of all the acquired assets from S–1 to S–2 and from S–2 to S–3 because, in each transfer, the transferee corporation is controlled by the transferor corporation, S–2 and S–3 are members of the qualified group, and the transaction satisfies the requirements of §1.368–1(d).

*Example 4. Contribution of acquiring stock to controlled corporation after a reorganization under section 368(a)(1)(A).* (i) *Facts*. Pursuant to a plan of reorganization, S–1 acquires all of the T assets in the merger of T into S–1. In the merger, the T shareholders receive consideration 50 percent of which is P stock and 50 percent of which is cash. Also, pursuant to the plan of reorganization, P transfers all of the S–1 stock to S–4.

(ii) *Analysis*. Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(D), is not disqualified by the transfer of all of the S–1 stock to S–4 because the transferee corporation is controlled by the transferor corporation, S–4 is a member of the qualified group, and the transaction satisfies the requirements of §1.368–1(d).

*Example 5. Contribution of acquired assets to a partnership after a reorganization under section 368(a)(1)(A).* (i) *Facts*. Pursuant to a plan of reorganization, S–1 acquires all of the T assets in the merger of T into S–1. In the merger, the T shareholders receive consideration 50 percent of which is P stock and 50 percent of which is cash. In addition, pursuant to the plan of reorganization, S–1 transfers all of the T assets to PRS, a partnership in which S–1 owns a 33 1/3 percent interest. S–1 does not perform active and substantial management functions as a partner with respect to PRS' business.

(ii) *Analysis*. Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(D), is not disqualified by the transfer of T assets from S–1 to PRS because S–1 has an ownership interest in PRS immediately after the transfer, S–1 is a member of the qualified group and is treated as conducting the business of PRS under §1.368–1(d)(4)(iii), and the transaction satisfies the requirements of §1.368–1(d).

*Example 6. Distribution of acquired assets to a partnership after a reorganization under section 368(a)(1)(A).* (i) *Facts*. P owns an 80 percent interest in PRS, a partnership. PRS owns 20 percent of the stock of S–1. Pursuant to a plan of reorganization, S–1 acquires all of the T assets in the merger of T into S–1. In the merger, the T shareholders receive consideration 50 percent of which is P stock and 50 percent of which is cash. In addition, pursuant to the plan of reorganization, S–1 distributes less than substantially all of the T assets to PRS in redemption of 5 percent of the stock of S–1 owned by PRS.

(ii) *Analysis*. Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(D), is not disqualified by the transfer of T assets from S–1 to PRS because PRS receives less than substantially all of the T assets, P is a member of the qualified group and is treated as conducting the business of PRS under §1.368–1(d)(4)(iii), and the transaction satisfies the requirements of §1.368–1(d).

*Example 7. Contributions of acquired stock to controlled corporations after a reorganization under section 368(a)(1)(B).* (i) *Facts*. Pursuant to a plan of reorganization, the T shareholders transfer all of their T stock to S–1 solely in exchange for P stock. In addition, pursuant to the plan of reorganization, S–1 transfers 50 percent of the T stock to S–2, and S–2 transfers that T stock to S–3.

(ii) *Analysis*. Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(B), is not disqualified by the successive transfers of part of the acquired stock from S–1 to S–2, and from S–2 to S–3 because, in each transfer, the transferee corporation is controlled by the transferor corporation, S–2 and S–3 are members of the qualified group, and the transaction satisfies the requirements of §1.368–1(d).

*Example 8. Contributions of acquiring corporation stock to controlled corporations after a reorganization under section 368(a)(1)(B).* (i) *Facts*. Pursuant to a plan of reorganization, the T shareholders transfer all of their T stock to S–1 solely in exchange for P stock. In addition, as part of the plan of reorganization, following the acquisition of T stock by S–1, P transfers 10 percent of the S–1 stock to S–4, and S–4 transfers that S–1 stock to S–5.

(ii) *Analysis*. Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(B), is not disqualified by the successive transfers of S–1 stock to S–4 and from S–4 to S–5 because, in each transfer, the transferee corporation is controlled by the transferor corporation, S–4 and S–5 are members of the qualified group, and the transaction satisfies the requirements of §1.368–1(d).

(4) *Effective date*. This paragraph (k) applies to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

Deborah M. Nolan,
*Acting Deputy Commissioner for Services and Enforcement.*

(Filed by the Office of the Federal Register on August 17, 2004, 8:45a.m., and published in the issue of the Federal Register for August 18, 2004, 69 F.R. 51209)

---

# Withdrawal of Proposed Regulations Relating to Corporate Reorganizations; Transfers of Assets or Stock Following a Reorganization

## Announcement 2004–69

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Withdrawal of notice of proposed rulemaking.

SUMMARY: This document withdraws a notice of proposed rulemaking (REG–165579–02, 2004–13 I.R.B. 651) regarding the effect of certain transfers of assets or stock on the qualification of certain transactions as reorganizations under section 368(a). The proposed regulations were published on March 2, 2004. After consideration of additional issues related to the effect of transfers of assets or stock on the qualification of a transaction as a reorganization, the IRS and Treasury Department have decided to withdraw the proposed regulations and issue new proposed regulations that provide a more complete set of rules addressing such transfers.

DATES: These proposed regulations are withdrawn August 17, 2004.

FOR FURTHER INFORMATION CONTACT: Jeffrey B. Fienberg (202) 622–7770 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

### Background

On March 2, 2004, the IRS and Treasury Department issued proposed regulations regarding the effect of certain transfers of assets or stock on the qualification of certain transactions as reorganizations under section 368(a) (69 FR 9771) (hereinafter the March 2004 proposed regulations). After consideration of additional issues related to the effect of transfers of assets or stock on the qualification of a transaction as a reorganization, including distributions of assets or stock after purported reorganizations, the IRS and Treasury Department have decided to withdraw the March 2004 proposed regulations and issue new proposed regulations that provide a more complete set of rules addressing such transfers. Accordingly, the March 2004 proposed regulations are withdrawn.

**Drafting Information**

The principal author of this withdrawal notice is Jeffrey B. Fienberg of the Office of Associate Chief Counsel (Corporate).

* * * * *

**Withdrawal of Notice of Proposed Rulemaking**

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking (REG–165579–02) published in the **Federal Register** on March 2, 2004 (69 FR 9771), is hereby withdrawn.

Deborah M. Nolan,
*Acting Deputy Commissioner for Services and Enforcement.*

(Filed by the Office of the Federal Register on August 16, 2004, 8:45 a.m., and published in the issue of the Federal Register for August 17, 2004, 69 F.R. 51026)

## Penalty Relief Under Section 6715

## Announcement 2004–70

The Internal Revenue Service will not assert the penalty under section 6715 of the Internal Revenue Code with respect to dyed diesel fuel that, due to shortages of clear diesel fuel in the State of Florida caused by Hurricanes Charley and Frances, has been delivered by wholesale dealers to retail dealers for resale to highway users or has been sold by wholesale dealers directly to end users for highway use. This relief from the section 6715 penalty will apply only to dyed diesel fuel that wholesale dealers deliver or sell in the State of Florida and only to fuel delivered or sold by wholesale dealers during the period September 2, 2004, through September 15, 2004. In the case of wholesale dealers, penalty relief will be available only if the wholesale dealer reports and pays the tax on the dyed diesel fuel that is delivered or sold for highway use. The return and payment will be due on October 31, 2004, and the IRS will not assert penalties for failure to make semimonthly deposits of the tax. Wholesale dealers should call 1–866–699–4096 (a toll-free number) for instructions on the proper method for reporting and paying this tax.

In general, diesel fuel may be removed tax free from a terminal if it is dyed in the manner specified in the regulations under section 4082 of the Internal Revenue Code. Section 4081(b) of the Internal Revenue Code imposes a tax on blended diesel fuel created by mixing dyed diesel fuel with clear diesel fuel that has been previously taxed. Under regulations, the seller of the dyed fuel in the mixture is liable for this tax if the dyed fuel is sold as fuel that has previously been taxed. A sale of dyed diesel fuel by a wholesaler to a retailer will be treated as meeting this condition if the wholesaler delivers the dyed fuel into the retailer's storage tank for clear diesel fuel and the fuel qualifies for relief from the section 6715 penalty. Section 4041(a) of the Internal Revenue Code imposes a tax on sales of dyed diesel fuel that has not been previously taxed to persons that will use the fuel in a taxable highway use. Section 6715 of the Internal Revenue Code imposes a penalty if dyed diesel fuel is sold for highway use or is knowingly used on the highway.

Recent and imminent hurricanes in Florida have resulted in critical shortages of clear, low-sulfur diesel fuel in that State. The Internal Revenue Service and the Environmental Protection Agency are concerned that these shortages could impair the ability of emergency vehicles and utility repair vehicles to respond to existing damage from Hurricane Charley and expected damage from Hurricane Frances. Although limited quantities of dyed, high-sulfur diesel fuel are also available in Florida, Clean Air Act restrictions and the section 6715 penalty restrict this fuel to nontaxable off-highway uses. The relief announced today by the Internal Revenue Service and the Environmental Protection Agency's exercise of its enforcement discretion under the Clean Air Act restrictions will make all diesel fuel in the State of Florida available for highway use.

The principal author of this announcement is Barbara Franklin of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this announcement, contact Ms. Franklin at (202) 622–3130 (not a toll-free call).

## Section 1045 Application to Partnerships; Hearing

## Announcement 2004–73

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Change in date of public hearing; extension of time to submit outlines of oral comments.

SUMMARY: This document changes the date of the public hearing on the notice of proposed rulemaking (REG–150562–03, 2004–32 I.R.B. 175) that relates to the application of section 1045 of the Internal Revenue Code (Code) to partnerships and their partners. It also extends the time to submit outlines of oral comments for the hearing.

DATES: The public hearing originally scheduled for November 2, 2004, at 10 a.m. will be held November 9, 2004, at 10 a.m. Additional outlines of oral comments must be received by October 19, 2004.

ADDRESSES: The public hearing will be held in the Auditorium, Internal Revenue Service Building, 1111 Constitution Avenue, NW, Washington, DC. Send submissions to: CC:PA:LPD:PR (REG–150562–03), 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–150562–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the IRS Internet site at *http://www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS and REG–150562–03).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Charlotte Chyr, (202) 622–3070, or Jian H. Grant, (202) 622–3050; concerning submissions, the hearing, and/or placement on the building access list to attend the hearing, Sonya M. Cruse of the Publications and Regulations Branch, Legal Processing Division, Associate Chief Counsel (Procedures and Administration), at (202) 622–4693 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

**Backgrounds**

A notice of proposed rulemaking and notice of public hearing, appearing in the **Federal Register** on Thursday, July 15, 2004, (69 FR 42370), announced that a public hearing on the notice of proposed rulemaking relating to the application of section 1045 of the Internal Revenue Code (Code) to partnerships and their partners would be held on November 2, 2004, in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Subsequently, the date of the public hearing has been changed to November 9, 2004, at 10 a.m. in the IRS Auditorium. Outlines of oral comments must be received by October 19, 2004.

Cynthia E. Grigsby,
*Acting Chief, Publications and Regulations Branch, Legal Processing Division, Associate Chief Counsel (Procedures and Administration).*

(Filed by the Office of the Federal Register on September 1, 2004, 8:45 a.m., and published in the issue of the Federal Register for September 2, 2004, 69 F.R. 53664)

# Definition of Terms

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

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

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

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

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

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

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

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

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

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

# Abbreviations

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

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

## Numerical Finding List[1]

Bulletins 2004–27 through 2004–39

### Announcements:



### Notices:



### Proposed Regulations:



**Proposed Regulations— Continued:**



### Revenue Procedures:



### Revenue Rulings:



**Revenue Rulings— Continued:**



### Tax Conventions:



### Treasury Decisions:



[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2004–1 through 2004–26 is in Internal Revenue Bulletin 2004–26, dated June 28, 2004.

## Findings List of Current Actions on Previously Published Items[1]

Bulletins 2004–27 through 2004–39

### Notices:

**98-65**
Superseded by
Rev. Proc. 2004-40, 2004-29 I.R.B. *50*

**2001-50**
Modified by
Rev. Proc. 2004-46, 2004-31 I.R.B. *142*

**2004-2**
Modified by
Notice 2004-50, 2004-33 I.R.B. *196*
2004-2,
Corrected by
Ann. 2004-67, 2004-36 I.R.B. *459*

### Proposed Regulations:

**INTL-116-90**
Withdrawn by
REG-208246-90, 2004-36 I.R.B. *450*

**REG-208254-90**
Withdrawn by
REG-136481-04, 2004-37 I.R.B. *480*

**REG-104683-00**
Partially withdrawn by
Ann. 2004-64, 2004-35 I.R.B. *402*

**REG-165579-02**
Withdrawn by
Ann. 2004-69, 2004-39 I.R.B. *542*

**REG-150562-03**
Corrected by
Ann. 2004-68, 2004-38 I.R.B. *508*
Ann. 2004-73, 2004-39 I.R.B. *543*

### Revenue Procedures:

**79-61**
Superseded by
Rev. Proc. 2004-44, 2004-31 I.R.B. *134*

**89-37**
Obsoleted by
Rev. Rul. 2004-90, 2004-34 I.R.B. *317*

**94-64**
Superseded by
Rev. Proc. 2004-38, 2004-27 I.R.B. *10*

**96-18**
Obsoleted by
Rev. Rul. 2004-90, 2004-34 I.R.B. *317*

**96-53**
Superseded by
Rev. Proc. 2004-40, 2004-29 I.R.B. *50*

**Revenue Procedures— Continued:**

**96-60**
Superseded by
Rev. Proc. 2004-53, 2004-34 I.R.B. *320*

**98-41**
Superseded by
Rev. Proc. 2004-56, 2004-35 I.R.B. *376*

**2000-37**
Modified by
Rev. Proc. 2004-51, 2004-33 I.R.B. *294*

**2002-9**
Modified and amplified by
Rev. Proc. 2004-41, 2004-30 I.R.B. *90*

**2003-30**
Superseded by
Rev. Proc. 2004-54, 2004-34 I.R.B. *325*

**2003-52**
Superseded by
Rev. Proc. 2004-50, 2004-33 I.R.B. *211*

**2004-23**
Modified by
Rev. Proc. 2004-57, 2004-38 I.R.B. *498*

**2004-4**
Modified by
Rev. Proc. 2004-44, 2004-31 I.R.B. *134*

### Revenue Rulings:

**54-379**
Superseded by
Rev. Rul. 2004-68, 2004-31 I.R.B. *118*

**58-120**
Obsoleted by
Rev. Rul. 2004-90, 2004-34 I.R.B. *317*

**62-60**
Amplified by
Rev. Proc. 2004-53, 2004-34 I.R.B. *320*

**70-58**
Obsoleted by
Rev. Rul. 2004-90, 2004-34 I.R.B. *317*

**73-354**
Obsoleted by
Rev. Rul. 2004-76, 2004-31 I.R.B. *111*

**78-371**
Distinguished by
Rev. Rul. 2004-86, 2004-33 I.R.B. *191*

**79-64**
Obsoleted by
Rev. Rul. 2004-90, 2004-34 I.R.B. *317*

**Revenue Rulings— Continued:**

**80-7**
Amplified and clarified by
Rev. Rul. 2004-71, 2004-30 I.R.B. *74*
Rev. Rul. 2004-72, 2004-30 I.R.B. *77*
Rev. Rul. 2004-73, 2004-30 I.R.B. *80*
Rev. Rul. 2004-74, 2004-30 I.R.B. *84*

**80-366**
Obsoleted by
Rev. Rul. 2004-90, 2004-34 I.R.B. *317*

**81-100**
Clarified and modified by
Rev. Rul. 2004-67, 2004-28 I.R.B. *28*

**85-70**
Amplified and clarified by
Rev. Rul. 2004-71, 2004-30 I.R.B. *74*
Rev. Rul. 2004-72, 2004-30 I.R.B. *77*
Rev. Rul. 2004-73, 2004-30 I.R.B. *80*
Rev. Rul. 2004-74, 2004-30 I.R.B. *84*

**92-105**
Distinguished by
Rev. Rul. 2004-86, 2004-33 I.R.B. *191*

**2004-75**
Amplified by
Rev. Rul. 2004-97, 2004-39 I.R.B. *516*

### Treasury Decisions:

**9031**
Removed by
T.D. 9152, 2004-39 I.R.B. *509*

[1] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2004–1 through 2004–26 is in Internal Revenue Bulletin 2004–26, dated June 28, 2004.

# INDEX

## Internal Revenue Bulletins 2004–27 through 2004–39

The abbreviation and number in parenthesis following the index entry refer to the specific item; numbers in roman and italic type following the parentheses refer to the Internal Revenue Bulletin in which the item may be found and the page number on which it appears.

Key to Abbreviations:

| | |
|---|---|
| Ann | Announcement |
| CD | Court Decision |
| DO | Delegation Order |
| EO | Executive Order |
| PL | Public Law |
| PTE | Prohibited Transaction Exemption |
| RP | Revenue Procedure |
| RR | Revenue Ruling |
| SPR | Statement of Procedural Rules |
| TC | Tax Convention |
| TD | Treasury Decision |
| TDO | Treasury Department Order |

# EMPLOYEE PLANS



# EMPLOYMENT TAX



# ESTATE TAX



# EXCISE TAX

## EXCISE TAX—Cont.



## EXEMPT ORGANIZATIONS



## GIFT TAX



## INCOME TAX

INCOME TAX—Cont.

## INCOME TAX—Cont.



## SELF-EMPLOYMENT TAX