percent of the underpayment. For purposes of this section, the term ''underpayment'' means the excess of the amount of the payment required under this section over the amount (if any) of such payment paid on or before the date prescribed in paragraph (a)(4) of this section.

(6) *Refund of required payment*—(i) *In general.* If a partnership or S corporation is entitled to make a claim for refund pursuant to § 1.7519–1T(c), such partnership or S corporation should file a claim for refund, as provided in paragraph (a)(6)(ii) of this section. However, in no event shall a refund be made prior to April 15 of the second calendar year that follows the calendar year in which an applicable election year begins. For example, assume a partnership made a section 444 election to retain its taxable year for its taxable year beginning October 1, 1987, and as a result made a required payment for such year. Further assume that the partnership terminates its election for its taxable year beginning October 1, 1988. Based on these facts, the partnership will be entitled to a refund, but no earlier than April 15, 1989.

(ii) *Procedures for claiming refund.* [Reserved]

(iii) *Interest on refund.* No interest shall be allowed with respect to any refund of a required payment under § 1.7519–1T(C).

(b) *Assessment and collection of payment.* A required payment shall be assessed and collected in the same manner as if it were a tax imposed by subtitle C. Furthermore, no deduction shall be allowable to a partnership or S corporation (or their owners) with respect to the required payment.

(c) *Termination due to willful failure.* See § 1.444–1T(a)(5)(i)(C), which provides that willful failure to comply with the requirements of this section will result in the termination of the section 444 election.

(d) *Negligence and fraud penalties made applicable.* For purposes of section 6653, relating to additions to tax for negligence and fraud, any payment required by this section shall be treated as a tax.

[T.D. 8205, 53 FR 19709, May 27, 1988]

§ 1.7519–3T Effective date (temporary).

The provisions of §§ 1.7519–1T through § 1.7519–3T are effective for taxable years beginning after December 31, 1986.

[T.D. 8205, 53 FR 19710, May 27, 1988]

GENERAL ACTUARIAL VALUATIONS

§ 1.7520–1 Valuation of annuities, unitrust interests, interests for life or terms of years, and remainder or reversionary interests.

(a) *General actuarial valuations.* (1) Except as otherwise provided in this section and in § 1.7520–3 (relating to exceptions to the use of prescribed tables under certain circumstances), in the case of certain transactions after April 30, 1989, subject to income tax, the fair market value of annuities, interests for life or for a term of years (including unitrust interests), remainders, and reversions is their present value determined under this section. See § 20.2031–7(d) of this chapter (and, for periods prior to May 1, 2009, § 20.2031–7A) for the computation of the value of annuities, unitrust interests, life estates, terms for years, remainders, and reversions, other than interests described in paragraphs (a)(2) and (a)(3) of this section.

(2) For a transfer to a pooled income fund, see § 1.642(c)–6(e) (or, for periods prior to May 1, 2009, § 1.642(c)–6A) with respect to the valuation of the remainder interest.

(3) For a transfer to a charitable remainder annuity trust after April 30, 1989, see § 1.664–2 with respect to the valuation of the remainder interest. See § 1.664–4 with respect to the valuation of the remainder interest in property transferred to a charitable remainder unitrust.

(b) *Components of valuation*—(1) *Interest rate component*—(i) *Section 7520 Interest rate.* The section 7520 interest rate is the rate of return, rounded to the nearest two-tenths of one percent, that is equal to 120 percent of the applicable Federal mid-term rate, compounded annually, for purposes of section 1274(d)(1), for the month in which the valuation date falls. In rounding the rate to the nearest two-tenths of a percent, any rate that is midway between one two-tenths of a percent and another is rounded up to the higher of

those two rates. For example, if 120 percent of the applicable Federal midterm rate is 10.30, the section 7520 interest rate component is 10.4. The section 7520 interest rate is published monthly by the Internal Revenue Service in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter).

(ii) *Valuation date.* Except as provided in §1.7520–2, the valuation date is the date on which the transaction takes place.

(2) *Mortality component.* The mortality component reflects the mortality data most recently available from the United States census. As new mortality data becomes available after each decennial census, the mortality component described in this section will be revised and the revised mortality component tables will be published in the regulations at that time. For transactions with valuation dates on or after May 1, 2009, the mortality component table (Table 2000CM) is contained in §20.2031–7(d)(7) of this chapter. See §20.2031–7A for mortality component tables applicable to transactions for which the valuation date falls before May 1, 2009.

(c) *Tables.* The present value on the valuation date of an annuity, life estate, term of years, remainder, or reversion is computed by using the section 7520 interest rate component that is described in paragraph (b)(1) of this section and the mortality component that is described in paragraph (b)(2) of this section. Actuarial factors for determining these present values are included in tables in these regulations and in publications by the Internal Revenue Service. If a special factor is required in order to value an interest, the Internal Revenue Service will furnish the factor upon a request for a ruling. The request for a ruling must be accompanied by a recitation of the facts, including the date of birth for each measuring life and copies of relevant instruments. A request for a ruling must comply with the instructions for requesting a ruling published periodically in the Internal Revenue Bulletin (see Rev. Proc. 94–1, 1994–1 I.R.B. 10, and subsequent updates, and §§601.201 and 601.601(d)(2)(ii)(*b*) of this chapter) and include payment of the required user fee.

(1) *Regulation sections containing tables with interest rates between 0.2 and 14 percent for valuation dates on or after May 1, 2009.* Section 1.642(c)–6(e)(6) contains Table S used for determining the present value of a single life remainder interest in a pooled income fund as defined in §1.642(c)–5. See §1.642(c)–6A for actuarial factors for one life applicable to valuation dates before May 1, 2009. Section 1.664–4(e)(6) contains Table F (payout factors) and Table D (actuarial factors used in determining the present value of a remainder interest postponed for a term of years). Section 1.664–4(e)(7) contains Table U(1) (unitrust single life remainder factors). These tables are used in determining the present value of a remainder interest in a charitable remainder unitrust as defined in §1.664–3. See §1.664–4A for unitrust single life remainder factors applicable to valuation dates before May 1, 2009. Section 20.2031–7(d)(6) of this chapter contains Table B (actuarial factors used in determining the present value of an interest for a term of years), Table J (term certain annuity beginning-of-interval adjustment factors), and Table K (annuity end-of-interval adjustment factors). Section 20.2031–7(d)(7) contains Table S (single life remainder factors), and Table 2000CM (mortality components). These tables are used in determining the present value of annuities, life estates, remainders, and reversions. See §20.2031–7A for single life remainder factors for one life and mortality components applicable to valuation dates before May 1, 2009.

(2) *Internal Revenue Service publications containing tables with interest rates between 0.2 and 22 percent for valuation dates on or after May 1, 2009.* The following documents are available, at no charge, electronically via the IRS Internet site at *http://www.irs.gov:*

(i) Internal Revenue Service Publication 1457, ''Actuarial Valuations Version 3A'' (2009). This publication includes tables of valuation factors, as well as examples that show how to compute other valuation factors, for determining the present value of annuities, life estates, terms of years, remainders, and reversions, measured by one or two lives. These factors must

also be used in the valuation of interests in a charitable remainder annuity trust as defined in § 1.664–2 and a pooled income fund as defined in § 1.642(c)–5.

(ii) Internal Revenue Service Publication 1458, ''Actuarial Valuations Version 3B'' (2009). This publication includes term certain tables and tables of one and two life valuation factors for determining the present value of remainder interests in a charitable remainder unitrust as defined in § 1.664–3.

(iii) Internal Revenue Service Publication 1459, ''Actuarial Valuations Version 3C'' (2009). This publication includes tables for computing depreciation adjustment factors. See § 1.170A–12.

(d) *Effective/applicability date.* This section applies on and after May 1, 2009.

[T.D. 8540, 59 FR 30149, June 10, 1994, as amended by T.D. 8819, 64 FR 23210, 23229, Apr. 30, 1999; T.D. 8886, 65 FR 36928, 36943, June 12, 2000; T.D. 9448, 74 FR 21483, May 7, 2009; T.D. 9540, 76 FR 49611, Aug. 10, 2011]

§ 1.7520–2 Valuation of charitable interests.

(a) *In general*—(1) *Valuation.* Except as otherwise provided in this section and in § 1.7520–3 (relating to exceptions to the use of prescribed tables under certain circumstances), the fair market value of annuities, interests for life or for a term of years, remainders, and reversions for which an income tax charitable deduction is allowable is the present value of such interests determined under § 1.7520–1.

(2) *Prior-month election rule.* If any part of the property interest transferred qualifies for an income tax charitable deduction under section 170(c), the taxpayer may elect (under paragraph (b) of this section) to compute the present value of the interest transferred by use of the section 7520 interest rate for the month during which the interest is transferred or the section 7520 interest rate component for either of the 2 months preceding the month during which the interest is transferred. Paragraph (b) of this section explains how a prior-month election is made. The interest rate for the month so elected is the applicable section 7520 interest rate. If the actuarial factor for either or both of the 2 months preceding the month during which the interest is transferred is based on a mortality experience that is different from the mortality experience at the date of the transfer and if the taxpayer elects to use the section 7520 rate for a prior month with the different mortality experience, the taxpayer must use the actuarial factor derived from the mortality experience in effect during the month of the section 7520 rate elected. All actuarial computations relating to the transfer must be made by applying the interest rate component and the mortality component of the month elected by the taxpayer.

(3) *Transfers of more than one interest in the same property.* If a taxpayer transfers more than one interest in the same property at the same time, for purposes of valuing the transferred interests, the taxpayer must use the same interest rate and mortality component for each interest in the property transferred. If more than one interest in the same property is transferred in two or more separate transfers at different times, the value of each interest is determined by the use of the interest rate component and mortality component in effect during the month of the transfer of that interest or, if applicable under paragraph (a)(2) of this section, either of the two months preceding the month of the transfer.

(4) *Information required with tax return.* The following information must be attached to the income tax return (or to the amended return) if the taxpayer claims a charitable deduction for the present value of a temporary or remainder interest in property—

(i) A complete description of the interest that is transferred, including a copy of the instrument of transfer;

(ii) The valuation date of the transfer;

(iii) The names and identification numbers of the beneficiaries of the transferred interest;

(iv) The names and birthdates of any measuring lives, a description of any relevant terminal illness condition of any measuring life, and (if applicable) an explanation of how any terminal illness condition was taken into account in valuing the interest; and

(v) A computation of the deduction showing the applicable section 7520 interest rate that is used to value the transferred interest.

(5) *Place for filing returns.* See section 6091 of the Internal Revenue Code and the regulations thereunder for the place for filing the return or other document required by this section.

(b) *Election of interest rate component*—(1) *Time for making election.* A taxpayer makes a prior-month election under paragraph (a)(2) of this section by attaching the information described in paragraph (b)(2) of this section to the taxpayer's income tax return or to an amended return for that year that is filed within 24 months after the later of the date the original return for the year was filed or the due date for filing the return.

(2) *Manner of making election.* A statement that the prior-month election under section 7520(a) of the Internal Revenue Code is being made and that identifies the elected month must be attached to the income tax return (or to the amended return).

(3) *Revocability.* The prior-month election may be revoked by filing an amended return within 24 months after the later of the date the original return of tax for the year was filed or the due date for filing the return. The revocation must be filed in the place referred to in paragraph (a)(5) of this section.

(c) *Effective dates.* Paragraph (a) of this section is effective as of May 1, 1989. Paragraph (b) of this section is effective for elections made after June 10, 1994.

[T.D. 8540, 59 FR 30149, June 10, 1994]

§ 1.7520–3 Limitation on the application of section 7520.

(a) *Internal Revenue Code sections to which section 7520 does not apply.* Section 7520 of the Internal Revenue Code does not apply for purposes of—

(1) Part I, subchapter D of subtitle A (section 401 et. seq.), relating to the income tax treatment of certain qualified plans. (However, section 7520 does apply to the estate and gift tax treatment of certain qualified plans and for purposes of determining excess accumulations under section 4980A);

(2) Sections 72 and 101(b), relating to the income taxation of life insurance, endowment, and annuity contracts, unless otherwise provided for in the regulations under sections 72, 101, and 1011 (see, particularly, §§ 1.101–2(e)(1)(iii)(*b*)(*2*), and 1.1011–2(c), *Example 8*);

(3) Sections 83 and 451, unless otherwise provided for in the regulations under those sections;

(4) Section 457, relating to the valuation of deferred compensation, unless otherwise provided for in the regulations under section 457;

(5) Sections 3121(v) and 3306(r), relating to the valuation of deferred amounts, unless otherwise provided for in the regulations under those sections;

(6) Section 6058, relating to valuation statements evidencing compliance with qualified plan requirements, unless otherwise provided for in the regulations under section 6058;

(7) Section 7872, relating to income and gift taxation of interest-free loans and loans with below-market interest rates, unless otherwise provided for in the regulations under section 7872; or

(8) Section 2702(a)(2)(A), relating to the value of a nonqualified retained interest upon a transfer of an interest in trust to or for the benefit of a member of the transferor's family; and

(9) Any other sections of the Internal Revenue Code to the extent provided by the Internal Revenue Service in revenue rulings or revenue procedures. (See §§ 601.201 and 601.601 of this chapter).

(b) *Other limitations on the application of section 7520*—(1) *In general*—(i) *Ordinary beneficial interests.* For purposes of this section:

(A) An *ordinary annuity interest* is the right to receive a fixed dollar amount at the end of each year during one or more measuring lives or for some other defined period. A standard section 7520 annuity factor for an ordinary annuity interest represents the present worth of the right to receive $1.00 per year for a defined period, using the interest rate prescribed under section 7520 for the appropriate month. If an annuity interest is payable more often than annually or is payable at the beginning of each period, a special adjustment must be made in any computation with a standard section 7520 annuity factor.

(B) An *ordinary income interest* is the right to receive the income from, or the use of, property during one or more measuring lives or for some other defined period. A standard section 7520 income factor for an ordinary income interest represents the present worth of the right to receive the use of $1.00 for a defined period, using the interest rate prescribed under section 7520 for the appropriate month.

(C) An *ordinary remainder or reversionary interest* is the right to receive an interest in property at the end of one or more measuring lives or some other defined period. A standard section 7520 remainder factor for an ordinary remainder or reversionary interest represents the present worth of the right to receive $1.00 at the end of a defined period, using the interest rate prescribed under section 7520 for the appropriate month.

(ii) *Certain restricted beneficial interests.* A *restricted beneficial interest* is an annuity, income, remainder, or reversionary interest that is subject to a contingency, power, or other restriction, whether the restriction is provided for by the terms of the trust, will, or other governing instrument or is caused by other circumstances. In general, a standard section 7520 annuity, income, or remainder factor may not be used to value a restricted beneficial interest. However, a special section 7520 annuity, income, or remainder factor may be used to value a restricted beneficial interest under some circumstances. See paragraph (b)(4) *Example 2* of this section, which illustrates a situation where a special section 7520 actuarial factor is needed to take into account the shorter life expectancy of the terminally ill measuring life. See §1.7520–1(c) for requesting a special factor from the Internal Revenue Service.

(iii) *Other beneficial interests.* If, under the provisions of this paragraph (b), the interest rate and mortality components prescribed under section 7520 are not applicable in determining the value of any annuity, income, remainder, or reversionary interest, the actual fair market value of the interest (determined without regard to section 7520) is based on all of the facts and circumstances if and to the extent permitted by the Internal Revenue Code provision applicable to the property interest.

(2) *Provisions of governing instrument and other limitations on source of payment*—(i) *Annuities.* A standard section 7520 annuity factor may not be used to determine the present value of an annuity for a specified term of years or the life of one or more individuals unless the effect of the trust, will, or other governing instrument is to ensure that the annuity will be paid for the entire defined period. In the case of an annuity payable from a trust or other limited fund, the annuity is not considered payable for the entire defined period if, considering the applicable section 7520 interest rate at the valuation date of the transfer, the annuity is expected to exhaust the fund before the last possible annuity payment is made in full. For this purpose, it must be assumed that it is possible for each measuring life to survive until age 110. For example, for a fixed annuity payable annually at the end of each year, if the amount of the annuity payment (expressed as a percentage of the initial corpus) is less than or equal to the applicable section 7520 interest rate at the date of the transfer, the corpus is assumed to be sufficient to make all payments. If the percentage exceeds the applicable section 7520 interest rate and the annuity is for a definite term of years, multiply the annual annuity amount by the Table B term certain annuity factor, as described in §1.7520–1(c)(1), for the number of years of the defined period. If the percentage exceeds the applicable section 7520 interest rate and the annuity is payable for the life of one or more individuals, multiply the annual annuity amount by the Table B annuity factor for 110 years minus the age of the youngest individual. If the result exceeds the limited fund, the annuity may exhaust the fund, and it will be necessary to calculate a special section 7520 annuity factor that takes into account the exhaustion of the trust or fund. This computation would be modified, if appropriate, to take into account annuities with different payment terms. See §25.7520–3(b)(2)(v) *Example 5* of this chapter, which provides an illustration

involving an annuity trust that is subject to exhaustion.

(ii) *Income and similar interests*—(A) *Beneficial enjoyment.* A standard section 7520 income factor for an ordinary income interest may not be used to determine the present value of an income or similar interest in trust for a term of years or for the life of one or more individuals unless the effect of the trust, will, or other governing instrument is to provide the income beneficiary with that degree of beneficial enjoyment of the property during the term of the income interest that the principles of the law of trusts accord to a person who is unqualifiedly designated as the income beneficiary of a trust for a similar period of time. This degree of beneficial enjoyment is provided only if it was the transferor's intent, as manifested by the provisions of the governing instrument and the surrounding circumstances, that the trust provide an income interest for the income beneficiary during the specified period of time that is consistent with the value of the trust corpus and with its preservation. In determining whether a trust arrangement evidences that intention, the treatment required or permitted with respect to individual items must be considered in relation to the entire system provided for in the administration of the subject trust. Similarly, in determining the present value of the right to use tangible property (whether or not in trust) for one or more measuring lives or for some other specified period of time, the interest rate component prescribed under section 7520 and §1.7520–1 may not be used unless, during the specified period, the effect of the trust, will or other governing instrument is to provide the beneficiary with that degree of use, possession, and enjoyment of the property during the term of interest that applicable state law accords to a person who is unqualifiedly designated as a life tenant or term holder for a similar period of time.

(B) *Diversions of income and corpus.* A standard section 7520 income factor for an ordinary income interest may not be used to value an income interest or similar interest in property for a term of years or for one or more measuring lives if—

(*1*) The trust, will, or other governing instrument requires or permits the beneficiary's income or other enjoyment to be withheld, diverted, or accumulated for another person's benefit without the consent of the income beneficiary; or

(*2*) The governing instrument requires or permits trust corpus to be withdrawn from the trust for another person's benefit during the income beneficiary's term of enjoyment without the consent of and accountability to the income beneficiary for such diversion.

(iii) *Remainder and reversionary interests.* A standard section 7520 remainder interest factor for an ordinary remainder or reversionary interest may not be used to determine the present value of a remainder or reversionary interest (whether in trust or otherwise) unless, consistent with the preservation and protection that the law of trusts would provide for a person who is unqualifiedly designated as the remainder beneficiary of a trust for a similar duration, the effect of the administrative and dispositive provisions for the interest or interests that precede the remainder or reversionary interest is to assure that the property will be adequately preserved and protected (e.g., from erosion, invasion, depletion, or damage) until the remainder or reversionary interest takes effect in possession and enjoyment. This degree of preservation and protection is provided only if it was the transferor's intent, as manifested by the provisions of the arrangement and the surrounding circumstances, that the entire disposition provide the remainder or reversionary beneficiary with an undiminished interest in the property transferred at the time of the termination of the prior interest.

(iv) *Pooled income fund interests.* In general, pooled income funds are created and administered to achieve a special rate of return. A beneficial interest in a pooled income fund is not ordinarily valued using a standard section 7520 income or remainder interest factor. The present value of a beneficial interest in a pooled income fund is determined according to rules and special remainder factors prescribed in §1.642(c)–6 and, when applicable, the

rules set forth in paragraph (b)(3) of this section, if the individual who is the measuring life is terminally ill at the time of the transfer.

(3) *Mortality component.* The mortality component prescribed under section 7520 may not be used to determine the present value of an annuity, income interest, remainder interest, or reversionary interest if an individual who is a measuring life is terminally ill at the time of the transaction. For purposes of this paragraph (b)(3), an individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50 percent probability that the individual will die within 1 year. However, if the individual survives for eighteen months or longer after the date of the transaction, that individual shall be presumed to have not been terminally ill at the time of the transaction unless the contrary is established by clear and convincing evidence.

(4) *Examples.* The provisions of this paragraph (b) are illustrated by the following examples:

Example 1. Annuity funded with unproductive property. The taxpayer transfers corporation stock worth $1,000,000 to a trust. The trust provides for a 6 percent ($60,000 per year) annuity in cash or other property to be paid to a charitable organization for 25 years and for the remainder to be distributed to the donor's child. The trust specifically authorizes, but does not require, the trustee to retain the shares of stock. The section 7520 interest rate for the month of the transfer is 8.2 percent. The corporation has paid no dividends on this stock during the past 5 years, and there is no indication that this policy will change in the near future. Under applicable state law, the corporation is considered to be a sound investment that satisfies fiduciary standards. Therefore, the trust's sole investment in this corporation is not expected to adversely affect the interest of either the annuitant or the remainder beneficiary. Considering the 6 percent annuity payout rate and the 8.2 percent section 7520 interest rate, the trust corpus is considered sufficient to pay this annuity for the entire 25-year term of the trust, or even indefinitely. Although it appears that neither beneficiary would be able to compel the trustee to make the trust corpus produce investment income, the annuity interest in this case is considered to be an ordinary annuity interest, and the standard section 7520 annuity factor may be used to determine the present value of the annuity. In this case, the section 7520 annuity factor would represent the right to receive $1.00 per year for a term of 25 years.

Example 2. Terminal illness. The taxpayer transfers property worth $1,000,000 to a charitable remainder unitrust described in section 664(d)(2) and §1.664–3. The trust provides for a fixed-percentage 7 percent unitrust benefit (each annual payment is equal to 7 percent of the trust assets as valued at the beginning of each year) to be paid quarterly to an individual beneficiary for life and for the remainder to be distributed to a charitable organization. At the time the trust is created, the individual beneficiary is age 60 and has been diagnosed with an incurable illness and there is at least a 50 percent probability of the individual dying within 1 year. Assuming the presumption in paragraph (b)(3) of this section does not apply, because there is at least a 50 percent probability that this beneficiary will die within 1 year, the standard section 7520 unitrust remainder factor for a person age 60 from the valuation tables may not be used to determine the present value of the charitable remainder interest. Instead, a special unitrust remainder factor must be computed that is based on the section 7520 interest rate and that takes into account the projection of the individual beneficiary's actual life expectancy.

(5) *Additional limitations.* Section 7520 does not apply to the extent as may otherwise be provided by the Commissioner.

(c) *Effective date.* Section 1.7520–3(a) is effective as of May 1, 1989. The provisions of paragraph (b) of this section are effective with respect to transactions after December 13, 1995.

[T.D. 8540, 59 FR 30150, June 10, 1994, as amended by T.D. 8630, 60 FR 63915, Dec. 13, 1995]

§ 1.7520–4 Transitional rules.

(a) *Reliance.* If the valuation date is after April 30, 1989, and before June 10, 1994, a taxpayer can rely on Notice 89–24, 1989–1 C.B. 660, or Notice 89–60, 1989–1 C.B. 700 (See §601.601(d)(2)(ii)(*b*) of this chapter), in valuing the transferred interest.

(b) *Effective date.* This section is effective as of May 1, 1989.

[T.D. 8540, 59 FR 30150, June 10, 1994]

§ 1.7701–1 Definitions; spouse, husband and wife, husband, wife, marriage.

(a) *In general.* For the definition of the terms spouse, husband and wife,

husband, wife, and marriage, see §301.7701–18 of this chapter.

(b) *Applicability date*. The rules of this section apply to taxable years ending on or after September 2, 2016.

[T.D. 9785, 81 FR 60616, Sept. 2, 2016]

§ 1.7701(l)–0 Table of contents.

This section lists captions that appear in §§1.7701(l)–1 and 1.7701(l)–3:

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§ 1.7701(l)–3 Recharacterizing financing arrangements involving fast-pay stock.

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[T.D. 8853, 65 FR 1313, Jan. 10, 2000]

§ 1.7701(l)–1 Conduit financing arrangements.

Section 7701(l) authorizes the issuance of regulations that recharacterize any multiple-party financing transaction as a transaction directly among any two or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by title 26 of the United States Code.

[T.D. 8611, 60 FR 41015, Aug. 11, 1995, as amended by T.D. 8735, 62 FR 53502, Oct. 14, 1997]

§ 1.7701(l)–3 Recharacterizing financing arrangements involving fast-pay stock.

(a) *Purpose and scope*. This section is intended to prevent the avoidance of tax by persons participating in fast-pay arrangements (as defined in paragraph (b)(1) of this section) and should be interpreted in a manner consistent with this purpose. This section applies to all fast-pay arrangements. Paragraph (c) of this section recharacterizes certain fast-pay arrangements to ensure the participants are taxed in a manner reflecting the economic substance of the arrangements. Paragraph (f) of this section imposes reporting requirements on certain participants.

(b) *Definitions*—(1) *Fast-pay arrangement*. A fast-pay arrangement is any arrangement in which a corporation has fast-pay stock outstanding for any part of its taxable year.

(2) *Fast-pay stock*—(i) *Defined*. Stock is fast-pay stock if it is structured so that dividends (as defined in section 316) paid by the corporation with respect to the stock are economically (in whole or in part) a return of the holder's investment (as opposed to only a return on the holder's investment). Unless clearly demonstrated otherwise, stock is presumed to be fast-pay stock if—

(A) It is structured to have a dividend rate that is reasonably expected to decline (as opposed to a dividend rate that is reasonably expected to fluctuate or remain constant); or

(B) It is issued for an amount that exceeds (by more than a de minimis amount, as determined under the principles of §1.1273–1(d)) the amount at

which the holder can be compelled to dispose of the stock.

(ii) *Determination.* The determination of whether stock is fast-pay stock is based on all the facts and circumstances, including any related agreements such as options or forward contracts. A related agreement includes any direct or indirect agreement or understanding, oral or written, between the holder of the stock and the issuing corporation, or between the holder of the stock and one or more other shareholders in the corporation. To determine if it is fast-pay stock, stock is examined when issued, and, for stock that is not fast-pay stock when issued, when there is a significant modification in the terms of the stock or the related agreements or a significant change in the relevant facts and circumstances. Stock is not fast-pay stock solely because a redemption is treated as a dividend as a result of section 302(d) unless there is a principal purpose of achieving the same economic and tax effect as a fast-pay arrangement. See §1.1001–6(e) for additional rules that may apply to stock that provides for a rate referencing a discontinued IBOR, as defined in §1.1001–6(h)(4).

(3) *Benefited stock.* With respect to any fast-pay stock, all other stock in the corporation (including other fast-pay stock having any significantly different characteristics) is benefited stock.

(c) *Recharacterization of certain fast-pay arrangements*—(1) *Scope.* This paragraph (c) applies to any fast-pay arrangement—

(i) In which the corporation that has outstanding fast-pay stock is a regulated investment company (RIC) (as defined in section 851) or a real estate investment trust (REIT) (as defined in section 856); or

(ii) If the Commissioner determines that a principal purpose for the structure of the fast-pay arrangement is the avoidance of any tax imposed by the Internal Revenue Code. Application of this paragraph (c)(1)(ii) is at the Commissioner's discretion, and a determination under this paragraph (c)(1)(ii) applies to all parties to the fast-pay arrangement, including transferees.

(2) *Recharacterization.* A fast-pay arrangement described in paragraph (c)(1) of this section is recharacterized as an arrangement directly between the benefited shareholders and the fast-pay shareholders. The inception and resulting relationships of the recharacterized arrangement are deemed to be as follows:

(i) *Relationship between benefited shareholders and fast-pay shareholders.* The benefited shareholders issue financial instruments (the financing instruments) directly to the fast-pay shareholders in exchange for cash equal to the fair market value of the fast-pay stock at the time of issuance (taking into account any related agreements). The financing instruments have the same terms (other than issuer) as the fast-pay stock. Thus, for example, the timing and amount of the payments made with respect to the financing instruments always match the timing and amount of the distributions made with respect to the fast-pay stock.

(ii) *Relationship between benefited shareholders and corporation.* The benefited shareholders contribute to the corporation the cash they receive for issuing the financing instruments. Distributions made with respect to the fast-pay stock are distributions made by the corporation with respect to the benefited shareholders' benefited stock.

(iii) *Relationship between fast-pay shareholders and corporation.* For purposes of determining the relationship between the fast-pay shareholders and the corporation, the fast-pay stock is ignored. The corporation is the paying agent of the benefited shareholders with respect to the financing instruments.

(3) *Other rules*—(i) *Character of the financing instruments.* The character of a financing instrument (for example, stock or debt) is determined under general tax principles and depends on all the facts and circumstances.

(ii) *Multiple types of benefited stock.* If any benefited stock has any significantly different characteristics from any other benefited stock, the recharacterization rules of this paragraph (c) apply among the different types of benefited stock as appropriate

to match the economic substance of the fast-pay arrangement.

(iii) Transactions affecting benefited stock—(A) Sale of benefited stock. If one person sells benefited stock to another—

(*1*) In addition to any consideration actually paid and received for the benefited stock, the buyer is deemed to pay and the seller is deemed to receive the amount necessary to terminate the seller's position in the financing instruments at fair market value; and

(*2*) The buyer is deemed to issue financing instruments to the fast-pay shareholders in exchange for the amount necessary to terminate the seller's position in the financing instruments.

(B) *Transactions other than sales.* Except for transactions subject to paragraph (c)(3)(iii)(A) of this section, in the case of any transaction affecting benefited stock, the parties to the transaction must make appropriate adjustments to properly take into account the fast-pay arrangement as characterized under paragraph (c)(2) of this section.

(iv) *Adjustment to basis for amounts accrued or paid in taxable years ending before February 27, 1997.* In the case of a fast-pay arrangement involving amounts accrued or paid in taxable years ending before February 27, 1997, and recharacterized under this paragraph (c), a benefited shareholder must decrease its basis in any benefited stock (as determined under paragraph (c)(2)(ii) of this section) by the amount (if any) that—

(A) Its income attributable to the benefited stock (reduced by deductions attributable to the financing instruments) for taxable years ending before February 27, 1997, computed by recharacterizing the fast-pay arrangement under this paragraph (c) and by treating the financing instruments as debt; exceeds

(B) Its income attributable to such stock for taxable years ending before February 27, 1997, computed without applying the rules of this paragraph (c).

(d) *Prohibition against affirmative use of recharacterization by taxpayers.* A taxpayer may not use the rules of paragraph (c) of this section if a principal purpose for using such rules is the avoidance of any tax imposed by the Internal Revenue Code. Thus, with respect to such taxpayer, the Commissioner may depart from the rules of this section and recharacterize (for all purposes of the Internal Revenue Code) the fast-pay arrangement in accordance with its form or its economic substance. For example, if a foreign person acquires fast-pay stock in a REIT and a principal purpose for acquiring such stock is to reduce United States withholding taxes by applying the rules of paragraph (c) of this section, the Commissioner may, for purposes of determining the foreign person's United States tax consequences (including withholding tax), depart from the rules of paragraph (c) of this section and treat the foreign person as holding fast-pay stock in the REIT.

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

Example 1. Decline in dividend rate. (i) *Facts.* Corporation X issues 100 shares of A Stock and 100 shares of B Stock for $1,000 per share. By its terms, a share of B Stock is reasonably expected to pay a $110 dividend in years 1 through 10 and a $30 dividend each year thereafter. If X liquidates, the holder of a share of B Stock is entitled to a preference equal to the share's issue price. Otherwise, the B Stock cannot be redeemed at either X's or the shareholder's option.

(ii) *Analysis.* When issued, the B Stock has a dividend rate that is reasonably expected to decline from an annual rate of 11 percent of its issue price to an annual rate of 3 percent of its issue price. Since the B Stock is structured to have a declining dividend rate, the B Stock is fast-pay stock, and the A Stock is benefited stock.

Example 2. Issued at a premium. (i) *Facts.* The facts are the same as in *Example 1* of this paragraph (e) except that a share of B Stock is reasonably expected to pay an annual $110 dividend as long as it is outstanding, and Corporation X has the right to redeem the B Stock for $400 a share at the end of year 10.

(ii) *Analysis.* The B Stock is structured so that the issue price of the B Stock ($1,000) exceeds (by more than a de minimis amount) the price at which the holder can be compelled to dispose of the stock ($400). Thus, the B Stock is fast-pay stock, and the A Stock is benefited stock.

Example 3. Planned section 302(d) redemptions. (i) *Facts.* Corporation L, a subchapter C corporation, issues 220 shares of common stock for $1,000 per share. No other stock is

authorized, but L can issue warrants entitling the holder to acquire L common stock for $3,000 per share until such time as L adopts a plan of liquidation. L can adopt a plan of liquidation if approved by 90 percent of its shareholders. Half of L's stock is purchased by Corporation M, and half by Organization N, which is tax exempt. At the time of purchase, M and N agree that for a period of ten years L will annually redeem (and N will tender) ten shares of stock in exchange for $12,100 and ten warrants. It is anticipated that, under sections 302 and 301, the annual payment to N will be a distribution of property that is a dividend.

(ii) *Analysis*. Considering all the facts and circumstances, including the agreement between M and N, L's redemption of N's stock is undertaken with a principal purpose of achieving the same economic and tax effect as a fast-pay arrangement. Thus, N's stock is fast-pay stock, M's stock is benefited stock, and the parties have entered into a fast-pay arrangement. Because L is neither a RIC nor a REIT, whether this fast-pay arrangement is recharacterized under paragraph (c) of this section depends on whether the Commissioner determines, under paragraph (c)(1)(ii) of this section, that a principal purpose for the structure of the fast-pay arrangement is the avoidance of any tax imposed by the Internal Revenue Code.

Example 4. Recharacterization illustrated. (i) *Facts*. On formation, REIT Y issues 100 shares of C Stock and 100 shares of D Stock for $1,000 per share. By its terms, a share of D Stock is reasonably expected to pay a $110 dividend in years 1 through 10 and a $30 dividend each year thereafter. In years 1 through 10, persons holding a majority of the D Stock must consent before Y may take any action that would result in Y liquidating or dissolving, merging or consolidating, losing its REIT status, or selling substantially all of its assets. Thereafter, Y may take these actions without consent so long as the D Stock shareholders receive $400 in exchange for their D Stock.

(ii) *Analysis*. When issued, the D Stock has a dividend rate that is reasonably expected to decline from an annual rate of 11 percent of its issue price to an annual rate of 3 percent of its issue price. In addition, the $1,000 issue price of a share of D Stock exceeds the price at which the shareholder can be compelled to dispose of the stock ($400). Thus, the D Stock is fast-pay stock, and the C Stock is benefited stock. Because Y is a REIT, the fast-pay arrangement is recharacterized under paragraph (c) of this section.

(iii) *Recharacterization*. The fast-pay arrangement is recharacterized as follows:

(A) Under paragraph (c)(2)(i) of this section, the C Stock shareholders are treated as issuing financing instruments to the D Stock shareholders in exchange for $100,000 ($1,000, the fair market value of each share of D Stock, multiplied by 100, the number of shares).

(B) Under paragraph (c)(2)(ii) of this section, the C Stock shareholders are treated as contributing $200,000 to Y (the $100,000 received for the financing instruments, plus the $100,000 actually paid for the C Stock) in exchange for the C Stock.

(C) Under paragraph (c)(2)(ii) of this section, each distribution with respect to the D Stock is treated as a distribution with respect to the C Stock.

(D) Under paragraph (c)(2)(iii) of this section, the C Stock shareholders are treated as making payments with respect to the financing instruments, and Y is treated as the paying agent of the financing instruments for the C Stock shareholders.

Example 5. Transfer of benefited stock illustrated. (i) *Facts*. The facts are the same as in Example 4 of this paragraph (e). Near the end of year 5, a person holding one share of C Stock sells it for $1,300. The buyer is unrelated to REIT Y or to any of the D Stock shareholders. At the time of the sale, the amount needed to terminate the seller's position in the financing instruments at fair market value is $747.

(ii) *Benefited shareholder's treatment on sale*. Under paragraph (c)(3)(iii)(A) of this section, the seller's amount realized is $2,047 ($1,300, the amount actually received, plus $747, the amount necessary to terminate the seller's position in the financing instruments at fair market value). The seller's gain on the sale of the common stock is $47 ($2,047, the amount realized, minus $2,000, the seller's basis in the common stock). The seller has no income or deduction with respect to terminating its position in the financing instruments.

(iii) *Buyer's treatment on purchase*. Under paragraph (c)(3)(iii)(A) of this section, the buyer's basis in the share of D Stock is $2,047 ($1,300, the amount actually paid, plus $747, the amount needed to terminate the seller's position in the financing instruments at fair market value). Under paragraph (c)(3)(iii)(B) of this section, simultaneous with the sale, the buyer is treated as issuing financing instruments to the fast-pay shareholders in exchange for $747, the amount necessary to terminate the seller's position in the financing instruments at fair market value.

Example 6. Fast-pay arrangement involving amounts accrued or paid in a taxable year ending before February 27, 1997. (i) *Facts*. Y is a calendar year taxpayer. In June 1996, Y acquires shares of REIT T benefited stock for $15,000. In December 1996, Y receives dividends of $100. Under the recharacterization rules of paragraph (c)(2) of this section, Y's 1996 income attributable to the benefited stock is $1,200, Y's 1996 deduction attributable to the financing instruments is $500, and Y's basis in the benefited stock is $25,000.

(ii) *Analysis.* Under paragraph (c)(3)(iv) of this section, Y's basis in the benefited stock is reduced by $600. This is the amount by which Y's 1996 income from the fast-pay arrangement as recharacterized under this section ($1,200 of income attributable to the benefited stock less $500 of deductions attributable to the financing instruments), exceeds Y's 1996 income from the fast-pay arrangement as not recharacterized under this section ($100 of income attributable to the benefited stock). Thus, in 1997 when the fast-pay arrangement is recharacterized, Y's basis in the benefited stock is $24,400.

(f) *Reporting requirement*—(1) *Filing requirements*—(i) *In general.* A corporation that has fast-pay stock outstanding at any time during the taxable year must attach the statement described in paragraph (f)(2) of this section to its federal income tax return for such taxable year. This paragraph (f)(1)(i) does not apply to a corporation described in paragraphs (f)(1)(ii), (iii), or (iv) of this section.

(ii) *Controlled foreign corporation.* In the case of a controlled foreign corporation (CFC), as defined in section 957, that has fast-pay stock outstanding at any time during its taxable year (during which time it was a CFC), each controlling United States shareholder (within the meaning of §1.964–1(c)(5)) must attach the statement described in paragraph (f)(2) of this section to the shareholder's Form 5471 for the CFC's taxable year. The provisions of section 6038 and the regulations under section 6038 apply to any statement required by this paragraph (f)(1)(ii).

(iii) *Foreign personal holding company.* In the case of a foreign personal holding company (FPHC), as defined in section 552, that has fast-pay stock outstanding at any time during its taxable year (during which time it was a FPHC), each United States citizen or resident who is an officer, director, or 10-percent shareholder (within the meaning of section 6035(e)(1)) of such FPHC must attach the statement described in paragraph (f)(2) of this section to his or her Form 5471 for the FPHC's taxable year. The provisions of sections 6035 and 6679 and the regulations under sections 6035 and 6679 apply to any statement required by this paragraph (f)(1)(iii).

(iv) *Passive foreign investment company.* In the case of a passive foreign investment company (PFIC), as defined in section 1297, that has fast-pay stock outstanding at any time during its taxable year (during which time it was a PFIC), each shareholder that has elected (under section 1295) to treat the PFIC as a qualified electing fund and knows or has reason to know that the PFIC has outstanding fast-pay stock must attach the statement described in paragraph (f)(2) of this section to the shareholder's Form 8621 for the PFIC's taxable year. Each shareholder owning 10 percent or more of the shares of the PFIC (by vote or value) is presumed to know that the PFIC has issued fast-pay stock. The provisions of sections 1295(a)(2) and 1298(f) and the regulations under those sections (including §1.1295–1T(f)(2)) apply to any statement required by this paragraph (f)(1)(iv).

(2) *Statement.* The statement required under this paragraph (f) must say, ''This fast-pay stock disclosure statement is required by §1.7701(l)–3(f) of the income tax regulations.'' The statement must also identify the corporation that has outstanding fast-pay stock and must contain the date on which the fast-pay stock was issued, the terms of the fast-pay stock, and (to the extent the filing person knows or has reason to know such information) the names and taxpayer identification numbers of the shareholders of any stock that is not traded on an established securities market (as described in §1.7704–1(b)).

(g) *Effective date*—(1) *In general.* Except as provided in paragraph (g)(4) of this section (relating to reporting requirements), this section applies to taxable years ending after February 26, 1997. Thus, all amounts accrued or paid during the first taxable year ending after February 26, 1997, are subject to this section.

(2) *Election to limit taxable income attributable to a recharacterized fast-pay arrangement for periods before April 1, 2000*—(i) *Limit.* For periods before April 1, 2000, provided the shareholder recharacterizes the fast-pay arrangement consistently for all such periods, a

shareholder may limit its taxable income attributable to a fast-pay arrangement recharacterized under paragraph (c) of this section to the taxable income that results if the fast-pay arrangement is recharacterized under either—

(A) Notice 97–21, 1997–1 C.B. 407, see § 601.601(d)(2) of this chapter; or

(B) Paragraph (c) of this section, computed by assuming the financing instruments are debt.

(ii) *Adjustment and statement.* A shareholder that limits its taxable income to the amount determined under paragraph (g)(2)(i)(A) of this section must include as an adjustment to taxable income the excess, if any, of the amount determined under paragraph (g)(2)(i)(B) of this section, over the amount determined under paragraph (g)(2)(i)(A) of this section. This adjustment to taxable income must be made in the shareholder's first taxable year that includes April 1, 2000. A shareholder to which this paragraph (g)(2)(ii) applies must include a statement in its books and records identifying each fast-pay arrangement for which an adjustment must be made and providing the amount of the adjustment for each such fast-pay arrangement.

(iii) *Examples.* The following examples illustrate the rules of this paragraph (g)(2). For purposes of these examples, assume that a shareholder may limit its taxable income under this paragraph (g)(2) for periods before January 1, 2000.

Example 1. Fast-pay arrangement recharacterized under Notice 97–21; REIT holds third-party debt. (i) *Facts.* (A) REIT Y is formed on January 1, 1997, at which time it issues 1,000 shares of fast-pay stock and 1,000 shares of benefited stock for $100 per share. Y and all of its shareholders are U.S. persons and have calendar taxable years. All shareholders of Y have elected to accrue market discount based on a constant interest rate, to include the market discount in income as it accrues, and to amortize bond premium.

(B) For years 1 through 5, the fast-pay stock has an annual dividend rate of $17 per share ($17,000 for all fast-pay stock); in later years, the fast-pay stock has an annual dividend rate of $1 per share ($1,000 for all fast-pay stock). At the end of year 5, and thereafter, a share of fast-pay stock can be acquired by Y in exchange for $50 ($50,000 for all fast-pay stock).

(C) On the day Y is formed, it acquires a five-year mortgage note (the note) issued by an unrelated third party for $200,000. The note provides for annual interest payments on December 31 of $18,000 (a coupon interest rate of 9.00 percent, compounded annually), and one payment of principal at the end of 5 years. The note can be prepaid, in whole or in part, at any time.

(ii) *Recharacterization under Notice 97–21*—(A) *In general.* One way to recharacterize the fast-pay arrangement under Notice 97–21 is to treat the fast-pay shareholders and the benefited shareholders as if they jointly purchased the note from the issuer with the understanding that over the five-year term of the note the benefited shareholders would use their share of the interest to buy (on a dollar-for-dollar basis) the fast-pay shareholders' portion of the note. The benefited shareholders' and the fast-pay shareholders' yearly taxable income under Notice 97–21 can then be calculated after determining their initial portions of the note and whether those initial portions are purchased at a discount or premium.

(B) *Determining initial portions of the debt instrument.* The fast-pay shareholders' and the benefited shareholders' initial portions of the note can be determined by comparing the present values of their expected cash flows. As a group, the fast-pay shareholders expect to receive cash flows of $135,000 (five annual payments of $17,000, plus a final payment of $50,000). As a group, the benefited shareholders expect to receive cash flows of $155,000 (five annual payments of $1,000, plus a final payment of $150,000). Using a discount rate equal to the yield to maturity (as determined under § 1.1272–1(b)(1)(i)) of the mortgage note (9.00 percent, compounded annually), the present value of the fast-pay shareholders' cash flows is $98,620, and the present value of the benefited shareholders' cash flows is $101,380. Thus, the fast-pay shareholders initially acquire 49 percent of the note at a $1,380 premium (that is, they paid $100,000 for $98,620 of principal in the note). The benefited shareholders initially acquire 51 percent of the note at a $1,380 discount (that is, they paid $100,000 for $101,380 of principal in the note). Under section 171, the fast-pay shareholders' premium is amortizable based on their yield in their initial portion of the note (8.574 percent, compounded annually). The benefited shareholders' discount accrues based on the yield in their initial portion of the note (9.353 percent, compounded annually).

(C) *Taxable income under Notice 97–21*—(*1*) *Fast-pay shareholders.* Under Notice 97–21, the fast-pay shareholders compute their taxable income attributable to the fast-pay arrangement for periods before January 1, 2000, by subtracting the amortizable premium from the accrued interest on the fast-pay shareholders' portion of the note. For purposes of

paragraph (g)(2)(i)(A) of this section, the fast-pay shareholders' taxable income as a group is as follows:

Taxable period	Interest income	Amortizable premium	Taxable income
1/1/97–12/31/97	$8,876	($302)	$8,574
1/1/98–12/31/98	8,145	(293)	7,852
1/1/99–12/31/99	7,348	(281)	7,067
Total	24,369	(876)	23,493

(*2*) *Benefited shareholders.* Under Notice 97–21, the benefited shareholders compute their taxable income attributable to the fast-pay arrangement for periods before January 1, 2000, by adding the accrued discount to the accrued interest on the benefited shareholders' portion of the note. For purposes of paragraph (g)(2)(i)(A) of this section, the benefited shareholders' taxable income as a group is as follows:

Taxable period	Interest income	Accrued discount	Taxable income
1/1/97–12/31/97	$9,124	$229	$9,353
1/1/98–12/31/98	9,855	251	10,106
1/1/99–12/31/99	10,652	274	10,926
Total	29,631	754	30,385

(iii) *Taxable income under the recharacterization of this section*—(A) *Fast-pay shareholders.* Under paragraphs (c) and (g)(2)(i)(B) of this section, the fast-pay shareholders' taxable income attributable to the fast-pay arrangement for periods before January 1, 2000, is the interest deemed paid on the financing instruments. For purposes of paragraph (g)(2)(i)(B) of this section, the fast-pay shareholders' taxable income as a group is as follows:

Taxable period	Taxable income
1/1/97–12/31/97	$8,574
1/1/98–12/31/98	7,852
1/1/99–12/31/99	7,067
Total	23,493

(B) *Benefited shareholders.* Under paragraphs (c) and (g)(2)(i)(B) of this section, the benefited shareholders compute their taxable income attributable to the fast-pay arrangement for periods before January 1, 2000, by subtracting the interest deemed paid on the financing instruments from the dividends actually and deemed paid on the benefited stock. For purposes of paragraph (g)(2)(i)(B) of this section, the benefited shareholders' taxable income as a group is as follows:

Taxable period	Dividends paid on benefited stock	Interest paid on financing instruments	Taxable income
1/1/97–12/31/97	$18,000	($8,574)	$9,426
1/1/98–12/31/98	18,000	(7,852)	10,148
1/1/99–12/31/99	18,000	(7,067)	10,933
Total	54,000	(23,493)	30,507

(iv) *Limit on taxable income under paragraph (g)(2)(i) of this section*—(A) *Fast-pay shareholders.* For periods before January 1, 2000, the fast-pay shareholders have the same taxable income under the recharacterization of Notice 97–21 and paragraph (g)(2)(i)(A) of this section ($23,493) as they have under the recharacterization of paragraphs (c) and (g)(2)(i)(B) of this section ($23,493). Thus, under paragraph (g)(2)(i) of this section, the fast-pay shareholders may limit their taxable income attributable to the fast-pay arrangement for periods before January 1, 2000, to $23,493 (as a group).

(B) *Benefited shareholders.* For periods before January 1, 2000, the benefited shareholders have taxable income attributable to the fast-pay arrangement of $30,385 under the recharacterization of Notice 97–21 and paragraph (g)(2)(i)(A) of this section, and taxable income of $30,507 under the recharacterization of paragraphs (c) and (g)(2)(i)(B) of this section. Thus, under paragraph (g)(2)(i) of this section, the benefited shareholders may limit their taxable income attributable to the fast-pay arrangement for periods before January 1, 2000, to either $30,385 (as a group) or $30,507 (as a group).

(v) *Adjustment to taxable income under paragraph (g)(2)(ii) of this section.* Under paragraph (g)(2)(ii) of this section, any benefited shareholder that limited its taxable income to the amount determined under paragraph (g)(2)(i)(A) of this section must include as an adjustment to taxable income the excess, if any, of the amount determined under paragraph (g)(2)(i)(B) of this section, over the amount determined under paragraph (g)(2)(i)(A) of this section. If all benefited shareholders limited their taxable income to the amount determined under paragraph (g)(2)(i)(A) of this section, then as a group their adjustment to income is $122 ($30,507, minus $30,385). Each shareholder must include its adjustment in income for the taxable year that includes January 1, 2000.

Example 2. REIT holds debt issued by a benefited shareholder. (i) *Facts.* The facts are the same as in *Example 1* of this paragraph (g)(2) except that corporation Z holds 800 shares (80 percent) of the benefited stock, and Z, instead of a third party, issues the mortgage note acquired by Y.

(ii) *Recharacterization under Notice 97–21.* Because Y holds a debt instrument issued by Z, the fast-pay arrangement is recharacterized under Notice 97–21 as an arrangement in

which Z issued one or more instruments directly to the fast-pay shareholders and the other benefited shareholders.

(A) *Fast-pay shareholders*. Consistent with this recharacterization, Z is treated as issuing a debt instrument to the fast-pay shareholders for $100,000. The debt instrument provides for five annual payments of $17,000 and an additional payment of $50,000 in year five. Thus, the debt instrument's yield to maturity is 8.574 percent per annum, compounded annually.

(B) *Benefited shareholders*. Z is also treated as issuing a debt instrument to the other benefited shareholders for $20,000 (200 shares multiplied by $100, or 20 percent of the $100,000 paid to Y by the benefited shareholders as a group). This debt instrument provides for five annual payments of $200 and an additional payment of $30,000 in year five. The debt instrument's yield to maturity is 9.304 percent per annum, compounded annually.

(C) *Issuer's interest expense under Notice 97–21*. Under Notice 97–21, Z's interest expense attributable to the fast-pay arrangement for periods before January 1, 2000, equals the interest accrued on the debt instrument held by the fast-pay shareholders, plus the interest accrued on the debt instrument held by the benefited shareholders other than Z. For purposes of paragraph (g)(2)(i)(A) of this section, Z's interest expense is as follows:

Taxable period	Accrued interest fast-pay shareholders	Accrued interest other benefited shareholders	Total interest expense
1/1/97–12/31/97	($8,574)	($1,861)	($10,435)
1/1/98–12/31/98	(7,852)	(2,015)	(9,867)
1/1/99–12/31/99	(7,067)	(2,184)	(9,251)
Total	(23,493)	(6,060)	(29,553)

(iii) *Recharacterization under this section*. Under paragraphs (c) and (g)(2)(i)(B) of this section, Z's taxable income attributable to the fast-pay arrangement for periods before January 1, 2000, equals Z's share of the dividends actually and deemed paid on the benefited stock (80 percent of the outstanding benefited stock), reduced by the sum of the interest accrued on the note held by Y and the interest accrued on the financing instruments deemed to have been issued by Z. For purposes of paragraph (g)(2)(i)(B) of this section, Z's taxable income is as follows:

Taxable period	Dividends benefited stock	Accrued interest on debt held by Y	Accrued interest financing instruments	Taxable expense
1/1/97–12/31/97	$14,400	($18,000)	($6,859)	($10,459)
1/1/98–12/31/98	14,400	(18,000)	(6,281)	(9,881)
1/1/99–12/31/99	14,400	(18,000)	(5,654)	(9,254)
Total	43,200	(54,000)	(18,794)	(29,594)

(iv) *Limit on taxable income under this paragraph (g)(2)*. For periods before January 1, 2000, Z has a taxable loss attributable to the fast-pay arrangement of $29,553 under the recharacterization of Notice 97–21 and paragraph (g)(2)(i)(A) of this section, and a taxable loss of $29,594 under the recharacterization of paragraphs (c) and (g)(2)(i)(B) of this section. Thus, under paragraph (g)(2)(i) of this section, Z may report a taxable loss attributable to the fast-pay arrangement for periods before January 1, 2000, of either $29,553 or $29,594. Under paragraph (g)(2)(ii), Z has no adjustment to its taxable income for its taxable year that includes January 1, 2000.

(3) *Rule to comply with this section*. To comply with this section for each taxable year in which it failed to do so, a taxpayer should file an amended return. For taxable years ending before Janaury 10, 2000, a taxpayer that has complied with Notice 97–21, 1997–1 C.B. 407 (see § 601.601(d)(2) of this chapter), for all such taxable years is considered to have complied with this section and limited its taxable income under paragraph (g)(2)(i)(A) of this section.

(4) *Reporting requirements*. The reporting requirements of paragraph (f) of this section apply to taxable years (of the person required to file the statement) ending after January 10, 2000.

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§ 1.7701(l)–4 Rules regarding inversion transactions.

(a) *Overview*. This section provides rules applicable to United States shareholders of controlled foreign corporations after certain inversion transactions. Paragraph (b) of this section

defines specified transactions and provides the scope of the rules in this section. Paragraph (c) of this section provides rules recharacterizing certain specified transactions. Paragraph (d) of this section sets forth rules governing transactions that affect the stock of an expatriated foreign subsidiary following a recharacterized specified transaction. Paragraph (e) of this section sets forth a rule concerning the treatment of amounts included in income as a result of a specified transaction as foreign personal holding company income. Paragraph (f) of this section sets forth definitions that apply for purposes of this section. Paragraph (g) of this section sets forth examples illustrating these rules. Paragraph (h) of this section provides applicability dates. See §1.367(b)–4(e) and (f) for rules concerning certain other exchanges after an inversion transaction. See also §1.956–2(a)(4), (c)(5), and (d)(2) for additional rules applicable to United States property held by controlled foreign corporations after an inversion transaction.

(b) *Specified transaction*—(1) *In general*. Except as provided in paragraph (b)(2) of this section, paragraph (c) of this section applies to specified transactions. For purposes of this section, a *specified transaction* is, with respect to an expatriated foreign subsidiary, a transaction in which stock of the expatriated foreign subsidiary is issued or transferred to a person that immediately before the issuance or transfer is a specified related person, provided the transaction occurs during the applicable period. However, a specified transaction does not include a transaction in which stock of the expatriated foreign subsidiary is deemed issued pursuant to section 304.

(2) *Exceptions*. Paragraph (c) of this section does not apply to a specified transaction—

(i) That is a fast-pay arrangement that is recharacterized under §1.7701(l)–3(c)(2);

(ii) In which the specified stock was transferred by a shareholder of the expatriated foreign subsidiary, and the shareholder either—

(A) Pursuant to §1.367(b)–4(e)(1), both—

(*1*) Included in gross income as a deemed dividend the section 1248 amount attributable to the specified stock; and

(*2*) After taking into account the increase in basis provided in §1.367(b)–2(e)(3)(ii) resulting from the deemed dividend (if any), recognized all realized gain with respect to the stock that otherwise would not have been recognized; or

(B) Included in gross income all of the gain recognized on the transfer of the specified stock (including gain included in gross income as a dividend pursuant to section 964(e), section 1248(a), or section 356(a)(2)); or

(iii) In which—

(A) Immediately after the specified transaction and any related transaction, the expatriated foreign subsidiary is a controlled foreign corporation;

(B) The post-transaction ownership percentage with respect to the expatriated foreign subsidiary is at least 90 percent of the pre-transaction ownership percentage with respect to the expatriated foreign subsidiary; and

(C) The post-transaction ownership percentage with respect to any lower-tier expatriated foreign subsidiary is at least 90 percent of the pre-transaction ownership percentage with respect to the lower-tier expatriated foreign subsidiary. See *Example 3* and *Example 4* of paragraph (g) of this section.

(c) *Recharacterization of specified transactions*—(1) *In general*. Except as otherwise provided, a specified transaction that is recharacterized under this paragraph (c) is recharacterized for all purposes of the Internal Revenue Code as of the date on which the specified transaction occurs, unless and until the rules of paragraph (d) of this section apply to alter or terminate the recharacterization. For purposes of paragraphs (c)(2) and (3) and (d) of this section, stock is considered owned by a section 958(a) U.S. shareholder if it is owned within the meaning of section 958(a) by the section 958(a) U.S. shareholder.

(2) *Specified transactions through stock issuance*. A specified transaction in which the specified stock is issued by an expatriated foreign subsidiary to a

specified related person is recharacterized as follows—

(i) The transferred property is treated as having been transferred by the specified related person to the persons that were section 958(a) U.S. shareholders of the expatriated foreign subsidiary immediately before the specified transaction, in proportion to the stock of the expatriated foreign subsidiary owned by each section 958(a) U.S. shareholder, in exchange for deemed instruments in the section 958(a) U.S. shareholders; and

(ii) The transferred property treated as transferred to the section 958(a) U.S. shareholders pursuant to paragraph (c)(2)(i) of this section is treated as having been contributed by the section 958(a) U.S. shareholders (through intermediate entities, if any, in exchange for equity in the intermediate entities) to the expatriated foreign subsidiary in exchange for deemed issued stock in the expatriated foreign subsidiary. See *Example 1*, *Example 2*, and *Example 6* of paragraph (g) of this section.

(3) *Specified transactions through shareholder transfer*. A specified transaction in which specified stock is transferred by shareholders of the expatriated foreign subsidiary to a specified related person is recharacterized as follows—

(i) The transferred property is treated as having been transferred by the specified related person to the persons that were section 958(a) U.S. shareholders of the expatriated foreign subsidiary immediately before the specified transaction, in proportion to the specified stock owned by each section 958(a) U.S. shareholder, in exchange for deemed instruments in the section 958(a) U.S. shareholders; and

(ii) To the extent the section 958(a) U.S. shareholders are not the transferring shareholders, the transferred property treated as transferred to the section 958(a) U.S. shareholders pursuant to paragraph (c)(3)(i) of this section is treated as having been contributed by the section 958(a) U.S. shareholders (through intermediate entities, if any, in exchange for equity in the intermediate entities) to the transferring shareholder in exchange for equity in the transferring shareholder. See *Example 5* of paragraph (g) of this section.

(4) *Treatment of deemed instruments following a recharacterized specified transaction*—(i) *Deemed instruments*. The deemed instruments described in paragraphs (c)(2) and (3) of this section have the same terms as the specified stock issued or transferred pursuant to the specified transaction (that is, the disregarded specified stock), other than the issuer. When a distribution is made with respect to the disregarded specified stock, matching seriatim distributions with respect to the deemed issued stock are treated as made by the expatriated foreign subsidiary, through intermediate entities, if any, to the section 958(a) U.S. shareholders, which, in turn, then are treated as making corresponding payments with respect to the deemed instruments to the specified related person.

(ii) *Paying agent*. The expatriated foreign subsidiary is treated as the paying agent of the section 958(a) U.S. shareholder with respect to the deemed instruments treated as issued by the section 958(a) U.S. shareholder to the specified related person.

(d) *Transactions affecting ownership of stock of an expatriated foreign subsidiary following a recharacterized specified transaction*—(1) *Transfers of stock other than specified stock*. When, after a specified transaction with respect to an expatriated foreign subsidiary that is recharacterized under paragraph (c)(2) or (3) of this section, stock of the expatriated foreign subsidiary, other than disregarded specified stock, that is owned by a section 958(a) U.S. shareholder is transferred, the deemed issued stock treated as owned by the section 958(a) U.S. shareholder as a result of the specified transaction continues to be treated as directly owned by the holder, as are the deemed instruments treated as issued to the specified related person as a result of the specified transaction.

(2) *Transactions in which the expatriated foreign subsidiary ceases to be a foreign related person*. When, after a specified transaction with respect to an expatriated foreign subsidiary that is recharacterized under paragraph (c)(2) or (3) of this section, there is a transaction that affects the ownership of the stock (including disregarded specified stock) of the expatriated foreign subsidiary, and, immediately after the

transaction, the expatriated foreign subsidiary is not a foreign related person (determined without taking into account the recharacterization under paragraph (c)(2) or (3) of this section), then, immediately before the transaction—

(i) Each section 958(a) U.S. shareholder that is treated as owning deemed issued stock in the expatriated foreign subsidiary under paragraph (c)(2) or (3) of this section is treated as transferring the deemed issued stock (after the deemed issued stock is deemed to be transferred to the section 958(a) U.S. shareholder through intermediate entities, if any, in redemption of equity deemed issued by the intermediate entities pursuant to paragraph (c)(2) or (3) of this section) to the specified related person that is treated as holding the deemed instruments issued by the section 958(a) U.S. shareholder under paragraph (c)(2) or (3) of this section, in redemption of the deemed instruments; and

(ii) The deemed issued stock that is treated as transferred pursuant to paragraph (d)(2)(i) of this section is treated as recapitalized into the disregarded specified stock actually held by the specified related person, which immediately thereafter is treated as specified stock owned by the specified related person for all purposes of the Internal Revenue Code. See *Example 8*, *Example 9*, and *Example 12* of paragraph (g) of this section.

(3) *Transfers in which disregarded specified stock ceases to be held by a foreign related person, specified related person, or expatriated entity*. When, after a specified transaction with respect to an expatriated foreign subsidiary that is recharacterized under paragraph (c)(2) or (3) of this section, there is a direct or indirect transfer of the disregarded specified stock in the expatriated foreign subsidiary, and immediately after the transfer, the expatriated foreign subsidiary is a foreign related person, then, to the extent that, as a result of the transfer, the disregarded specified stock is actually held (determined without taking into account the recharacterization under paragraph (c)(2) or (3) of this section) by a person that is not a foreign related person, a specified related person, or an expatriated entity, immediately before the transfer—

(i) Each section 958(a) U.S. shareholder that is treated as owning all or a portion of the deemed issued stock in the expatriated foreign subsidiary is treated as transferring the deemed issued stock that is allocable to the transferred disregarded specified stock that is out-of-group transferred disregarded specified stock (after the deemed issued stock is deemed to be transferred to the section 958(a) U.S. shareholder through intermediate entities, if any, in redemption of equity deemed issued by the intermediate entities pursuant to paragraph (c)(2) or (3) of this section) to the specified related person that is treated as holding the deemed instruments allocable to the out-of-group transferred disregarded specified stock, in redemption of the deemed instruments that are allocable to the out-of-group transferred disregarded specified stock; and

(ii) The deemed issued stock that is treated as transferred pursuant to paragraph (d)(3)(i) of this section is treated as recapitalized into the disregarded specified stock actually held by the specified related person, which immediately thereafter is treated as specified stock owned by the specified related person for all purposes of the Internal Revenue Code. See *Example 7* and *Example 11* of paragraph (g) of this section.

(4) *Certain direct transfers of disregarded specified stock to which unwind rules do not apply*. When a specified related person directly transfers the disregarded specified stock of the expatriated foreign subsidiary and paragraphs (d)(2) and (3) of this section do not apply with respect to the transfer, the specified related person is deemed to transfer the deemed instruments allocable to the transferred disregarded specified stock, whether it is in-group transferred disregarded specified stock or out-of-group transferred disregarded specified stock, to the transferee of the specified stock, in lieu of the disregarded specified stock, in exchange for the consideration provided by the transferee for the disregarded specified stock. See *Example 10* of paragraph (g) of this section.

(5) *Determination of deemed issued stock and deemed instruments allocable to transferred disregarded specified stock*—(i) *Out-of-group transfers of disregarded specified stock*. For purposes of paragraphs (d)(3) and (4) of this section, the portion of the deemed issued stock treated as owned, and of the deemed instruments treated as issued, by each section 958(a) U.S. shareholder as a result of the specified transaction that is allocable to out-of-group transferred disregarded specified stock is the amount that is proportionate to the ratio of the amount of the out-of-group transferred disregarded specified stock to the amount of disregarded specified stock of the expatriated foreign subsidiary that is actually held by the specified related person immediately before the transfer referred to in paragraph (d)(3) or (4) of this section as a result of the specified transaction.

(ii) *In-group direct transfers of disregarded specified stock*. For purposes of paragraph (d)(4) of this section, the portion of the deemed issued stock treated as owned by each section 958(a) U.S. shareholder as a result of the specified transaction that is allocable to in-group transferred disregarded specified stock is the amount that is proportionate to the ratio of the amount of the in-group transferred disregarded specified stock to the amount of disregarded specified stock of the expatriated foreign subsidiary that is actually held by the specified related person immediately before the transfer described in paragraph (d)(4) of this section as a result of the specified transaction.

(e) *Certain exception from foreign personal holding company income not available*. An amount included in the gross income of a controlled foreign corporation as a dividend with respect to stock transferred in a specified transaction does not qualify for the exception from foreign personal holding company income provided by section 954(c)(6) (to the extent in effect).

(f) *Definitions*. In addition to the definitions in §1.7874–12, the following definitions and special rules apply for purposes of this section:

(1) *Deemed instruments* mean, with respect to a specified transaction, instruments deemed issued by a section 958(a) U.S. shareholder in exchange for transferred property in the specified transaction.

(2) *Deemed issued stock* means, with respect to a specified transaction, stock of an expatriated foreign subsidiary deemed issued to a section 958(a) U.S. shareholder (or an intermediate entity) in the specified transaction.

(3) *Disregarded specified stock* means, with respect to a specified transaction, specified stock that is actually held by a specified related person but that is disregarded for all purposes of the Internal Revenue Code pursuant to paragraph (c)(2) or (3) of this section.

(4) *Indirect ownership*. To determine indirect ownership of the stock of a corporation for purposes of calculating a pre-transaction ownership percentage or post-transaction ownership percentage with respect to that corporation, the principles of section 958(a) apply without regard to whether an intermediate entity is foreign or domestic. For this purpose, stock of the corporation that is directly or indirectly (applying the principles of section 958(a) without regard to whether an intermediate entity is foreign or domestic) owned by a domestic corporation that is an expatriated entity is not treated as indirectly owned by a non-EFS foreign related person.

(5) *In-group transferred disregarded specified stock* means disregarded specified stock that is directly transferred to a foreign related person, a specified related person, or an expatriated entity.

(6) A *lower-tier expatriated foreign subsidiary* means an expatriated foreign subsidiary, stock of which is directly or indirectly owned by an expatriated foreign subsidiary.

(7) *Out-of-group transferred disregarded specified stock* means disregarded specified stock that, as a result of a transfer of disregarded specified stock, is actually held by a person that is not a foreign related person, a specified related person, or an expatriated entity.

(8) *Pre-transaction ownership percentage* means, with respect to a corporation, 100 percent less the percentage of stock (by value) in the corporation that, immediately before a specified

transaction and any related transaction, is owned, in the aggregate, directly or indirectly by non-EFS foreign related persons.

(9) *Post-transaction ownership percentage* means, with respect to a corporation, 100 percent less the percentage of stock (by value) in the corporation that, immediately after the specified transaction and any related transaction, is owned, in the aggregate, directly or indirectly by non-EFS foreign related persons.

(10) A *section 958(a) U.S. shareholder* means, with respect to an expatriated foreign subsidiary, a United States shareholder with respect to the expatriated foreign subsidiary that owns (within the meaning of section 958(a)) stock of the expatriated foreign subsidiary and that is an expatriated entity.

(11) *Specified stock* means the stock of the expatriated foreign subsidiary that is issued or transferred to a specified related person in a specified transaction.

(12) *Transferred property* means the property transferred by the specified related person in exchange for specified stock in a specified transaction.

(g) *Examples.* The following examples illustrate the regulations described in this section. Except as otherwise provided, FA, a foreign corporation, wholly owns DT, a domestic corporation, which, in turn, wholly owns FT, a foreign corporation that is a controlled foreign corporation. FA also wholly owns FS, a foreign corporation that is a controlled foreign corporation for its taxable year beginning January 1, 2017, but not for prior taxable years. FA acquired DT in an inversion transaction that was completed on January 1, 2015. Accordingly, DT is the domestic entity and a section 958(a) U.S. shareholder with respect to FT, FT is an expatriated foreign subsidiary, and FA and FS are non-EFS foreign related persons and specified related persons. All entities have a calendar year tax year for U.S. tax purposes.

Example 1. (i) *Facts.* On February 1, 2015, FA acquires $6x of FT stock, representing 60% of the total voting power and value of the stock of FT, from FT in a stock issuance, in exchange for $6x of cash.

(ii) *Analysis.* (A) Under paragraph (b) of this section, FA's acquisition of the FT specified stock from FT is a specified transaction because stock of an expatriated foreign subsidiary was issued to a specified related person (FA) during the applicable period. Furthermore, the exceptions to recharacterization in paragraph (b)(2) of this section do not apply to the transaction.

(B) FA's acquisition of the FT specified stock is recharacterized under paragraphs (c)(1) and (2) of this section as follows, with the result that FT continues to be a CFC even before its taxable year beginning January 1, 2017:

(*1*) DT is treated as having issued deemed instruments to FA in exchange for $6x of cash.

(*2*) DT is treated as having contributed the $6x of cash to FT in exchange for deemed issued stock of FT.

(C) Under paragraph (c)(4)(i) of this section, any distribution with respect to the FT specified stock issued to FA will be treated as a distribution to DT, which, in turn, will be treated as making a matching distribution with respect to the deemed instruments that DT is treated as having issued to FA. Under paragraph (c)(4)(ii) of this section, FT is treated as the paying agent of DT with respect to the deemed instruments issued by DT to FA.

Example 2. (i) *Facts.* DT owns stock of FT representing 60% of the total voting power and value of the stock of FT, and the remaining stock of FT, representing 40% of the total voting power and value, is owned by USP, a domestic corporation that is not an expatriated entity. On February 1, 2015, FA acquires $6x of FT stock, representing 60% of the total voting power and value of the stock of FT, from FT in a stock issuance, in exchange for $6x of cash.

(ii) *Analysis.* (A) Under paragraph (b) of this section, FA's acquisition of the FT specified stock from FT is a specified transaction because stock of an expatriated foreign subsidiary was issued to a specified related person (FA) during the applicable period. Furthermore, the exceptions to recharacterization in paragraph (b)(2) of this section do not apply to the transaction.

(B) FA's acquisition of the FT specified stock is recharacterized under paragraphs (c)(1) and (2) of this section as follows, with the result that FT continues to be a CFC even before its taxable year beginning January 1, 2017:

(*1*) DT is treated as having issued deemed instruments to FA in exchange for $6x of cash.

(*2*) DT is treated as having contributed the $6x of cash to FT in exchange for deemed issued stock of FT.

(*3*) DT is treated as owning $8.40x of the stock of FT, representing 84% of the total voting power and value of the stock of FT.

USP owns $1.60x of the stock of FT, representing 16% of the total voting power and value of the stock of FT.

(C) Under paragraph (c)(4)(i) of this section, any distribution with respect to the FT specified stock issued to FA will be treated as a distribution to DT, which, in turn, will be treated as making a matching distribution with respect to the deemed instruments that DT is treated as having issued to FA. Under paragraph (c)(4)(ii) of this section, FT is treated as the paying agent of DT with respect to the deemed instruments issued by DT to FA.

Example 3. (i) *Facts.* DT owns stock of FT representing 50% of the total voting power and value of the $8x of stock of FT outstanding, and the remaining stock of FT, representing 50% of the total voting power and value, is owned by USP, a domestic corporation that is not an expatriated entity. On April 30, 2016, FA and USP each simultaneously acquire $1x of FT stock from FT in a stock issuance, in exchange for $1x of cash each.

(ii) *Analysis.* (A) Under paragraph (b) of this section, FA's acquisition of the FT specified stock from FT is a specified transaction because stock of an expatriated foreign subsidiary was issued to a specified related person (FA) during the applicable period.

(B) However, the specified transaction is not recharacterized under paragraphs (c)(1) and (2) of this section because the exception in paragraph (b)(2)(iii) of this section applies. The exception applies because FT remains a controlled foreign corporation immediately after the specified transaction and any related transaction, and the post-transaction ownership percentage with respect to FT is 90% (90%/100%), or at least 90%, of the pre-transaction ownership percentage with respect to FT. The rule in paragraph (b)(2)(iii)(C) of this section does not apply because there is no lower-tier expatriated foreign subsidiary. Although FA (a non-EFS foreign related person) indirectly owns $4x of FT stock both immediately before and after the specified transaction and any related transaction, all of that stock is directly owned by DT (a domestic corporation), and as a result, under paragraph (f)(4) of this section, none of that stock is treated as directly or indirectly owned by FA for purposes of calculating the pre-transaction ownership percentage and the post-transaction ownership percentage with respect to FT. Accordingly, under paragraph (f)(8) of this section, the pre-transaction ownership percentage with respect to FT (100% less the percentage of stock (by value) in FT that, immediately before the specified transaction with respect to FT and any related transaction, is owned by non-EFS foreign related persons) is 100 (100% − 0%). Under paragraph (f)(9) of this section, the post-transaction ownership percentage with respect to FT (100% less the percentage of stock (by value) in FT that, immediately after the specified transaction with respect to FT and any related transaction, is owned by non-EFS foreign related persons) is 90 (100% − 10% ($1x/$10x)).

Example 4. (i) *Facts.* On February 1, 2015, FA acquires 60% of the FT stock owned by DT in exchange for $2.40x of cash in a fully taxable transaction. DT recognizes and includes in income all of the gain (including any gain treated as a deemed dividend pursuant to section 1248(a)) with respect to the FT stock transferred to FA.

(ii) *Analysis.* (A) Under paragraph (b) of this section, FA's acquisition of the FT specified stock is a specified transaction because stock of an expatriated foreign subsidiary was transferred to a specified related person (FA) during the applicable period.

(B) However, the specified transaction is not recharacterized under paragraphs (c)(1) and (c)(3) of this section because the exception in paragraph (b)(2)(ii) of this section applies. The exception applies because DT recognizes and includes in income all of the gain (including any gain treated as a deemed dividend pursuant to section 1248(a)) with respect to the FT specified stock transferred to FA.

Example 5. (i) *Facts.* On February 1, 2015, DT and FA organize FPRS, a foreign partnership, with nominal capital. DT transfers all of the stock of FT to FPRS in exchange for 40% of the capital and profits interests in the partnership. Furthermore, FA contributes property to FPRS in exchange for the other 60% of the capital and profits interests.

(ii) *Analysis.* (A) Under paragraph (b) of this section, DT's transfer of the FT specified stock is a specified transaction, because stock of an expatriated foreign subsidiary was transferred to a specified related person (FPRS) during the applicable period. The exceptions to recharacterization in paragraph (b)(2) of this section do not apply to the transaction.

(B) DT's transfer of the FT specified stock is recharacterized under paragraphs (c)(1) and (c)(3) of this section as follows, with the result that FT continues to be a CFC even before its taxable year beginning January 1, 2017:

(*1*) FPRS is treated as having issued 40% of its capital and profits interests to DT in exchange for deemed instruments treated as having been issued by DT.

(*2*) DT is treated as continuing to own all of the stock of FT, as well as the FPRS interests.

(C) Under paragraph (c)(4)(i) of this section, any distribution with respect to the FT specified stock transferred to FPRS will be treated as a distribution to DT, which, in turn, will be treated as making a matching distribution with respect to the deemed instruments that DT is treated as having issued to FPRS. Under paragraph (c)(4)(ii) of

this section, FT is treated as the paying agent of DT with respect to the deemed instruments issued by DT to FPRS.

Example 6. (i) *Facts*. DT wholly owns FT2, a foreign corporation that is a controlled foreign corporation. FT and FT2 each own 50% of the capital and profits interests in DPRS, a domestic partnership. DPRS wholly owns FT3, a foreign corporation that is a controlled foreign corporation. FT2 and FT3 are expatriated foreign subsidiaries. On April 30, 2016, FS acquires $9x of the stock of each of FT and FT2, representing 9% of the total voting power and value of the stock of FT and FT2, from FT and FT2, respectively, in a stock issuance, in exchange for cash of $9x each. Also on April 30, 2016, in a related transaction, FS acquires $9x of the stock of FT3, representing 9% of the total voting power and value of the stock of FT3, from FT3 in a stock issuance, in exchange for cash of $9x.

(ii) *Analysis*. (A) Under paragraph (b) of this section, the acquisitions by FS of the specified stock of each of FT, FT2, and FT3 from FT, FT2, and FT3 are specified transactions with respect to each of FT, FT2, and FT3, respectively, because stock of an expatriated foreign subsidiary was issued to a specified related person (FS) during the applicable period.

(B) If FS had acquired only stock of FT and FT2, and had not acquired stock of FT3 in a related transaction, the specified transactions resulting from the acquisitions with respect to FT and FT2 would not have been recharacterized under paragraphs (c)(1) and (2) of this section, because the exception from recharacterization in paragraph (b)(2)(iii) of this section would have applied. FT and FT2 remain controlled foreign corporations immediately after each specified transaction and any related transaction. Under paragraph (f)(9) of this section, the post-transaction ownership percentage with respect to each of FT, FT2, and FT3 (a lower-tier expatriated foreign subsidiary of FT and FT2) would have been 91% ((100% − 9%)/(100% − 0%)), or at least 90%, of the pre-transaction ownership percentage determined under paragraph (f)(8) of this section with respect to each of FT, FT2, and FT3 (100%).

(C) However, for the specified transactions with respect to FT, FT2, and FT3, the post-transaction ownership percentage determined under paragraph (f)(9) of this section with respect to FT3 (the lower-tier expatriated foreign subsidiary of FT and FT2), 100% less the percentage of stock (by value) in FT3 that, immediately after each of the specified transactions with respect to each of FT and FT2 and any related transaction, is owned by the non-EFS foreign related persons, is 82.81 (100% − (9% × 50% × 91%) − (9% × 50% × 91%) − 9%). Accordingly, the post-transaction ownership percentage with respect to FT3 is 82.81% (82.81/(100% − 0%)), which is less than 90%, of the pre-transaction ownership percentage determined under paragraph (f)(8) of this section with respect to FT3. Thus, the exception from recharacterization in paragraph (b)(2)(iii) of this section does not apply with respect to the specified transactions with respect to FT, FT2, or FT3.

(D) The specified transactions with respect to FT and FT2 are recharacterized under paragraphs (c)(1) and (2) of this section as follows:

(*1*) DT is treated as having issued 2 deemed instruments worth $9x each to FA in exchange for $18x ($9x + $9x) of cash.

(*2*) DT is treated as having contributed $9x of cash to each of FT and FT2 in exchange for deemed issued stock of FT and FT2.

(*3*) DT is treated as continuing to own all of the stock of FT and FT2.

(E) Under paragraph (c)(4)(i) of this section, any distribution with respect to the FT and FT2 specified stock issued to FS will be treated as a distribution to DT, which, in turn, will be treated as making a matching distribution with respect to the deemed instruments that DT is treated as having issued to FS. Under paragraph (c)(4)(ii) of this section, FT and FT2 are treated as the paying agents of DT with respect to the deemed instruments issued by DT to FS.

(F) The specified transaction with respect to FT3 is recharacterized under paragraphs (c)(1) and (2) of this section as follows:

(*1*) DPRS is treated as having issued a deemed instrument worth $9x to FA in exchange for $9x of cash.

(*2*) DPRS is treated as having contributed $9x of cash to FT3 in exchange for deemed issued stock of FT3.

(*3*) DPRS is treated as continuing to own all of the stock of FT3.

(G) Under paragraph (c)(4)(i) of this section, any distribution with respect to the FT3 specified stock issued to FS will be treated as a distribution to DPRS, which, in turn, will be treated as making a matching distribution with respect to the deemed instruments that DPRS is treated as having issued to FS. Under paragraph (c)(4)(ii) of this section, FT3 is treated as the paying agent of DPRS with respect to the deemed instrument issued by DPRS to FS.

Example 7. (i) *Facts*. The facts are the same as in *Example 1* of this paragraph (g). On April 30, 2016, FA transfers $4x of the FT disregarded specified stock that it acquired on February 1, 2015 to USP, a domestic corporation that is not an expatriated entity, in exchange for $4x of cash.

(ii) *Results*. After the transfer, FT remains a foreign related person. Therefore, paragraph (d)(2) of this section does not apply. However, the $4x of FT disregarded specified stock transferred to USP ceases to be held

by a foreign related person, a specified related person, or an expatriated entity (determined without taking into account paragraph (c)(2) or (3) of this section). Therefore, under paragraph (d)(3) of this section, immediately before the transfer of the disregarded specified stock, DT is deemed to transfer $4x ($6x × ($4x/$6x)) of the FT deemed issued stock that it is treated as owning to FA, the specified related person, in redemption of $4x ($6x × ($4x/$6x)) of the DT deemed instruments that FA is treated as owning, and the $4x of FT deemed issued stock deemed transferred to FA is deemed recapitalized into disregarded specified stock actually held by FA, which is thereafter treated as owned by FA for all purposes of the Code until the transfer to USP.

Example 8. (i) *Facts*. The facts are the same as in *Example 7* of this paragraph (g), except that on April 30, 2016, FA transfers all $6x of the FT disregarded specified stock to USP in exchange for $6x of cash.

(ii) *Results*. After the transfer, FT ceases to be a foreign related person (determined without taking into account paragraph (c)(2) or (3) of this section). Therefore, under paragraph (d)(2) of this section, immediately before the transfer of the disregarded specified stock, DT is deemed to transfer the $6x of FT deemed issued stock that it is treated as owning to FA, the specified related person, in redemption of the $6x of DT deemed instruments that FA is treated as owning, and the $6x of FT deemed issued stock deemed transferred to FA is deemed recapitalized into disregarded specified stock actually held by FA, which is thereafter treated as owned by FA for all purposes of the Code until the transfer to USP.

Example 9. (i) *Facts*. The facts are the same as in *Example 7* of this paragraph (g), except that on April 30, 2016, FA transfers $5.5x of the FT disregarded specified stock to USP in exchange for $5.5x of cash.

(ii) *Results*. After the transfer, FT ceases to be a foreign related person (determined without taking into account paragraph (c)(2) or (3) of this section). Therefore, under paragraph (d)(2) of this section, immediately before the transfer of the disregarded specified stock, DT is deemed to transfer the $6x of FT deemed issued stock that it is treated as owning to FA, the specified related person, in redemption of the $6x of DT deemed instruments that FA is treated as owning, and the $6x of FT deemed issued stock deemed transferred to FA is deemed recapitalized into disregarded specified stock actually held by FA, which is thereafter treated as owned by FA for all purposes of the Code and $5.5x of which is transferred to USP. The remaining $0.5x of the specified stock continues to be treated as owned by FA for all purposes of the Code.

Example 10. (i) *Facts*. The facts are the same as in *Example 1* of this paragraph (g). On April 30, 2016, FA transfers $5x of the FT disregarded specified stock that it acquired on February 1, 2015 to DS, a domestic corporation wholly owned by DT, in exchange for $5x of cash.

(ii) *Results*. After the transfer, FT remains a foreign related person because DS is wholly owned by DT. Therefore, paragraph (d)(2) of this section does not apply. Furthermore, the $5x of FT disregarded specified stock is not, as a result of the transfer, held by a person that is not a foreign related person, a specified related person, or an expatriated entity. Therefore, paragraph (d)(3) of this section does not apply. Because FA, a specified related person, directly transferred disregarded specified stock of FT in a transaction to which paragraphs (d)(2) and (3) of this section do not apply, under paragraph (d)(4) of this section, FA is treated as transferring the $5x of deemed instruments of DT allocable to the $5x of in-group transferred disregarded specified stock ($6x × ($5x/$6x)) to DS.

Example 11. (i) *Facts*. On February 1, 2015, FS acquires $6x of FT stock, representing 60% of the total voting power and value of the stock of FT, from FT in a stock issuance, in exchange for $6x of cash. The $6x of FT stock is specified stock, and the transaction is recharacterized under paragraph (c)(2) of this section. See *Example 1* of this paragraph (g). On April 30, 2016, FA transfers stock of FS representing 60% of the total voting power and value of the stock of FS to USP, a domestic corporation that is not an expatriated entity. As a result of the transfer, FS ceases to be a foreign related person.

(ii) *Results*. After the February 1, 2015 transfer, FT remains a foreign related person because the FT stock is acquired by FS, a foreign related person with respect to DT at that time. Therefore, paragraph (d)(2) of this section does not apply. However, after the April 30, 2016 transfer, because FS ceases to be a foreign related person, it ceases to be a specified related person. Furthermore, the $6x of disregarded specified stock held before the transaction continues to be held by FS after the transaction, and therefore is not held by a foreign related person, a specified related person, or an expatriated entity after the transaction. Accordingly, under paragraph (d)(3) of this section, immediately before the transfer of FS disregarded specified stock, DT is deemed to transfer $6x ($6x × ($6x/$6x)) of the FT deemed issued stock that it is treated as owning to FS, the specified related person, in redemption of $6x ($6x × ($6x/$6x)) of the DT deemed instruments that FS is treated as owning, and the $6x of FT deemed issued stock deemed transferred to FS is deemed recapitalized into disregarded specified stock actually held by FS, which thereafter is treated as owned by FS for all purposes of the Code, including after the transfer of 60% of the FS stock to USP.

Example 12. (i) *Facts.* The facts are the same as in *Example 1* of this paragraph (g). On April 30, 2016, FP, a foreign corporation that is not a foreign related person acquires $15x of FT stock, representing 60% of the total voting power and value of the stock of FT, from FT in a stock issuance, in exchange for $15x of cash.

(ii) *Results.* After the transaction, FT ceases to be a foreign related person. Therefore, under paragraph (d)(2) of this section, immediately before the issuance of FT stock to FP, DT is deemed to transfer the $6x of FT deemed issued stock that it is treated as owning to FA, the specified related person, in redemption of the $6x of DT deemed instruments that FA is treated as owning, and the $6x of FT deemed issued stock deemed transferred to FA is deemed recapitalized into disregarded specified stock actually held by FA, which thereafter is treated as owned by FA for all purposes of the Code.

Example 13. (i) *Facts.* The facts are the same as in *Example 1* of this paragraph (g). On April 30, 2016, FS acquires $4x of the FT stock owned by DT in exchange for $4x of cash in a fully taxable transaction. DT recognizes and includes in income all of the gain (including any gain treated as a deemed dividend pursuant to section 1248(a)) with respect to the FT stock transferred to FS.

(ii) *Results.* (A) The transfer of FT stock by DT to FS is a specified transaction, but it is not recharacterized under paragraphs (c)(1) and (3) of this section because the exception in paragraph (b)(2)(ii) of this section applies. See *Example 4* of this paragraph (g).

(B) After the transfer, FT remains a foreign related person. Therefore, paragraph (d)(2) of this section does not apply. The disregarded specified stock of FT is not, as a result of the transfer, held by a person that is not a foreign related person, a specified related person, or an expatriated entity. Therefore, paragraph (d)(3) of this section does not apply. There has been no direct transfer of specified stock. Therefore, paragraph (d)(4) of this section also does not apply.

(C) Under paragraph (d)(1) of this section, the $6x of deemed issued stock treated as owned by DT as a result of the specified transaction in which FA acquired FT stock continues to be treated as owned by DT, and the $6x of deemed instruments treated as issued by DT to FA continue to be treated as owned by FA.

(h) *Applicability date.* Except as otherwise provided in this paragraph (h), this section applies to specified transactions completed on or after September 22, 2014, but only if the inversion transaction was completed on or after September 22, 2014. Paragraph (b)(2)(ii)(A)(*2*) of this section applies to specified transactions completed on or after November 19, 2015, but only if the inversion transaction was completed on or after September 22, 2014. Paragraphs (d) and (f)(5), (7), and (10) of this section apply to specified transactions completed on or after April 4, 2016, but only if the inversion transaction was completed on or after September 22, 2014. For inversion transactions completed on or after September 22, 2014, however, taxpayers may elect to apply paragraphs (d) and (f)(5), (7), and (10) of this section to specified transactions completed before April 4, 2016. In addition, for inversion transactions completed on or after September 22, 2014, in lieu of applying paragraphs (d) and (f)(5) and (7) of this section to specified transactions completed on or after September 22, 2014, and before April 4, 2016, taxpayers may elect to apply the principles of §1.7701(l)–3(c)(3)(iii). Furthermore, for inversion transactions completed on or after September 22, 2014, in lieu of applying paragraph (f)(10) of this section to specified transactions completed on or after September 22, 2014, and before April 4, 2016, taxpayers may elect to define a section 958(a) U.S. shareholder as a United States shareholder with respect to the expatriated foreign subsidiary that owns (within the meaning of section 958(a)) stock in the expatriated foreign subsidiary, but only if such United States shareholder is related (within the meaning of section 267(b) or 707(b)(1)) to the specified related person or is under the same common control (within the meaning of section 482) as the specified related person.

[T.D. 9834, 83 FR 32538, July 12, 2018]

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[T.D. 9287, 71 FR 53970, Sept. 13, 2006]

§ 1.7702–2 Attained age of the insured under a life insurance contract.

(a) *In general.* This section provides guidance on determining the attained age of an insured under a contract that is a life insurance contract under the applicable law, for purposes of determining the guideline level premium of the contract under section 7702(c)(4), applying the cash value corridor of section 7702(d) or applying the computational rules of section 7702(e), as applicable.

(b) *Contract insuring a single life.* (1) If a contract insures the life of a single individual, either of the following two ages may be treated as the attained age of the insured with respect to that contract—

(i) The insured's age determined by reference to the individual's actual birthday as of the date of determination (actual age); or

(ii) The insured's age determined by reference to contract anniversary (rather than the individual's actual birthday), so long as the age assumed under the contract (contract age) is within 12 months of the actual age as of that date.

(2) Once determined under paragraph (b)(1) of this section, the attained age with respect to an individual insured under a contract changes annually. Moreover, the same attained age must be used for purposes of applying sections 7702(c)(4), 7702(d), and 7702(e), as applicable.

(c) *Contract insuring multiple lives on a last-to-die basis*—(1) *In general.* Except as provided in paragraph (c)(2) of this section, if a contract insures the lives of more than one individual on a last-to-die basis, the attained age of the insured is determined by applying paragraph (b) of this section as if the youngest individual were the only insured under the contract for purposes of sections 7702(c)(4), 7702(d), and 7702(e), as applicable.

(2) *Modifications to cash value and future mortality charges upon the death of insured.* If both the cash value and future mortality charges under a contract change by reason of the death of one or more insureds to no longer take into account the attained age of the deceased insured or insureds, the youngest surviving insured shall thereafter be treated as the only insured under the contract.

(d) *Contract insuring multiple lives on a first-to-die basis.* If a contract insures

the lives of more than one individual on a first-to-die basis, the attained age of the insured is determined by applying paragraph (b) of this section as if the oldest individual were the only insured under the contract for purposes of sections 7702(c)(4), 7702(d), and 7702(e), as applicable.

(e) *Examples.* The following examples illustrate the determination of the attained age of the insured for purposes of sections 7702(c)(4), 7702(d), and 7702(e), as applicable. The examples are as follows:

Example 1. (i) X was born on May 1, 1947. X became 60 years old on May 1, 2007. On January 1, 2008, X purchases from IC a contract insuring X's life. January 1 is the contract anniversary date for all future years. IC determines X's annual premiums on an age-last-birthday basis. Based on the method used by IC to determine age, X has an attained age of 60 for the first contract year, 61 for the second contract year, and so on.

(ii) Section 1.7702–2(b)(1) permits the determination of attained age under either of two alternative approaches. Section 1.7702–2(b)(1)(i) provides that, if a contract insures the life of a single insured individual, the attained age may be determined by reference to the individual's actual birthday as of the date of determination. Under this provision, X has an attained age of 60 for the first contract year, 61 for the second contract year, and so on. Alternatively, §1.7702–2(b)(1)(ii) provides that the insured's age may be determined by reference to contract anniversary (rather than the individual's actual birthday), so long as the age assumed under the contract is within 12 months of the actual age as of that date. If IC determines X's attained age under §1.7702–2(b)(1)(ii), X likewise has an attained age of 60 for the first contract year, 61 for the second contract year, and so on. Whichever provision IC uses to determine X's attained age must be used consistently from year to year for purposes of sections 7702(c)(4), 7702(d), and 7702(e), as applicable.

Example 2. (i) The facts are the same as in *Example 1* except that, under the contract, X's annual premiums are determined on an age-nearest-birthday basis. X's nearest birthday to January 1, 2008, is May 1, 2008, when X will become 61 years old. Based on the method used by IC to determine age, X has an attained age of 61 for the first contract year, 62 for the second contract year, and so on.

(ii) Section 1.7702–2(b)(1) permits the determination of attained age under either of two alternative approaches. Section 1.7702–2(b)(1)(i) provides that, if a contract insures the life of a single insured individual, the attained age may be determined by reference to the individual's actual birthday as of the date of determination. Under this provision, X has an attained age of 60 for the first contract year, 61 for the second contract year, and so on. Alternatively, §1.7702–2(b)(1)(ii) provides that the insured's age may be determined by reference to contract anniversary (rather than the individual's actual birthday), so long as the age assumed under the contract is within 12 months of the actual age as of that date. If IC determines X's attained age under §1.7702–2(b)(1)(ii), X has an attained age of 61 for the first contract year, 62 for the second contract year, and so on. Whichever provision IC uses to determine X's attained age must be used consistently from year to year for purposes of sections 7702(c)(4), 7702(d), and 7702(e), as applicable.

Example 3. (i) The facts are the same as in *Example 1* except that the face amount of the contract is increased on May 15, 2011. During the contract year beginning January 1, 2011, the age assumed under the contract on an age-last-birthday basis is 63 years. However, X has an actual age of 64 as of the date the face amount of the contract is increased.

(ii) Section 1.7702–2(b)(1)(ii) provides that the insured's age may be determined by reference to contract anniversary (rather than the individual's actual birthday), so long as the age assumed under the contract is within 12 months of the actual age. Section 1.7702–2(b)(2) provides that, once determined under paragraph (b)(1) of this section, the attained age with respect to an individual insured under a contract changes annually. Accordingly, X continues to be 63 years old throughout the contract year beginning January 1, 2011, for purposes of sections 7702(c)(4), 7702(d), and 7702(e), as applicable.

Example 4. (i) The facts are the same as in *Example 1* except that in addition to X (born in 1947), the insurance contract also insures the life of Y, born on September 1, 1942. The death benefit will be paid when the second of the two insureds dies.

(ii) Section 1.7702–2(c)(1) provides that if a life insurance contract insures the lives of more than one individual on a last-to-die basis, the attained age of the insured is determined by applying §1.7702–2(b) as if the youngest individual were the only insured under the contract. Because X is younger than Y, the attained age of X must be used for purposes of sections 7702(c)(4), 7702(d), and 7702(e), as applicable.

Example 5. (i) The facts are the same as *Example 4* except that X (the younger of the two insureds) dies in 2012. After X's death, both the cash value and mortality charges of the life insurance contract are adjusted to take into account only the life of Y.

(ii) Section 1.7702–2(c)(1) provides that if a life insurance contract insures the lives of more than one individual on a last-to-die

basis, the attained age of the insured is determined by applying §1.7702–2(b) as if the youngest individual were the only insured under the contract. Paragraph (c)(2) of this section provides that if both the cash value and future mortality charges under a contract change by reason of the death of an insured to no longer take into account the attained age of the deceased insured, the youngest surviving insured is thereafter treated as the only insured under the contract. Because both the cash value and mortality charges are adjusted after X's death to take into account only the life of Y, only the attained age of Y is taken into account after X's death for purposes of sections 7702(c)(4), 7702(d), and 7702(e), as applicable.

Example 6. (i) The facts are the same as *Example 1* except that in addition to X (born in 1947), the insurance contract also insures the life of Z, born on September 1, 1952. The death benefit will be paid when the first of the two insureds dies.

(ii) Section 1.7702–2(d) provides that if a life insurance contract insures the lives of more than one individual on a first-to-die basis, the attained age of the insured is determined by applying §1.7702–2(b) as if the oldest individual were the only insured under the contract. Because X is older than Z, the attained age of X must be used for purposes of sections 7702(c)(4), 7702(d), and 7702(e), as applicable.

(f) *Effective dates*—(1) *In general*. Except as provided in paragraph (f)(2) of this section, these regulations apply to all life insurance contracts that are either—

(i) Issued after December 31, 2008; or

(ii) Issued on or after October 1, 2007 and based upon the 2001 CSO tables.

(2) *Contracts issued before the general effective date*. Pursuant to section 7805(b)(7), a taxpayer may apply these regulations retroactively for contracts issued before October 1, 2007, provided that the taxpayer does not later determine qualification of those contracts in a manner that is inconsistent with these regulations.

[T.D. 9287, 71 FR 53970, Sept. 13, 2006]

§ 1.7702B–1 Consumer protection provisions.

(a) *In general*. Under sections 7702B(b)(1)(F), 7702B(g), and 4980C, qualified long-term care insurance contracts and issuers of those contracts are required to satisfy certain provisions of the Long-Term Care Insurance Model Act (Model Act) and Long-Term Care Insurance Model Regulation (Model Regulation) promulgated by the National Association of Insurance Commissioners (NAIC), as adopted as of January 1993. The requirements for qualified long-term care insurance contracts under section 7702B(b)(1)(F) and (g) relate to guaranteed renewal or noncancellability, prohibitions on limitations and exclusions, extension of benefits, continuation or conversion of coverage, discontinuance and replacement of policies, unintentional lapse, disclosure, prohibitions against post-claims underwriting, minimum standards, inflation protection, prohibitions against pre-existing conditions exclusions and probationary periods, and prior hospitalization. The requirements for qualified long-term care insurance contracts under section 4980C relate to application forms and replacement coverage, reporting requirements, filing requirements for marketing, standards for marketing, appropriateness of recommended purchase, standard format outline of coverage, delivery of a shopper's guide, right to return, outline of coverage, certificates under group plans, policy summary, monthly reports on accelerated death benefits, and incontestability period.

(b) *Coordination with State requirements*—(1) *Contracts issued in a State that imposes more stringent requirements*. If a State imposes a requirement that is more stringent than the analogous requirement imposed by section 7702B(g) or 4980C, then, under section 4980C(f), compliance with the more stringent requirement of State law is considered compliance with the parallel requirement of section 7702B(g) or 4980C. The principles of paragraph (b)(3) of this section apply to any case in which a State imposes a requirement that is more stringent than the analogous requirement imposed by section 7702B(g) or 4980C (as described in this paragraph (b)(1)), but in which there has been a failure to comply with that State requirement.

(2) *Contracts issued in a State that has adopted the model provisions*. If a State imposes a requirement that is the same as the parallel requirement imposed by section 7702B(g) or 4980C, compliance with that requirement of State law is considered compliance with the parallel requirement of section 7702B(g) or

4980C, and failure to comply with that requirement of State law is considered failure to comply with the parallel requirement of section 7702B(g) or 4980C.

(3) *Contracts issued in a State that has not adopted the model provisions or more stringent requirements.* If a State has not adopted the Model Act, the Model Regulation, or a requirement that is the same as or more stringent than the analogous requirement imposed by section 7702B(g) or 4980C, then the language, caption, format, and content requirements imposed by sections 7702B(g) and 4980C with respect to contracts, applications, outlines of coverage, policy summaries, and notices will be considered satisfied for a contract subject to the law of that State if the language, caption, format, and content are substantially similar to those required under the parallel provision of the Model Act or Model Regulation. Only nonsubstantive deviations are permitted in order for language, caption, format, and content to be considered substantially similar to the requirements of the Model Act or Model Regulation.

(c) *Effective date.* This section applies with respect to contracts issued after December 10, 1999.

[T.D. 8792, 63 FR 68186, Dec. 10, 1998]

§ 1.7702B–2 Special rules for pre-1997 long-term care insurance contracts.

(a) *Scope.* The definitions and special provisions of this section apply solely for purposes of determining whether an insurance contract (other than a qualified long-term care insurance contract described in section 7702B(b) and any regulations issued thereunder) is treated as a qualified long-term care insurance contract for purposes of the Internal Revenue Code under section 321(f)(2) of the Health Insurance Portability and Accountability Act of 1996 (Public Law 104–191).

(b) *Pre-1997 long-term care insurance contracts*—(1) *In general.* A pre-1997 long-term care insurance contract is treated as a qualified long-term care insurance contract, regardless of whether the contract satisfies section 7702B(b) and any regulations issued thereunder.

(2) *Pre-1997 long-term care insurance contract defined.* A pre-1997 long-term care insurance contract is any insurance contract with an issue date before January 1, 1997, that met the long-term care insurance requirements of the State in which the contract was sitused on the issue date. For this purpose, the long-term care insurance requirements of the State are the State laws (including statutory and administrative law) that are intended to regulate insurance coverage that constitutes ''long-term care insurance'' (as defined in section 4 of the National Association of Insurance Commissioners (NAIC) Long-Term Care Insurance Model Act, as in effect on August 21, 1996), regardless of the terminology used by the State in describing the insurance coverage.

(3) *Issue date of a contract*—(i) *In general.* Except as otherwise provided in this paragraph (b)(3), the issue date of a contract is the issue date assigned to the contract by the insurance company. In no event is the issue date earlier than the date the policyholder submitted a signed application for coverage to the insurance company. If the period between the date the signed application is submitted to the insurance company and the date coverage under which the contract actually becomes effective is substantially longer than under the insurance company's usual business practice, then the issue date is the later of the date coverage under which the contract becomes effective or the issue date assigned to the contract by the insurance company. A policyholder's right to return a contract within a free-look period following delivery for a full refund of any premiums paid is not taken into account in determining the contract's issue date.

(ii) *Special rule for group contracts.* The issue date of a group contract (including any certificate issued thereunder) is the date on which coverage under the group contract becomes effective.

(iii) *Exchange of contract or certain changes in a contract treated as a new issuance.* For purposes of this paragraph (b)(3)—

(A) A contract issued in exchange for an existing contract after December 31, 1996, is considered a contract issued after that date;

(B) Any change described in paragraph (b)(4) of this section is treated as the issuance of a new contract with an issue date no earlier than the date the change goes into effect; and

(C) If a change described in paragraph (b)(4) of this section occurs with regard to one or more, but fewer than all, of the certificates evidencing coverage under a group contract, then the insurance coverage under the changed certificates is treated as coverage under a newly issued group contract (and the insurance coverage provided by any unchanged certificate continues to be treated as coverage under the original group contract).

(4) *Changes treated as the issuance of a new contract*—(i) *In general.* For purposes of paragraph (b)(3) of this section, except as provided in paragraph (b)(4)(ii) of this section, the following changes are treated as the issuance of a new contract—

(A) A change in the terms of a contract that alters the amount or timing of an item payable by either the policyholder (or certificate holder), the insured, or the insurance company;

(B) A substitution of the insured under an individual contract; or

(C) A change (other than an immaterial change) in the contractual terms, or in the plan under which the contract was issued, relating to eligibility for membership in the group covered under a group contract.

(ii) *Exceptions.* For purposes of this paragraph (b)(4), the following changes are not treated as the issuance of a new contract—

(A) A policyholder's exercise of any right provided under the terms of the contract as in effect on December 31, 1996, or a right required by applicable State law to be provided to the policyholder;

(B) A change in the mode of premium payment (for example, a change from monthly to quarterly premiums);

(C) In the case of a policy that is guaranteed renewable or noncancellable, a classwide increase or decrease in premiums;

(D) A reduction in premiums due to the purchase of a long-term care insurance contract by a family member of the policyholder;

(E) A reduction in coverage (with a corresponding reduction in premiums) made at the request of a policyholder;

(F) A reduction in premiums as a result of extending to an individual policyholder a discount applicable to similar categories of individuals pursuant to a premium rate structure that was in effect on December 31, 1996, for the issuer's pre-1997 long-term care insurance contracts of the same type;

(G) The addition, without an increase in premiums, of alternative forms of benefits that may be selected by the policyholder;

(H) The addition of a rider (including any similarly identifiable amendment) to a pre-1997 long-term care insurance contract in any case in which the rider, if issued as a separate contract of insurance, would itself be a qualified long-term care insurance contract under section 7702B and any regulations issued thereunder (including the consumer protection provisions in section 7702B(g) to the extent applicable to the addition of a rider);

(I) The deletion of a rider or provision of a contract that prohibited coordination of benefits with Medicare (often referred to as an HHS (Health and Human Services) rider);

(J) The effectuation of a continuation or conversion of coverage right that is provided under a pre-1997 group contract and that, in accordance with the terms of the contract as in effect on December 31, 1996, provides for coverage under an individual contract following an individual's ineligibility for continued coverage under the group contract; and

(K) The substitution of one insurer for another insurer in an assumption reinsurance transaction.

(5) *Examples.* The following examples illustrate the principles of this paragraph (b):

Example 1. (i) On December 3, 1996, A, an individual, submits a signed application to an insurance company to purchase a nursing home contract that meets the long-term care insurance requirements of the State in which the contract is sitused. The insurance company decides on December 20, 1996, that it will issue the contract, and assigns December 20, 1996, as the issue date for the contract. Under the terms of the contract, A's insurance coverage becomes effective on January 1, 1997. The company delivers the

contract to A on January 3, 1997. A has the right to return the contract within 15 days following delivery for a refund of all premiums paid.

(ii) Under paragraph (b)(3)(i) of this section, the issue date of the contract is December 20, 1996. Thus, the contract is a pre-1997 long-term care insurance contract that is treated as a qualified long-term care insurance contract.

Example 2. (i) The facts are the same as in *Example 1,* except that the insurance coverage under the contract does not become effective until March 1, 1997. Under the insurance company's usual business practice, the period between the date of the application and the date the contract becomes effective is 30 days or less.

(ii) Under paragraph (b)(3)(i) of this section, the issue date of the contract is March 1, 1997. Thus, the contract is not a pre-1997 long-term care insurance contract, and, accordingly, the contract must meet the requirements of section 7702B(b) and any regulations issued thereunder to be a qualified long-term care insurance contract.

Example 3. (i) B, an individual, is the policyholder under a long-term care insurance contract purchased in 1995. On June 15, 2000, the insurance coverage and premiums under the contract are increased by agreement between B and the insurance company.

(ii) Under paragraph (b)(4)(i)(A) of this section, a change in the terms of a contract that alters the amount or timing of an item payable by the policyholder or the insurance company is treated as the issuance of a new contract. Thus, B's coverage is treated as coverage under a contract issued on June 15, 2000, and, accordingly, the contract must meet the requirements of section 7702B(b) and any regulations issued thereunder in order to be a qualified long-term care insurance contract.

Example 4. (i) C, an individual, is the policyholder under a long-term care insurance contract purchased in 1994. At that time and through December 31, 1996, the contract met the long-term care insurance requirements of the State in which the contract was sitused. In 1996, the policy was amended to add a provision requiring the policyholder to be offered the right to increase dollar limits for inflation every three years (without the policyholder being required to pass a physical or satisfy any other underwriting requirements). During 2002, C elects to increase the amount of insurance coverage (with a resulting premium increase) pursuant to the inflation provision.

(ii) Under paragraph (b)(4)(ii)(A) of this section, an increase in the amount of insurance coverage at the election of the policyholder (without the insurance company's consent and without underwriting or other limitations on the policyholder's rights) pursuant to a pre-1997 inflation provision is not treated as the issuance of a new contract. Thus, C's contract continues to be a pre-1997 long-term care insurance contract that is treated as a qualified long-term care insurance contract.

(c) *Effective date.* This section is applicable January 1, 1999.

[T.D. 8792, 63 FR 68187, Dec. 10, 1998]

§ 1.7703–1 Determination of marital status.

(a) *General rule.* The determination of whether an individual is married shall be made as of the close of his taxable year unless his spouse dies during his taxable year, in which case such determination shall be made as of the time of such death; and, except as provided in paragraph (b) of this section, an individual shall be considered as married even though living apart from his spouse unless legally separated under a decree of divorce or separate maintenance. The provisions of this paragraph may be illustrated by the following examples:

Example 1. Taxpayer A and his wife B both make their returns on a calendar year basis. In July 1954, they enter into a separation agreement and thereafter live apart, but no decree of divorce or separate maintenance is issued until March 1955. If A itemizes and claims his actual deductions on his return for the calendar year 1954, B may not elect the standard deduction on her return since B is considered as married to A (although permanently separated by agreement) on the last day of 1954.

Example 2. Taxpayer A makes his returns on the basis of a fiscal year ending June 30. His wife B makes her returns on the calendar year basis. A died in October 1954. In such case, since A and B were married as of the date of death, B may not elect the standard deduction for the calendar year 1954 if the income of A for the short taxable year ending with the date of his death is determined without regard to the standard deduction.

(b) *Certain married individuals living apart.* (1) For purposes of Part IV of Subchapter B of Chapter 1 of the Code, an individual is not considered as married for taxable years beginning after December 31, 1969, if (i) such individual is married (within the meaning of paragraph (a) of this section) but files a separate return; (ii) such individual maintains as his home a household which constitutes for more than one-half of the taxable year the principal

place of abode of a dependent (*a*) who (within the meaning of section 152 and the regulations thereunder) is a son, stepson, daughter, or stepdaughter of the individual, and (*b*) with respect to whom such individual is entitled to a deduction for the taxable year under section 151; (iii) such individual furnishes over half of the cost of maintaining such household during the taxable year; and (iv) during the entire taxable year such individual's spouse is not a member of such household.

(2) For purposes of subparagraph (1)(ii)(*a*) of this paragraph, a legally adopted son or daughter of an individual, a child (described in paragraph (c)(2) of §1.152–2) who is a member of an individual's household if placed with such individual by an authorized placement agency (as defined in paragraph (c)(2) of §1.152–2) for legal adoption by such individual, or a foster child (described in paragraph (c)(4) of §1.152–2) of an individual if such child satisfies the requirements of section 152(a)(9) of the Code and paragraph (b) of §1.152–1 with respect to such individual, shall be treated as a son or daughter of such individual by blood.

(3) For purposes of subparagraph (1)(ii) of this paragraph, the household must actually constitute the home of the individual for his taxable year. However, a physical change in the location of such home will not prevent an individual from qualifying for the treatment provided in subparagraph (1) of this paragraph. It is not sufficient that the individual maintain the household without being its occupant. The individual and the dependent described in subparagraph (1)(ii)(*a*) of this paragraph must occupy the household for more than one-half of the taxable year of the individual. However, the fact that such dependent is born or dies within the taxable year will not prevent an individual from qualifying for such treatment if the household constitutes the principal place of abode of such dependent for the remaining or preceding part of such taxable year. The individual and such dependent will be considered as occupying the household during temporary absences from the household due to special circumstances. A nonpermanent failure to occupy the common abode by reason of illness, education, business, vacation, military service, or a custody agreement under which a child or stepchild is absent for less than 6 months in the taxable year of the taxpayer, shall be considered a temporary absence due to special circumstances. Such absence will not prevent an individual from qualifying for the treatment provided in subparagraph (1) of this paragraph if (i) it is reasonable to assume that such individual or the dependent will return to the household and (ii) such individual continues to maintain such household or a substantially equivalent household in anticipation of such return.

(4) An individual shall be considered as maintaining a household only if he pays more than one-half of the cost thereof for his taxable year. The cost of maintaining a household shall be the expenses incurred for the mutual benefit of the occupants thereof by reason of its operation as the principal place of abode of such occupants for such taxable year. The cost of maintaining a household shall not include expenses otherwise incurred. The expenses of maintaining a household include property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance, and food consumed on the premises. Such expenses do not include the cost of clothing, education, medical treatment, vacations, life insurance, and transportation. In addition, the cost of maintaining a household shall not include any amount which represents the value of services rendered in the household by the taxpayer or by a dependent described in subparagraph (1)(ii)(*a*) of this paragraph.

(5) For purposes of subparagraph (1)(iv) of this paragraph, an individual's spouse is not a member of the household during a taxable year if such household does not constitute such spouse's place of abode at any time during such year. An individual's spouse will be considered to be a member of the household during temporary absences from the household due to special circumstances. A nonpermanent failure to occupy such household as his abode by reason of illness, education, business, vacation, or military

service shall be considered a mere temporary absence due to special circumstances.

(6) The provisions of this paragraph may be illustrated by the following example:

Example. Taxpayer A, married to B at the close of the calendar year 1971, his taxable year, is living apart from B, but A is not legally separated from B under a decree of divorce or separate maintenance. A maintains a household as his home which is for 7 months of 1971 the principal place of abode of C, his son, with respect to whom A is entitled to a deduction under section 151. A pays for more than one-half the cost of maintaining that household. At no time during 1971 was B a member of the household occupied by A and C. A files a separate return for 1971. Under these circumstances, A is considered as not married under section 143(b) for purposes of the standard deduction. Even though A is married and files a separate return A may claim for 1971 as his standard deduction the larger of the low income allowance up to a maximum of $1,050 consisting of both the basic allowance and additional allowance (rather than the basic allowance only subject to the $500 limitation applicable to a separate return of a married individual) or the percentage standard deduction subject to the $1,500 limitation (rather than the $750 limitation applicable to a separate return of a married individual). See §1.141–1. For purposes of the provisions of part IV of subchapter B of chapter 1 of the Code and the regulations thereunder, A is treated as unmarried.

[T.D. 7123, 36 FR 11086, June 9, 1971. Redesignated by T.D. 8712, 62 FR 2283, Jan. 16, 1997]

§ 1.7704–1 Publicly traded partnerships.

(a) *In general*—(1) *Publicly traded partnership.* A domestic or foreign partnership is a publicly traded partnership for purposes of section 7704(b) and this section if—

(i) Interests in the partnership are traded on an established securities market; or

(ii) Interests in the partnership are readily tradable on a secondary market or the substantial equivalent thereof.

(2) *Partnership interest*—(i) *In general.* For purposes of section 7704(b) and this section, an interest in a partnership includes—

(A) Any interest in the capital or profits of the partnership (including the right to partnership distributions); and

(B) Any financial instrument or contract the value of which is determined in whole or in part by reference to the partnership (including the amount of partnership distributions, the value of partnership assets, or the results of partnership operations).

(ii) *Exception for non-convertible debt.* For purposes of section 7704(b) and this section, an interest in a partnership does not include any financial instrument or contract that—

(A) Is treated as debt for federal tax purposes; and

(B) Is not convertible into or exchangeable for an interest in the capital or profits of the partnership and does not provide for a payment of equivalent value.

(iii) *Exception for tiered entities.* For purposes of section 7704(b) and this section, an interest in a partnership or a corporation (including a regulated investment company as defined in section 851 or a real estate investment trust as defined in section 856) that holds an interest in a partnership (lower-tier partnership) is not considered an interest in the lower-tier partnership.

(3) *Definition of transfer.* For purposes of section 7704(b) and this section, a transfer of an interest in a partnership means a transfer in any form, including a redemption by the partnership or the entering into of a financial instrument or contract described in paragraph (a)(2)(i)(B) of this section.

(b) *Established securities market.* For purposes of section 7704(b) and this section, an established securities market includes—

(1) A national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f);

(2) A national securities exchange exempt from registration under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f) because of the limited volume of transactions;

(3) A foreign securities exchange that, under the law of the jurisdiction where it is organized, satisfies regulatory requirements that are analogous to the regulatory requirements under the Securities Exchange Act of 1934 described in paragraph (b) (1) or (2) of this

section (such as the London International Financial Futures Exchange; the Marche a Terme International de France; the International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited; the Frankfurt Stock Exchange; and the Tokyo Stock Exchange);

(4) A regional or local exchange; and

(5) An interdealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers by electronic means or otherwise.

(c) *Readily tradable on a secondary market or the substantial equivalent thereof*—(1) *In general.* For purposes of section 7704(b) and this section, interests in a partnership that are not traded on an established securities market (within the meaning of section 7704(b) and paragraph (b) of this section) are readily tradable on a secondary market or the substantial equivalent thereof if, taking into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market.

(2) *Secondary market or the substantial equivalent thereof.* For purposes of paragraph (c)(1) of this section, interests in a partnership are readily tradable on a secondary market or the substantial equivalent thereof if—

(i) Interests in the partnership are regularly quoted by any person, such as a broker or dealer, making a market in the interests;

(ii) Any person regularly makes available to the public (including customers or subscribers) bid or offer quotes with respect to interests in the partnership and stands ready to effect buy or sell transactions at the quoted prices for itself or on behalf of others;

(iii) The holder of an interest in the partnership has a readily available, regular, and ongoing opportunity to sell or exchange the interest through a public means of obtaining or providing information of offers to buy, sell, or exchange interests in the partnership; or

(iv) Prospective buyers and sellers otherwise have the opportunity to buy, sell, or exchange interests in the partnership in a time frame and with the regularity and continuity that is comparable to that described in the other provisions of this paragraph (c)(2).

(3) *Secondary market safe harbors.* The fact that a transfer of a partnership interest is not within one or more of the safe harbors described in paragraph (e), (f), (g), (h), or (j) of this section is disregarded in determining whether interests in the partnership are readily tradable on a secondary market or the substantial equivalent thereof.

(d) *Involvement of the partnership required.* For purposes of section 7704(b) and this section, interests in a partnership are not traded on an established securities market within the meaning of paragraph (b)(5) of this section and are not readily tradable on a secondary market or the substantial equivalent thereof within the meaning of paragraph (c) of this section (even if interests in the partnership are traded or readily tradable in a manner described in paragraph (b)(5) or (c) of this section) unless—

(1) The partnership participates in the establishment of the market or the inclusion of its interests thereon; or

(2) The partnership recognizes any transfers made on the market by—

(i) Redeeming the transferor partner (in the case of a redemption or repurchase by the partnership); or

(ii) Admitting the transferee as a partner or otherwise recognizing any rights of the transferee, such as a right of the transferee to receive partnership distributions (directly or indirectly) or to acquire an interest in the capital or profits of the partnership.

(e) *Transfers not involving trading*—(1) *In general.* For purposes of section 7704(b) and this section, the following transfers (private transfers) are disregarded in determining whether interests in a partnership are readily tradable on a secondary market or the substantial equivalent thereof—

(i) Transfers in which the basis of the partnership interest in the hands of the transferee is determined, in whole or in part, by reference to its basis in the hands of the transferor or is determined under section 732;

(ii) Transfers at death, including transfers from an estate or testamentary trust;

(iii) Transfers between members of a family (as defined in section 267(c)(4));

(iv) Transfers involving the issuance of interests by (or on behalf of) the partnership in exchange for cash, property, or services;

(v) Transfers involving distributions from a retirement plan qualified under section 401(a) or an individual retirement account;

(vi) Block transfers (as defined in paragraph (e)(2) of this section);

(vii) Transfers pursuant to a right under a redemption or repurchase agreement (as defined in paragraph (e)(3) of this section) that is exercisable only—

(A) Upon the death, disability, or mental incompetence of the partner; or

(B) Upon the retirement or termination of the performance of services of an individual who actively participated in the management of, or performed services on a full-time basis for, the partnership;

(viii) Transfers pursuant to a closed end redemption plan (as defined in paragraph (e)(4) of this section);

(ix) Transfers by one or more partners of interests representing in the aggregate 50 percent or more of the total interests in partnership capital and profits in one transaction or a series of related transactions; and

(x) Transfers not recognized by the partnership (within the meaning of paragraph (d)(2) of this section).

(2) *Block transfers.* For purposes of paragraph (e)(1)(vi) of this section, a block transfer means the transfer by a partner and any related persons (within the meaning of section 267(b) or 707(b)(1)) in one or more transactions during any 30 calendar day period of partnership interests representing in the aggregate more than 2 percent of the total interests in partnership capital or profits.

(3) *Redemption or repurchase agreement.* For purposes of section 7704(b) and this section, a redemption or repurchase agreement means a plan of redemption or repurchase maintained by a partnership whereby the partners may tender their partnership interests for purchase by the partnership, another partner, or a person related to another partner (within the meaning of section 267(b) or 707(b)(1)).

(4) *Closed end redemption plan.* For purposes of paragraph (e)(1)(viii) of this section, a redemption or repurchase agreement (as defined in paragraph (e)(3) of this section) is a closed end redemption plan only if—

(i) The partnership does not issue any interest after the initial offering (other than the issuance of additional interests prior to August 5, 1988); and

(ii) No partner or person related to any partner (within the meaning of section 267(b) or 707(b)(1)) provides contemporaneous opportunities to acquire interests in similar or related partnerships which represent substantially identical investments.

(f) *Redemption and repurchase agreements.* For purposes of section 7704(b) and this section, the transfer of an interest in a partnership pursuant to a redemption or repurchase agreement (as defined in paragraph (e)(3) of this section) that is not described in paragraph (e)(1) (vii) or (viii) of this section is disregarded in determining whether interests in the partnership are readily tradable on a secondary market or the substantial equivalent thereof only if—

(1) The redemption or repurchase agreement provides that the redemption or repurchase cannot occur until at least 60 calendar days after the partner notifies the partnership in writing of the partner's intention to exercise the redemption or repurchase right;

(2) Either—

(i) The redemption or repurchase agreement requires that the redemption or repurchase price not be established until at least 60 calendar days after receipt of such notification by the partnership or the partner; or

(ii) The redemption or repurchase price is established not more than four times during the partnership's taxable year; and

(3) The sum of the percentage interests in partnership capital or profits transferred during the taxable year of the partnership (other than in private transfers described in paragraph (e) of this section) does not exceed 10 percent of the total interests in partnership capital or profits.

(g) *Qualified matching services*—(1) *In general.* For purposes of section 7704(b)

and this section, the transfer of an interest in a partnership through a qualified matching service is disregarded in determining whether interests in the partnership are readily tradable on a secondary market or the substantial equivalent thereof.

(2) *Requirements*. A matching service is a qualified matching service only if—

(i) The matching service consists of a computerized or printed listing system that lists customers' bid and/or ask quotes in order to match partners who want to sell their interests in a partnership (the selling partner) with persons who want to buy those interests;

(ii) Matching occurs either by matching the list of interested buyers with the list of interested sellers or through a bid and ask process that allows interested buyers to bid on the listed interest;

(iii) The selling partner cannot enter into a binding agreement to sell the interest until the 15th calendar day after the date information regarding the offering of the interest for sale is made available to potential buyers and such time period is evidenced by contemporaneous records ordinarily maintained by the operator at a central location;

(iv) The closing of the sale effected by virtue of the matching service does not occur prior to the 45th calendar day after the date information regarding the offering of the interest for sale is made available to potential buyers and such time period is evidenced by contemporaneous records ordinarily maintained by the operator at a central location;

(v) The matching service displays only quotes that do not commit any person to buy or sell a partnership interest at the quoted price (nonfirm price quotes) or quotes that express interest in a partnership interest without an accompanying price (nonbinding indications of interest) and does not display quotes at which any person is committed to buy or sell a partnership interest at the quoted price (firm quotes);

(vi) The selling partner's information is removed from the matching service within 120 calendar days after the date information regarding the offering of the interest for sale is made available to potential buyers and, following any removal (other than removal by reason of a sale of any part of such interest) of the selling partner's information from the matching service, no offer to sell an interest in the partnership is entered into the matching service by the selling partner for at least 60 calendar days; and

(vii) The sum of the percentage interests in partnership capital or profits transferred during the taxable year of the partnership (other than in private transfers described in paragraph (e) of this section) does not exceed 10 percent of the total interests in partnership capital or profits.

(3) *Closing*. For purposes of paragraph (g)(2)(iv) of this section, the closing of a sale occurs no later than the earlier of—

(i) The passage of title to the partnership interest;

(ii) The payment of the purchase price (which does not include the delivery of funds to the operator of the matching service or other closing agent to hold on behalf of the seller pending closing); or

(iii) The date, if any, that the operator of the matching service (or any person related to the operator within the meaning of section 267(b) or 707(b)(1)) loans, advances, or otherwise arranges for funds to be available to the seller in anticipation of the payment of the purchase price.

(4) *Optional features*. A qualified matching service may be sponsored or operated by a partner of the partnership (either formally or informally), the underwriter that handled the issuance of the partnership interests, or an unrelated third party. In addition, a qualified matching service may offer the following features—

(i) The matching service may provide prior pricing information, including information regarding resales of interests and actual prices paid for interests; a description of the business of the partnership; financial and reporting information from the partnership's financial statements and reports; and information regarding material events involving the partnership, including

special distributions, capital distributions, and refinancings or sales of significant portions of partnership assets;

(ii) The operator may assist with the transfer documentation necessary to transfer the partnership interest;

(iii) The operator may receive and deliver funds for completed transactions; and

(iv) The operator's fee may consist of a flat fee for use of the service, a fee or commission based on completed transactions, or any combination thereof.

(h) *Private placements*—(1) *In general.* For purposes of section 7704(b) and this section, except as otherwise provided in paragraph (h)(2) of this section, interests in a partnership are not readily tradable on a secondary market or the substantial equivalent thereof if—

(i) All interests in the partnership were issued in a transaction (or transactions) that was not required to be registered under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*); and

(ii) The partnership does not have more than 100 partners at any time during the taxable year of the partnership.

(2) *Exception for certain offerings outside of the United States.* Paragraph (h)(1) of this section does not apply to the offering and sale of interests in a partnership that was not required to be registered under the Securities Act of 1933 by reason of Regulation S (17 CFR 230.901 through 230.904) unless the offering and sale of the interests would not have been required to be registered under the Securities Act of 1933 if the interests had been offered and sold within the United States.

(3) *Anti-avoidance rule.* For purposes of determining the number of partners in the partnership under paragraph (h)(1)(ii) of this section, a person (beneficial owner) owning an interest in a partnership, grantor trust, or S corporation (flow-through entity), that owns, directly or through other flow-through entities, an interest in the partnership, is treated as a partner in the partnership only if—

(i) Substantially all of the value of the beneficial owner's interest in the flow-through entity is attributable to the flow-through entity's interest (direct or indirect) in the partnership; and

(ii) A principal purpose of the use of the tiered arrangement is to permit the partnership to satisfy the 100-partner limitation in paragraph (h)(1)(ii) of this section.

(i) [Reserved]

(j) *Lack of actual trading*—(1) *General rule.* For purposes of section 7704(b) and this section, interests in a partnership are not readily tradable on a secondary market or the substantial equivalent thereof if the sum of the percentage interests in partnership capital or profits transferred during the taxable year of the partnership (other than in transfers described in paragraph (e), (f), or (g) of this section) does not exceed 2 percent of the total interests in partnership capital or profits.

(2) *Examples.* The following examples illustrate the rules of this paragraph (j):

Example 1. Calculation of percentage interest transferred. (i) ABC, a calendar year limited partnership formed in 1996, has 9,000 units of limited partnership interests outstanding at all times during 1997, representing in the aggregate 95 percent of the total interests in capital and profits of ABC. The remaining 5 percent is held by the general partner.

(ii) During 1997, the following transactions occur with respect to the units of ABC's limited partnership interests—

(A) 800 units are sold through the use of a qualified matching service that meets the requirements of paragraph (g) of this section;

(B) 50 units are sold through the use of a matching service that does not meet the requirements of paragraph (g) of this section; and

(C) 500 units are transferred as a result of private transfers described in paragraph (e) of this section.

(iii) The private transfers of 500 units and the sale of 800 units through a qualified matching service are disregarded under paragraph (j)(1) of this section for purposes of applying the 2 percent rule. As a result, the total percentage interests in partnership capital and profits transferred for purposes of the 2 percent rule is .528 percent, determined by—

(A) Dividing the number of units sold through a matching service that did not meet the requirements of paragraph (g) of this section (50) by the total number of outstanding limited partnership units (9,000); and

(B) Multiplying the result by the percentage of total interests represented by limited partnership units (95 percent)

$([50 / 9{,}000] \times .95 = .528 \text{ percent})$.

Example 2. Application of the 2 percent rule. (i) ABC operates a service consisting of computerized video display screens on which subscribers view and publish nonfirm price quotes that do not commit any person to buy or sell a partnership interest and unpriced indications of interest in a partnership interest without an accompanying price. The ABC service does not provide firm quotes at which any person (including the operator of the service) is committed to buy or sell a partnership interest. The service may provide prior pricing information, including information regarding resales of interests and actual prices paid for interests; transactional volume information; and information on special or capital distributions by a partnership. The operator's fee may consist of a flat fee for use of the service; a fee based on completed transactions, including, for example, the number of nonfirm quotes or unpriced indications of interest entered by users of the service; or any combination thereof.

(ii) The ABC service is not an established securities market for purposes of section 7704(b) and this section. The service is not an interdealer quotation system as defined in paragraph (b)(5) of this section because it does not disseminate firm buy or sell quotations. Therefore, partnerships whose interests are listed and transferred on the ABC service are not publicly traded for purposes of section 7704(b) and this section as a result of such listing or transfers if the sum of the percentage interests in partnership capital or profits transferred during the taxable year of the partnership (other than in transfers described in paragraph (e), (f), or (g) of this section) does not exceed 2 percent of the total interests in partnership capital or profits. In addition, assuming the ABC service complies with the necessary requirements, the service may qualify as a matching service described in paragraph (g) of this section.

(k) *Percentage interests in partnership capital or profits*—(1) *Interests considered*—(i) *General rule.* Except as otherwise provided in this paragraph (k), for purposes of this section, the total interests in partnership capital or profits are determined by reference to all outstanding interests in the partnership.

(ii) *Exceptions*—(A) *General partner with greater than 10 percent interest.* If the general partners and any person related to the general partners (within the meaning of section 267(b) or 707(b)(1)) own, in the aggregate, more than 10 percent of the outstanding interests in partnership capital or profits at any one time during the taxable year of the partnership, the total interests in partnership capital or profits are determined without reference to the interests owned by such persons.

(B) *Derivative interests.* Any partnership interests described in paragraph (a)(2)(i)(B) of this section are taken into account for purposes of determining the total interests in partnership capital or profits only if and to the extent that the partnership satisfies paragraph (d) (1) or (2) of this section.

(2) *Monthly determination.* For purposes of this section, except in the case of block transfers (as defined in paragraph (e)(2) of this section), the percentage interests in partnership capital or profits represented by partnership interests that are transferred during a taxable year of the partnership is equal to the sum of the percentage interests transferred for each calendar month during the taxable year of the partnership in which a transfer of a partnership interest occurs (other than a private transfer as described in paragraph (e) of this section). The percentage interests in capital or profits of interests transferred during a calendar month is determined by reference to the partnership interests outstanding during that month.

(3) *Monthly conventions.* For purposes of paragraph (k)(2) of this section, a partnership may use any reasonable convention in determining the interests outstanding for a month, provided the convention is consistently used by the partnership from month to month during a taxable year and from year to year. Reasonable conventions include, but are not limited to, a determination by reference to the interests outstanding at the beginning of the month, on the 15th day of the month, or at the end of the month.

(4) *Block transfers.* For purposes of paragraph (e)(2) of this section (defining block transfers), the partnership must determine the percentage interests in capital or profits for each transfer of an interest during the 30 calendar day period by reference to the partnership interests outstanding immediately prior to such transfer.

(5) *Example.* The following example illustrates the rules of this paragraph (k):

Example. Conventions. (i) ABC limited partnership, a calendar year partnership formed

in 1996, has 1,000 units of limited partnership interests outstanding on January 1, 1997, representing in the aggregate 95 percent of the total interests in capital and profits of ABC. The remaining 5 percent is held by the general partner.

(ii) The following transfers take place during 1997—

(A) On January 15, 10 units of limited partnership interests are sold in a transaction that is not a private transfer;

(B) On July 10, 1,000 additional units of limited partnership interests are issued by the partnership (the general partner's percentage interest is unchanged); and

(C) On July 20, 15 units of limited partnership interests are sold in a transaction that is not a private transfer.

(iii) For purposes of determining the sum of the percentage interests in partnership capital or profits transferred, ABC chooses to use the end of the month convention. The percentage interests in partnership capital and profits transferred during January is .95 percent, determined by dividing the number of transferred units (10) by the total number of limited partnership units (1,000) and multiplying the result by the percentage of total interests represented by limited partnership units ([10/1,000] × .95). The percentage interests in partnership capital and profits transferred during July is .7125 percent ([15/2,000] × .95). ABC is not required to make determinations for the other months during the year because no transfers of partnership interests occurred during such months. ABC may qualify for the 2 percent rule for its 1997 taxable year because less than 2 percent (.95 percent + .7125 percent = 1.6625 percent) of its total interests in partnership capital and profits was transferred during that year.

(iv) If ABC had chosen to use the beginning of the month convention, the interests in capital or profits sold during July would have been 1.425 percent ([15/1,000] × .95) and ABC would not have satisfied the 2 percent rule for its 1997 taxable year because 2.375 percent (.95 + 1.425) of ABC's interests in partnership capital and profits was transferred during that year.

(l) *Effective date*—(1) *In general*. Except as provided in paragraph (l)(2) of this section, this section applies to taxable years of a partnership beginning after December 31, 1995.

(2) *Transition period*. For partnerships that were actively engaged in an activity before December 4, 1995, this section applies to taxable years beginning after December 31, 2005, unless the partnership adds a substantial new line of business after December 4, 1995, in which case this section applies to taxable years beginning on or after the addition of the new line of business. Partnerships that qualify for this transition period may continue to rely on the provisions of Notice 88–75 (1988–2 C.B. 386) (see §601.601(d)(2) of this chapter) for guidance regarding the definition of readily tradable on a secondary market or the substantial equivalent thereof for purposes of section 7704(b).

(3) *Substantial new line of business*. For purposes of paragraph (l)(2) of this section—

(i) Substantial is defined in §1.7704–2(c); and

(ii) A new line of business is defined in §1.7704–2(d), except that the applicable date is ''December 4, 1995'' instead of ''December 17, 1987''.

(4) *Termination under section 708(b)(1)(B)*. The termination of a partnership under section 708(b)(1)(B) due to the sale or exchange of 50 percent or more of the total interests in partnership capital and profits is disregarded in determining whether a partnership qualifies for the transition period provided in paragraph (l)(2) of this section.

[T.D. 8629, 60 FR 62029, Dec. 4, 1995]

§ 1.7704–2 Transition provisions.

(a) *Transition rule*—(1) *Statutory dates*. Section 7704 generally applies to taxable years beginning after December 31, 1987. In the case of an existing partnership, however, section 7704 and the regulations thereunder apply to taxable years beginning after December 31, 1997.

(2) *Effective date of regulations*. These regulations are effective for taxable years beginning after December 31, 1991.

(b) *Existing partnership*—(1) *In general*. For purposes of §1.7704–2, the term ''existing partnership'' means any partnership if—

(i) The partnership was a publicly traded partnership (within the meaning of section 7704(b)) on December 17, 1987;

(ii) A registration statement indicating that the partnership was to be a publicly traded partnership was filed with the Securities and Exchange Commission (SEC) with respect to the partnership on or before December 17, 1987; or

(iii) With respect to the partnership, an application was filed with a state

regulatory commission on or before December 17, 1987, seeking permission to restructure a portion of a corporation as a publicly traded partnership.

(2) *Changed status of an existing partnership.* A partnership will not qualify as an existing partnership after a new line of business is substantial.

(c) *Substantial*—(1) *In general.* A new line of business is substantial as of the earlier of—

(i) The taxable year in which the partnership derives more than 15 percent of its gross income from that line of business; or

(ii) The taxable year in which the partnership directly uses in that line of business more than 15 percent (by value) of its total assets.

(2) *Timing rule.* If a substantial new line of business is added during the taxable year (e.g., by acquisition), the line of business is treated as substantial as of the date it is added; otherwise a substantial new line of business is treated as substantial as of the first day of the taxable year in which it becomes substantial.

(d) *New line of business*—(1) *In general.* A new line of business is any business activity of the partnership not closely related to a pre-existing business of the partnership to the extent that the activity generates income other than ''qualifying income'' within the meaning of section 7704 and the regulations thereunder.

(2) *Pre-existing business.* A business activity is a pre-existing business of the partnership if—

(i) The partnership was actively engaged in the activity on or before December 17, 1987; or

(ii) The partnership is actively engaged in the business activity that was specifically described as a proposed business activity of the partnership in a registration statement or amendment thereto filed on behalf of the partnership with the SEC on or before December 17, 1987. For this purpose, a specific description does not include a general grant of authority to conduct any business.

(3) *Closely related.* All of the facts and circumstances will determine whether a new business activity is closely related to a pre-existing business of the partnership. The following factors, among others, will help to establish that a new business activity is closely related to a pre-existing business of the partnership and therefore is not a new line of business:

(i) The activity provides products or services very similar to the products or services provided by the pre-existing business.

(ii) The activity markets products and services to the same class of customers as that of the pre-existing business.

(iii) The activity is of a type that is normally conducted in the same business location as the pre-existing business.

(iv) The activity requires the use of similar operating assets as those used in the pre-existing business.

(v) The activity's economic success depends on the success of the pre-existing business.

(vi) The activity is of a type that would normally be treated as a unit with the pre-existing business in the business' accounting records.

(vii) If the activity and the pre-existing business are regulated or licensed, they are regulated or licensed by the same or similar governmental authority.

(viii) The United States Bureau of the Census assigns the activity the same four-digit Industry Number Standard Identification Code (Industry SIC Code) as the pre-existing business. Such codes are set forth in the Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual, prepared, and from time to time revised, by the Statistical Policy Division of the United States Office of Management and Budget. For example, if a partnership's pre-existing business is manufacturing steam turbines and then the partnership begins an activity manufacturing hydraulic turbines, both activities would be assigned the same Industry SIC Code, 3511—Steam, Gas, and Hydraulic Turbines, and Turbine Generator Set Units. In the case of a pre-existing business or activity that is listed under the Industry SIC Code, 9999—Nonclassifiable Establishments—or under a miscellaneous category (e.g., most Industry SIC Codes

ending in a ''9'' are miscellaneous categories), the similarity of the SIC Codes is ignored as a factor in determining whether the activity is closely related to the pre-existing business. The dissimilarity of the SIC Codes is considered in determining whether the business activity is closely related to the pre-existing line of business.

(e) *Activities conducted through controlled corporations*—(1) *In general.* An activity conducted by a corporation controlled by an existing partnership may be treated as an activity of the existing partnership if the effect of the arrangement is to permit the partnership to engage in an activity the income from which is not subject to a corporate-level tax and which would be a new line of business if conducted directly by the partnership. This determination is based upon all facts and circumstances.

(2) *Safe harbor*—(i) *In general.* This paragraph (e)(2) provides a safe harbor for activities of a corporation controlled by an existing partnership. An activity conducted by a corporation controlled by an existing partnership is not deemed to be an activity of the partnership for purposes of determining whether an existing partnership has added a new line of business if no more than 10% of the gross income that the partnership derives from the corporation during the taxable year is section 7704(d) qualifying income that is recharacterized as nonqualifying income under paragraphs (e)(2) (ii) and (iii) of this section. The Internal Revenue Service will not presume that an activity conducted through a corporation controlled by an existing partnership is an activity of the partnership solely because the partnership fails to satisfy the requirements of this paragraph (e)(2)(i).

(ii) *Recharacterization of qualifying income.* Gross income received by a partnership from a controlled corporation that would be qualifying income under section 7704(d) is subject to recharacterization as nonqualifying income if the amount is deductible in computing the income of the controlled corporation.

(iii) *Extent of recharacterization.* The amount of income described in paragraph (e)(2)(ii) of this section that is recharacterized as nonqualifying income is—

(A) The amount described in paragraph (e)(2)(ii) of this section; multiplied by

(B) The controlled corporation's taxable income (determined without regard to deductions for amounts paid to the partnership) that would not be qualifying income within the meaning of section 7704(d) if earned directly by the partnership; divided by

(C) The controlled corporation's taxable income (determined without regard to deductions for amounts paid to the partnership).

(3) *Control.* For purposes of paragraphs (e) (1) and (2) of this section, control of a corporation is determined generally under the rules of section 304(c). However, the application of section 304(c) is modified to apply only to partners who own five percent or more by value (directly or indirectly) of the existing partnership unless a principal purpose of the arrangement is to avoid tax at the corporate level.

(4) *Example.* The following example illustrates the application of the this paragraph (e):

Example. (i) PTP, an existing partnership, acquired all the stock of X corporation on January 1, 1993. During PTP's 1993 taxable year it received $185,000 of dividends and $15,000 of interest from X. Determined without regard to interest paid to PTP, X's taxable income during that period was $500,000 none of which was ''qualifying income'' within the meaning of section 7704 and the regulations thereunder. In computing the income of X, the $15,000 of interest paid to PTP is deductible.

(ii) Under paragraph (e)(2)(ii) of section, all $15,000 of PTP's interest income was nonqualifying income ($15,000 × 500,000/500,000). Under paragraph (e)(2) of this section, however, the activities of X will not be considered to be activities of PTP for the 1993 taxable year because no more than 10 percent of the gross income that PTP derived from X would be treated as other than qualifying income (15,000 / 200,000 = 7.5%).

(f) *Activities conducted through tiered partnerships.* An activity conducted by a partnership in which an existing partnership holds an interest (directly or through another partnership) will be considered an activity of the existing partnership.

(g) *Exceptions*—(1) *Coordination with gross income requirements of section*

7704(c)(2). A partnership that is either an existing partnership as of December 31, 1997, or an existing partnership that ceases to qualify as an existing partnership is subject to section 7704 and the regulations thereunder. Section 7704(a) does not apply to these partnerships, however, if these partnerships meet the gross income requirements of paragraphs (c) (1) and (2) of section 7704. For purposes of applying section 7704(c) (1) and (2) to these partnerships, the only taxable years that must be tested are those beginning on and after the earlier of—

(i) January 1, 1998; or

(ii) The day on which the partnership ceases to qualify as an existing partnership because of the addition of a new line of business; or

(iii) The first day of the first taxable year in which a new line of business becomes substantial (if the new line of business becomes substantial after the year in which it is added).

(2) *Specific exceptions.* In determining whether a partnership is an existing partnership for purposes of section 7704, the following events do not in themselves terminate the status of existing partnerships—

(i) Termination of the partnership under section 708(b)(1)(B) due to the sale or exchange of 50 percent or more of the total interests in partnership capital and profits;

(ii) Issuance of additional partnership units; and

(iii) Dropping a line of business. This event, however, could affect an existing partnership's status indirectly. For example, dropping one line of business could change the composition of the partnership's gross income. The change in composition could make a new line of business ''substantial,'' under paragraph (c) of this section, and terminate the partnership's status. See paragraph (b)(2) of this section.

(h) *Examples.* The following examples illustrate the application of this section:

Example 1. (i) On December 17, 1987, PTP, a calendar-year publicly traded partnership, owned and operated citrus groves. On March 1, 1993, PTP purchased a processing business involving frozen citrus products. In the partnership's 1993 taxable year, the partnership directly used in the processing business more than 15 percent (by value) of its total assets.

(ii) The citrus grove activities provide different products from the processing activities, are marketed to customers different from the customers of the processing activities, require different types of operating assets, are not commonly conducted at the same location, are not commonly treated as a unit in accounting records, do not depend upon one another for economic success, and do not have the same Industry SIC Code. Under the facts and circumstances, the processing business is not closely related to the citrus grove operation and is a new line of business under paragraph (d)(1) of this section.

(iii) The assets of the partnership used in the new line of business are substantial under paragraph (c)(2) of this section. Because PTP added a substantial new line of business after December 17, 1987, paragraph (b)(2) of this section terminates PTP's status as an existing partnership on March 1, 1993.

Example 2. (i) On December 17, 1987, PTP, a calendar-year publicly traded partnership, owned and operated retirement centers that serve the elderly. Each center contains three sections—

(A) A residential section, which includes suites of rooms, dining facilities, lounges, and gamerooms;

(B) An assisted-living section, which provides laundry and housekeeping services, health monitoring, and emergency care; and

(C) A nursing section, which provides private and semiprivate rooms, dining facilities, examination and treatment rooms, drugs, medical equipment, and physical, speech, and occupational therapy.

(ii) The business activities of each section constitute pre-existing businesses of PTP under paragraph (d)(2) of this section, because PTP was actively engaged in the activities on or before December 17, 1987.

(iii) The nursing sections primarily furnish health care. They employ nurses and therapists, are subject to federal, state, and local licensing requirements, and may change certain costs to government programs like Medicare and Medicaid.

(iv) In 1993, PTP acquired new nursing homes that treat inpatient adults of all ages. The nursing homes provide private and semiprivate rooms, dining facilities, examination and treatment rooms, drugs, medical equipment, and physical, speech, and occupational therapy. The nursing homes primarily furnish health care. They employ nurses and therapists, are subject to federal, state, and local licensing requirements, and may charge certain costs to government programs like Medicare and Medicaid.

(v) PTP's new nursing homes and old nursing sections provide very similar services, market to very similar customers, use similar types of property and personnel, and are licensed by the same regulatory agencies. The nursing homes and old nursing sections

have the same Industry SIC Code. Under these facts and circumstances, the new nursing homes are closely related to a pre-existing business of the partnership. Accordingly, under paragraph (d)(1) of this section, the acquisition of the new nursing homes is not the addition of a new line of business.

(vi) PTP was a publicly traded partnership on December 17, 1987, and was an existing partnership under paragraph (b)(1)(i) of this section. Because PTP has added no substantial new line of business after December 17, 1987, paragraph (b)(2) of this section does not terminate PTP's status as an existing partnership.

Example 3. (i) On December 17, 1987, PTP, a calendar-year publicly traded partnership, owned and operated cable television systems in the northeastern United States. PTP's registration statement described as its proposed business activities the ownership and operation of cable television systems, any ancillary operations, and any business permitted by the laws of the state in which PTP was formed.

(ii) PTP's cable systems include cables strung along telephone lines, converter boxes in subscribers' homes, other types of cable equipment, satellite dishes that receive programs broadcast by various television networks, and channels that carry public service announcements of local interest. Subscribers pay the systems a fee for the right to receive both the local announcements and the network signals relayed through the cables. Those fees constitute PTP's primary revenue. The systems operate under franchise agreements negotiated with each municipality in which they do business.

(iii) On September 1, 1993, PTP purchased a television station in the northwestern United States. The station owns broadcasting facilities, satellite dishes that receive programs broadcast by the station's network, and a studio that produces programs of interest to the area that receives the station's broadcasts. Fees from advertisers constitute the station's primary revenue. The station operates under a license from the Federal Communications Commission.

(iv) In the partnership's 1993 taxable year, the station generated less than 15 percent of PTP's gross income and constituted less than 15 percent of its total assets (by value). In PTP's 1994 taxable year, the station generated more than 15 percent of PTP's gross income.

(v) The cable systems relay signals through cables to subscribers and earn revenue from subscriber fees; the station broadcasts signals to the general public and earns revenue by selling air time for commercials. Despite certain similarities, the two types of activities generally require different operating assets and earn income from different sources. They are regulated by different agencies. They are not commonly conducted at the same location and do not generally depend upon one another for their economic success. They have different Industry SIC Codes. Under the facts and circumstances, the television station activities are not closely related to PTP's pre-existing business, the cable system activities.

(vi) As of December 17, 1987, PTP did not own and operate any television station. PTP's registration statement specifically described as its proposed business activities only the ownership and operation of cable television systems and any ancillary operations. For purposes of paragraph (d)(2) of this section, a specific description does not include PTP's general authority to carry on any business permitted by the state of its formation. Therefore, the television station line of business was not specifically described as a proposed business activity of PTP in its registration statement. PTP's acquisition of the television station business activity constitutes a new line of business under paragraph (d)(1) of this section.

(vii) PTP was a publicly traded partnership on December 17, 1987, and was an existing partnership under paragraph (b)(1)(i) of this section. PTP added a new line of business in 1993, but that line of business was not substantial under paragraph (c) of this section, and thus PTP remained an existing partnership for its 1993 taxable year. In 1994, the new line of business became substantial because it generated more than 15 percent of PTP's gross income. Paragraph (b)(2) of this section therefore terminates PTP's existing partnership status as of January 1, 1994, the first day of the first taxable year beginning after December 31, 1987, in which PTP's new line of business became substantial.

[T.D. 8450, 57 FR 58708, Dec. 11, 1992]

§ 1.7704–3 Qualifying income.

(a) *Certain investment income*—(1) *In general.* For purposes of section 7704(d)(1), qualifying income includes capital gain from the sale of stock, income from holding annuities, income from notional principal contracts (as defined in § 1.446–3), and other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner. Income from a notional principal contract is included in qualifying income only if the property, income, or cash flow that measures the amounts to which the partnership is entitled under the contract would give rise to qualifying income if held or received directly by the partnership.

(2) *Limitations.* Qualifying income described in paragraph (a)(1) of this section does not include income derived in the ordinary course of a trade or business. For purposes of the preceding sentence, income derived from an asset with respect to which the partnership is a broker, market maker, or dealer is income derived in the ordinary course of a trade or business; income derived from an asset with respect to which the taxpayer is a trader or investor is not income derived in the ordinary course of a trade or business.

(b) *Calculation of gross income and qualifying income*—(1) *Treatment of losses.* Except as otherwise provided in this section, in computing the gross income and qualifying income of a partnership for purposes of section 7704(c)(2) and this section, losses do not enter into the computation.

(2) *Certain positions that are marked to market.* Gain recognized with respect to a position that is marked to market (for example, under section 475(f), 1256, 1259, or 1296) shall not fail to be qualifying income solely because there is no sale or disposition of the position.

(3) *Certain items of ordinary income.* Gain recognized with respect to a capital asset shall not fail to be qualifying income solely because it is characterized as ordinary income under section 475(f), 988, 1258, or 1296.

(4) *Straddles.* In computing the gross income and qualifying income of a partnership for purposes of section 7704(c)(2) and this section, a straddle (as defined in section 1092(c)) shall be treated as set forth in this paragraph (b)(4). For purposes of the preceding sentence, two or more straddles that are part of a larger straddle shall be treated as a single straddle. The amount of the gain from any straddle to be taken into account shall be computed as follows:

(i) *Straddles other than mixed straddle accounts.* With respect to each straddle (whether or not a straddle during the taxable year) other than a mixed straddle account, the amount of gain taken into account shall be the excess, if any, of gain recognized during the taxable year with respect to property that was at any time a position in that straddle over any loss recognized during the taxable year with respect to property that was at any time a position in that straddle (including loss realized in an earlier taxable year).

(ii) *Mixed straddle accounts.* With respect to each mixed straddle account (as defined in §1.1092(b)–4T(b)), the amount of gain taken into account shall be the annual account gain for that mixed straddle account, computed pursuant to §1.1092(b)–4T(c)(2).

(5) *Certain transactions similar to straddles.* In computing the gross income and qualifying income of a partnership for purposes of section 7704(c)(2) and this section, related interests in property (whether or not personal property as defined in section 1092(d)(1)) that produce a substantial diminution of the partnership's risk of loss similar to that of a straddle (as defined in section 1092(c)) shall be combined so that the amount of gain taken into account by the partnership in computing its gross income shall be the excess, if any, of gain recognized during the taxable year with respect to such interests over any loss recognized during the taxable year with respect to such interests.

(6) *Wash sale rule*—(i) *Gain not taken into account.* Solely for purposes of section 7704(c)(2) and this section, if a partnership recognizes gain in a section 7704 wash sale transaction with respect to one or more positions in either a straddle (as defined in section 1092(c)) or an arrangement described in paragraph (b)(5) of this section, then the gain shall not be taken into account to the extent of the amount of unrecognized loss (as of the close of the taxable year) in one or more offsetting positions of the straddle or arrangement described in paragraph (b)(5) of this section.

(ii) *Section 7704 wash sale transaction.* For purposes of this paragraph (b)(6), a section 7704 wash sale transaction is a transaction in which—

(A) A partnership disposes of one or more positions of a straddle (as defined in section 1092(c)) or one or more related positions described in paragraph (b)(5) of this section; and

(B) The partnership acquires a substantially similar position or positions within a period beginning 30 days before the date of the disposition and ending 30 days after such date.

(c) *Effective date.* This section applies to taxable years of a partnership beginning on or after December 17, 1998. However, a partnership may apply this section in its entirety for all of the partnership's open taxable years beginning after any earlier date selected by the partnership.

[T.D. 8799, 63 FR 69553, Dec. 17, 1998]

§ 1.7704–4 Qualifying income—mineral and natural resources.

(a) *In general.* For purposes of section 7704(d)(1)(E), qualifying income is income and gains from qualifying activities with respect to minerals or natural resources as defined in paragraph (b) of this section. Qualifying activities are section 7704(d)(1)(E) activities (as described in paragraph (c) of this section) and intrinsic activities (as described in paragraph (d) of this section).

(b) *Mineral or natural resource.* The term mineral or natural resource (including fertilizer, geothermal energy, and timber) means any product of a character with respect to which a deduction for depletion is allowable under section 611, except that such term does not include any product described in section 613(b)(7)(A) or (B) (soil, sod, dirt, turf, water, mosses, or minerals from sea water, the air, or other similar inexhaustible sources). For purposes of this section, the term mineral or natural resource does not include industrial source carbon dioxide, fuels described in section 6426(b) through (e), any alcohol fuel defined in section 6426(b)(4)(A), or any biodiesel fuel as defined in section 40A(d)(1).

(c) *Section 7704(d)(1)(E) activities*—(1) *Definition.* Section 7704(d)(1)(E) activities include the exploration, development, mining or production, processing, refining, transportation, or marketing of any mineral or natural resource. Solely for purposes of section 7704(d), such terms are defined as provided in this paragraph (c).

(2) *Exploration.* An activity constitutes exploration if it is performed to ascertain the existence, location, extent, or quality of any deposit of mineral or natural resource before the beginning of the development stage of the natural deposit including by—

(i) Drilling an exploratory or stratigraphic type test well;

(ii) Conducting drill stem and production flow tests to verify commerciality of the deposit;

(iii) Conducting geological or geophysical surveys;

(iv) Interpreting data obtained from geological or geophysical surveys; or

(v) For minerals, testpitting, trenching, drilling, driving of exploration tunnels and adits, and similar types of activities described in Rev. Rul. 70–287 (1970–1 CB 146), (see § 601.601(d)(2)(ii)(*b*) of this chapter) if conducted prior to development activities with respect to the minerals.

(3) *Development.* An activity constitutes development if it is performed to make accessible minerals or natural resources, including by—

(i) Drilling wells to access deposits of minerals or natural resources;

(ii) Constructing and installing drilling, production, or dual purpose platforms in marine locations, or any similar supporting structures necessary for extraordinary non-marine terrain (such as swamps or tundra);

(iii) Completing wells, including by installing lease and well equipment, such as pumps, flow lines, separators, and storage tanks, so that wells are capable of producing oil and gas, and the production can be removed from the premises;

(iv) Performing a development technique such as, for minerals other than oil and natural gas, stripping, benching and terracing, dredging by dragline, stoping, and caving or room-and-pillar excavation, and for oil and natural gas, fracturing; or

(v) Constructing and installing gathering systems and custody transfer stations.

(4) *Mining or production.* An activity constitutes mining or production if it is performed to extract minerals or natural resources from the ground including by operating equipment to extract minerals or natural resources from mines and wells, or to extract minerals or natural resources from the waste or residue of prior mining or production allowable under this section. The recycling of scrap or salvaged metals or minerals from previously manufactured products or manufacturing processes is not considered to be the

extraction of ores or minerals from waste or residue.

(5) *Processing*. An activity constitutes processing if it is performed to convert raw mined or harvested products or raw well effluent to substances that can be readily transported or stored, as described in this paragraph (c)(5).

(i) *Natural gas*. An activity constitutes processing of natural gas if it is performed to—

(A) Purify natural gas, including by removal of oil or condensate, water, or non-hydrocarbon gases (such as carbon dioxide, hydrogen sulfide, nitrogen, and helium); and

(B) Separate natural gas into its constituents which are normally recovered in a gaseous phase (methane and ethane) and those which are normally recovered in a liquid phase (propane, butane, pentane, and heavier streams).

(ii) *Crude oil*. An activity constitutes processing of crude oil if it is performed to separate produced fluids by passing crude oil through mechanical separators to remove gas, placing crude oil in settling tanks to recover basic sediment and water, dehydrating crude oil, and operating heater-treaters that separate raw oil well effluent into crude oil, natural gas, and salt water.

(iii) *Ores and minerals other than natural gas or crude oil*. An activity constitutes processing of ores and minerals other than natural gas or crude oil if it meets the definition of mining processes under §1.613–4(f)(1)(ii), without regard to §1.613–4(f)(2)(iv).

(iv) *Timber*. An activity constitutes processing of timber if it is performed to modify the physical form of timber, including by the application of heat or pressure to timber, without adding any foreign substances. Processing of timber does not include activities that add chemicals or other foreign substances to timber to manipulate its physical or chemical properties, such as using a digester to produce pulp. Products that result from timber processing include wood chips, sawdust, rough lumber, kiln-dried lumber, veneers, wood pellets, wood bark, and rough poles. Products that are not the result of timber processing include pulp, paper, paper products, treated lumber, oriented strand board/plywood, and treated poles.

(6) *Refining*. An activity constitutes refining if the activity is set forth in this paragraph (c)(6).

(i) *Natural gas and crude oil*. (A) The refining of natural gas and crude oil includes the further physical or chemical conversion or separation processes of products resulting from activities listed in paragraph (c)(5)(i) and (ii) of this section, and the blending of petroleum hydrocarbons, to the extent they give rise to a product listed in paragraph (c)(5)(i) or (ii) of this section or to the products of a type produced in a petroleum refinery or natural gas processing plant listed in this paragraph (c)(6)(i)(A). Refining of natural gas and crude oil also includes the further physical or chemical conversion or separation processes and blending of the products listed in this paragraph (c)(6)(i)(A), to the extent that the resulting product is also listed in this paragraph (c)(6)(i)(A). The following products are of a type produced in a petroleum refinery or natural gas processing plant:

(*1*) Ethane.

(*2*) Ethylene.

(*3*) Propane.

(*4*) Propylene.

(*5*) Normal butane.

(*6*) Butylene.

(*7*) Isobutane.

(*8*) Isobutene.

(*9*) Isobutylene.

(*10*) Pentanes plus.

(*11*) Unfinished naphtha.

(*12*) Unfinished kerosene and light gas oils.

(*13*) Unfinished heavy gas oils.

(*14*) Unfinished residuum.

(*15*) Reformulated gasoline with fuel ethanol.

(*16*) Reformulated other motor gasoline.

(*17*) Conventional gasoline with fuel ethanol—Ed55 and lower gasoline.

(*18*) Conventional gasoline with fuel ethanol—greater than Ed55 gasoline.

(*19*) Conventional gasoline with fuel ethanol—other conventional finished gasoline.

(*20*) Reformulated blendstock for oxygenate (RBOB).

(*21*) Conventional blendstock for oxygenate (CBOB).

(*22*) Gasoline treated as blendstock (GTAB).

(*23*) Other motor gasoline blending components defined as gasoline blendstocks as provided in §48.4081–1(c)(3) of this chapter.

(*24*) Finished aviation gasoline and blending components.

(*25*) Special naphthas (solvents).

(*26*) Kerosene-type jet fuel.

(*27*) Kerosene.

(*28*) Distillate fuel oil (heating oils, diesel fuel, and ultra-low sulfur diesel fuel).

(*29*) Residual fuel oil.

(*30*) Lubricants (lubricating base oils).

(*31*) Asphalt and road oil (atmospheric or vacuum tower bottom).

(*32*) Waxes.

(*33*) Petroleum coke.

(*34*) Still gas.

(*35*) Naphtha less than 401 °F endpoint.

(*36*) Other products of a refinery that the Commissioner may identify through published guidance.

(B) For purposes of this section, the products listed in this paragraph (c)(6)(i)(B) are not products of refining:

(*1*) Heat, steam, or electricity produced by processing or refining.

(*2*) Products that are obtained from third parties or produced onsite for use in the refinery, such as hydrogen, if excess amounts are sold.

(*3*) Any product that results from further chemical change of a product listed in paragraph (c)(6)(i)(A) of this section that does not result in the same or another product listed in paragraph (c)(6)(i)(A) of this section (for example, production of petroleum coke from heavy (refinery) residuum qualifies, but any upgrading of petroleum coke (such as to calcined coke) does not qualify because it is further chemically changed and does not result in the same or another product listed in paragraph (c)(6)(i)(A) of this section).

(*4*) Plastics or similar petroleum derivatives.

(ii) *Ores and minerals other than natural gas or crude oil.* (A) An activity constitutes refining of ores and minerals other than natural gas or crude oil if it is one of the various processes performed subsequent to mining processes (as defined in paragraph (c)(5)(iii) of this section) to eliminate impurities or foreign matter and which are necessary steps in achieving a high degree of purity from metallic ores and minerals which are not customarily sold in the form of the crude mineral product, as specified in paragraph (c)(6)(ii)(B) of this section. Refining processes include: fine pulverization, electrowinning, electrolytic deposition, roasting, thermal or electric smelting, or substantially equivalent processes or combinations of processes used to separate or extract the specified metals listed in paragraph (c)(6)(ii)(B) of this section from the ore for the primary purpose of producing a purer form of the metal, as for example the smelting of concentrates to produce Doré bars or refining of blister copper.

(B) For purposes of this section, the specified metallic ores or minerals which are not customarily sold in the form of the crude mineral product are—

(*1*) Lead;

(*2*) Zinc;

(*3*) Copper;

(*4*) Gold;

(*5*) Silver; and

(*6*) Any other ores or minerals that the Commissioner may identify through published guidance.

(C) Refining does not include the introduction of additives that remain in the metal, for example, in the manufacture of alloys of gold. Also, the application of nonmining processes as defined in §1.613–4(g) in order to produce a specified metal that is considered a waste or by-product of production from a non-specified mineral deposit is not considered refining for purposes of this section.

(7) *Transportation*—(i) *General rule.* An activity constitutes transportation if it is performed to move minerals or natural resources, and products under paragraph (c)(4), (5), or (6) of this section, including by pipeline, marine vessel, rail, or truck. Except as provided in paragraph (c)(7)(ii) of this section, transportation does not include the movement of minerals or natural resources, and products produced under paragraph (c)(4), (5), or (6) of this section, directly to retail customers or to a place that sells or dispenses to retail customers. Retail customers do not include a person who acquires oil or gas for refining or processing, or a utility.

Transportation includes the following activities:

(A) Providing storage services.

(B) Providing terminalling services, including the following: Receiving products from pipelines, marine vessels, railcars, or trucks; storing products; loading products to pipelines, marine vessels, railcars, or trucks for distribution; testing and treating, as well as blending and additization, if income from such activities would be qualifying income pursuant to paragraph (c)(10)(iv) and (v) of this section; and separating and selling excess renewable identification numbers acquired as part of additization services to comply with environmental regulations.

(C) Moving or carrying (whether by owner or operator) products via pipelines, gathering systems, and custody transfer stations.

(D) Operating marine vessels (including time charters), railcars, or trucks.

(E) Providing compression services to a pipeline.

(F) Liquefying or regasifying natural gas.

(ii) *Transportation to retail customers or to a place that sells to retail customers.* Transportation includes the movement of minerals or natural resources, and products under paragraph (c)(4), (5), or (6) of this section, via pipeline to a place that sells to retail customers. Transportation also includes the movement of liquefied petroleum gas via trucks, rail cars, or pipeline to a place that sells to retail customers or directly to retail customers.

(8) *Marketing*—(i) *General rule.* An activity constitutes marketing if it is the bulk sale of minerals or natural resources, and products under paragraph (c)(4), (5), or (6) of this section. Except as provided in paragraph (c)(8)(ii) of this section, marketing does not include retail sales (sales made in small quantities directly to end users), which includes the operation of gasoline service stations, home heating oil delivery services, and local natural gas delivery services.

(ii) *Retail sales of liquefied petroleum gas.* Retail sales of liquefied petroleum gas are included in marketing.

(iii) *Certain activities that facilitate sale.* Marketing also includes certain activities that facilitate sales that constitute marketing under paragraphs (c)(8)(i) and (ii) of this section, including packaging, as well as blending and additization, if income from blending and additization would be qualifying income pursuant to paragraph (c)(10)(iv) and (v) of this section.

(9) *Fertilizer.* [Reserved]

(10) *Additional activities.* The following types of income as described in paragraph (c)(10)(i) through (v) of this section will be considered derived from a section 7704(d)(1)(E) activity.

(i) *Cost reimbursements.* If the partnership is in the trade or business of performing a section 7704(d)(1)(E) activity, qualifying income includes income received to reimburse the partnership for its costs in performing that section 7704(d)(1)(E) activity, whether imbedded in the rate the partnership charges or separately itemized. Reimbursable costs may include the cost of designing, constructing, installing, inspecting, maintaining, metering, monitoring, or relocating an asset used in that section 7704(d)(1)(E) activity, or providing office functions necessary to the operation of that section 7704(d)(1)(E) activity (such as staffing, purchasing supplies, billing, accounting, and financial reporting). For example, a pipeline operator that charges a customer for its cost to build, repair, or schedule flow on the pipelines that it operates will have qualifying income from such activity whether or not it itemizes those costs when it bills the customer.

(ii) *Hedging.* [Reserved]

(iii) *Passive Interests.* Qualifying income includes income and gains from a passive interest or non-operating interest, including production royalties, minimum annual royalties, net profits interests, delay rentals, and lease-bonus payments, if the interest is in a mineral or natural resource as defined in paragraph (b) of this section. Payments received on a production payment will not be qualifying income if they are properly treated as loan payments under section 636.

(iv) *Blending.* Qualifying income includes income and gains from performing blending activities or services with respect to products under paragraph (c)(4), (5), or (6) of this section, so long as the products being blended are

component parts of the same mineral or natural resource. For purposes of this paragraph (c)(10)(iv), products of oil and natural gas will be considered as from the same natural resource. Blending does not include combining different minerals or natural resources or products thereof together. However, see paragraph (c)(10)(v) of this section for rules concerning additization.

(v) *Additization.* Qualifying income includes income and gains from providing additization services with respect to products under paragraph (c)(4), (5), or (6) of this section to the extent specifically permitted in this paragraph (c)(10)(v). The addition of additives described in paragraph (c)(10)(v)(A) through (C) of this section is permissible if the additives aid in the transportation of a product, enhance or protect the intrinsic properties of a product, or are necessary as required by federal, state, or local law (for example, to meet environmental standards), but only if such additives do not create a new product.

(A) The addition of additives to products of natural gas and crude oil is permissible, provided that such additives constitute less than 5 percent (except that ethanol or biodiesel may be up to 20 percent) of the total volume for products of natural gas and crude oil and are added into the product by the terminal operator or upstream of the terminal operator.

(B) In the case of ores and minerals other than natural gas or crude oil, the addition of incidental amounts of material such as paper dots to identify shipments, anti-freeze to aid in shipping, or compounds to allay dust as required by law or reduce losses during shipping is permissible.

(C) In the case of timber, additization of incidental amounts to comply with government regulations is permissible, to the extent such additization does not create a new product. For example, the pressure treatment of wood is impermissible because it creates a new product.

(d) *Intrinsic activities*—(1) *General requirements.* An activity is an intrinsic activity only if the activity is specialized to support a section 7704(d)(1)(E) activity, is essential to the completion of the section 7704(d)(1)(E) activity, and requires the provision of significant services to support the section 7704(d)(1)(E) activity. Whether an activity is an intrinsic activity is determined on an activity-by-activity basis.

(2) *Specialization.* An activity is a specialized activity if—

(i) The partnership provides personnel (including employees of the partnership, an affiliate, subcontractor, or independent contractor performing work on behalf of the partnership) to support a section 7704(d)(1)(E) activity and those personnel have received training in order to support the section 7704(d)(1)(E) activity that is unique to the mineral or natural resource industry and of limited utility other than to perform or support a section 7704(d)(1)(E) activity; and

(ii) To the extent that the activity involves the sale, provision, or use of specific property, either—

(A) The property is primarily tangible property that is dedicated to, and has limited utility outside of, section 7704(d)(1)(E) activities and is not easily converted (as determined based on all the facts and circumstances, including the cost to convert the property) to another use other than supporting or performing the section 7704(d)(1)(E) activities (except that the use of non-specialized property typically used incidentally in operating a business will not cause a partnership to fail this paragraph (d)(2)(ii)(A)); or

(B) If the property is used as an injectant to perform a section 7704(d)(1)(E) activity that is also commonly used outside of section 7704(d)(1)(E) activities (such as water and lubricants), the partnership provides the injectants exclusively to those engaged in section 7704(d)(1)(E) activities; the partnership is also in the trade or business of collecting, cleaning, recycling, or otherwise disposing of injectants after use in accordance with Federal, state, or local regulations concerning waste products from mining or production activities; and the partnership operates its injectant delivery and disposal services within the same geographic area.

(3) *Essential.* (i) An activity is essential to the section 7704(d)(1)(E) activity if it is required to—

(A) Physically complete a section 7704(d)(1)(E) activity (including in a cost-effective manner, such as by making the activity economically viable), or

(B) Comply with Federal, state, or local law regulating the section 7704(d)(1)(E) activity.

(ii) Legal, financial, consulting, accounting, insurance, and other similar services do not qualify as essential to a section 7704(d)(1)(E) activity.

(4) *Significant services.* (i) An activity requires significant services to support the section 7704(d)(1)(E) activity if those services must be conducted on an ongoing or frequent basis by the partnership's personnel at the site or sites of the section 7704(d)(1)(E) activities. Alternatively, those services may be conducted offsite if the services are performed on an ongoing or frequent basis and are offered to those engaged in one or more section 7704(d)(1)(E) activities. If the services are monitoring, those services must be offered exclusively to those engaged in one or more section 7704(d)(1)(E) activities. Whether services are conducted on an ongoing or frequent basis is determined based on all the facts and circumstances, including recognized best practices in the relevant industry.

(ii) Personnel perform significant services only if those services are necessary for the partnership to perform an activity that is essential to the section 7704(d)(1)(E) activity, or to support the section 7704(d)(1)(E) activity. Personnel include employees of the partnership, an affiliate, subcontractor, or independent contractor performing work on behalf of the partnership.

(iii) Services are not significant services with respect to a section 7704(d)(1)(E) activity if the services principally involve the design, construction, manufacturing, repair, maintenance, lease, rent, or temporary provision of property.

(e) *Interpretations of section 611 and section 613.* This section and interpretations of this section have no effect on interpretations of sections 611 and 613, or other sections of the Code, or the regulations thereunder; however, this section incorporates some of the interpretations under section 611 and 613 and the regulations thereunder as provided in this section.

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

Example 1. Petrochemical products sourced from an oil and gas well. (i) Z, a publicly traded partnership, chemically converts a mixture of ethane and propane (obtained from physical separation of natural gas) into ethylene and propylene through use of a steam cracker. Z sells the ethylene and propylene in bulk to a third party.

(ii) Ethylene and propylene are products of refining as provided in paragraph (c)(6)(i) of this section; therefore, Z is engaged in a section 7704(d)(1)(E) activity. The income Z receives from the sale of ethylene and propylene is qualifying income for purposes of section 7704(d)(1)(E).

Example 2. Petroleum streams chemically converted into refinery grade olefins byproducts. (i) Y, a publicly traded partnership, owns a petroleum refinery. The refinery physically separates crude oil, obtaining heavy gas oil. The refinery then uses a catalytic cracking unit to chemically convert the heavy gas oil into a liquid stream suitable for gasoline blending and a gas stream containing ethane, ethylene, and other gases. The refinery also further physically separates the gas stream, resulting in refinery-grade ethylene. Y sells the ethylene in bulk to a third party.

(ii) Y's activities give rise to products of refining as provided in paragraph (c)(6)(i) of this section; therefore, Y is engaged in a section 7704(d)(1)(E) activity. The income Y receives from the sales of ethylene is qualifying income for purposes of section 7704(d)(1)(E).

Example 3. Converting methane gas into synthetic fuels through chemical change. (i) Y, a publicly traded partnership, chemically converts methane into methanol and synthesis gas, and further chemically converts those products into gasoline and diesel fuel. Y receives income from bulk sales of gasoline and diesel created during the conversion processes, as well as from sales of methanol.

(ii) With respect to the production of gasoline or diesel from methane, gasoline and diesel are products of refining as provided in paragraph (c)(6)(i) of this section; therefore, Y is engaged in a section 7704(d)(1)(E) activity. Y's income from the sale of gasoline and diesel is qualifying income for purposes of section 7704(d)(1)(E).

(iii) The income from the sale of methanol, an intermediate product in the conversion process, is not qualifying income for purposes of section 7704(d)(1)(E) because methanol is not a product of processing or refining as defined in paragraph (c)(5) and (6) of this section.

Example 4. Converting methanol into gasoline and diesel. (i) Assume the same facts as in

Example 3 of this paragraph (f), except Y purchases methanol and synthesis gas and chemically converts the methanol and synthesis gas into gasoline and diesel.

(ii) The chemical conversion of methanol and synthesis gas into gasoline and diesel is not refining as provided in paragraph (c)(6)(i) of this section because it is not the physical or chemical conversion or the separation or blending of products listed in paragraph (c)(6)(i)(A) of this section. Accordingly, the income from the sales of the gasoline and diesel is not qualifying income for purposes of section 7704(d)(1)(E).

Example 5. Delivery of refined products. (i) X, a publicly traded partnership, sells diesel to a government entity at wholesale prices and delivers those goods in bulk.

(ii) X's sale of a refined product to the government entity is a section 7704(d)(1)(E) activity because it is a bulk transportation and sale as described in paragraph (c)(7) and (8) of this section and is not a retail sale.

Example 6. Constructing a pipeline. (i) X, a publicly traded partnership, operates interstate and intrastate natural gas pipelines. Y, a corporation, is a construction firm. X pays Y to build a pipeline. X later seeks reimbursement for its cost to build the pipeline from A, a refiner who contracts with X to transport gasoline.

(ii) X, as an operator of pipelines, is engaged in transportation pursuant to paragraph (c)(7)(i)(C) of this section. The reimbursement X receives from A for X's cost to build the pipeline is qualifying income pursuant to paragraph (c)(10)(i) of this section because X receives the income to reimburse X for its costs in performing X's transportation activity and reimbursable costs may include construction costs. In contrast, Y is not in the trade or business of performing a 7704(d)(1)(E) activity, thus income Y received from X for building the pipeline is not qualifying income to Y.

Example 7. Delivery of water. (i) X, a publicly traded partnership, owns interstate and intrastate natural gas pipelines. X built a water delivery pipeline along the existing right of way for its natural gas pipeline to deliver water to A for use in A's fracturing activity. A uses the delivered water in fracturing to develop A's natural gas reserve in a cost-efficient manner. X earns income for transporting natural gas in the pipelines and for delivery of water.

(ii) X's income from transporting natural gas in its interstate and intrastate pipelines is qualifying income for purposes of section 7704(c) because transportation of natural gas is a section 7704(d)(1)(E) activity as provided in paragraph (c)(7)(i)(C) of this section.

(iii) The income X obtains from its water delivery services is not a section 7704(d)(1)(E) activity as provided in paragraph (c) of this section. However, because X's water delivery supports A's development of natural gas, a section 7704(d)(1)(E) activity, X's income from water delivery services may be qualifying income for purposes of section 7704(c) if the water delivery service is an intrinsic activity as provided in paragraph (d) of this section. An activity is an intrinsic activity if the activity is specialized to support the section 7704(d)(1)(E) activity, is essential to the completion of the section 7704(d)(1)(E) activity, and requires the provision of significant services to support the section 7704(d)(1)(E) activity. Under paragraph (d)(2)(ii)(B) of this section, the provision of water for use as an injectant in a section 7704(d)(1)(E) activity is specialized to that activity only if the partnership (1) provides the water exclusively to those engaged in section 7704(d)(1)(E) activities, (2) is also in the trade or business of cleaning, recycling, or otherwise disposing of water after use in accordance with Federal, state, or local regulations concerning waste products from mining or production activities, and (3) operates these disposal services within the same geographic area as that in which it delivers water. Because X does not perform such disposal services, X's water delivery activities are not specialized to support the section 7704(d)(1)(E) activity. Thus, X's water delivery is not an intrinsic activity. Accordingly, X's income from the delivery of water is not qualifying income for purposes of section 7704(c).

Example 8. Delivery of water and recovery and recycling of flowback. (i) Assume the same facts as in *Example 7* of this paragraph (f), except that X also collects and treats flowback at the drilling site in accordance with state regulations as part of its water delivery services and transports the treated flowback away from the site. In connection with these services, X provides personnel to perform these services on an ongoing or frequent basis that is consistent with best industry practices. X has provided these personnel with specialized training regarding the recovery and recycling of flowback produced during the development of natural gas, and this training is of limited utility other than to perform or support the development of natural gas.

(ii) The income X obtains from its water delivery services is not a section 7704(d)(1)(E) activity as provided in paragraph (c) of this section. However, because X's water delivery supports A's development of natural gas, a section 7704(d)(1)(E) activity, X's income from water delivery services may be qualifying income for purposes of section 7704(c) if the water delivery service is an intrinsic activity as provided in paragraph (d) of this section.

(iii) An activity is an intrinsic activity if the activity is specialized to support the section 7704(d)(1)(E) activity, is essential to the completion of the section 7704(d)(1)(E) activity, and requires the provision of significant services to support the section 7704(d)(1)(E)

activity. Under paragraph (d)(2)(ii)(B) of this section, the provision of water for use as an injectant in a section 7704(d)(1)(E) activity is specialized to that activity only if the partnership (1) provides the water exclusively to those engaged in section 7704(d)(1)(E) activities, (2) is also in the trade or business of cleaning, recycling, or otherwise disposing of water after use in accordance with Federal, state, or local regulations concerning waste products from mining or production activities, and (3) operates these disposal services within the same geographical area as where it delivers water. X's provision of personnel is specialized because those personnel received training regarding the recovery and recycling of flowback produced during the development of natural gas, and this training is of limited utility other than to perform or support the development of natural gas. The provision of water is also specialized because water is an injectant used to perform a section 7704(d)(1)(E) activity, and X also collects and treats flowback in accordance with state regulations as part of its water delivery services. Therefore, X meets the specialization requirement. The delivery of water is essential to support A's development activity because the water is needed for use in fracturing to develop A's natural gas reserve in a cost-efficient manner. Finally, the water delivery and recovery and recycling activities require significant services to support the development activity because X's personnel provide services necessary for the partnership to perform the support activity at the development site on an ongoing or frequent basis that is consistent with best industry practices. Because X's delivery of water and X's collection, transport, and treatment of flowback is a specialized activity, is essential to the completion of a section 7704(d)(1)(E) activity, and requires significant services, the delivery of water and the transport and treatment of flowback is an intrinsic activity. X's income from the delivery of water and the collection, treatment, and transport of flowback is qualifying income for purposes of section 7704(c).

(g) *Effective/applicability date and transition rule.* (1) *In general.* Except as provided in paragraph (g)(2) of this section, this section applies to income earned by a partnership in a taxable year beginning on or after January 19, 2017. Paragraph (g)(2) of this section applies during the period that ends on the last day of the partnership's taxable year that includes January 19, 2027 (Transition Period).

(2) *Income during Transition Period.* A partnership may treat income from an activity as qualifying income during the Transition Period if—

(i) The partnership received a private letter ruling from the IRS holding that the income from that activity is qualifying income;

(ii) Prior to May 6, 2015, the partnership was publicly traded, engaged in the activity, and treated the activity as giving rise to qualifying income under section 7704(d)(1)(E), and that income was qualifying income under the statute as reasonably interpreted prior to May 6, 2015;

(iii) Prior to May 6, 2015, the partnership was publicly traded and had entered into a binding agreement for construction of assets to be used in such activity that would give rise to income that was qualifying income under the statute as reasonably interpreted prior to May 6, 2015; or

(iv) The partnership is publicly traded and engages in the activity after May 6, 2015 but before January 19, 2017, and the income from that activity is qualifying income under the proposed regulations (REG–132634–14) contained in the Internal Revenue Bulletin (IRB) 2015–21 (see *https://www.irs.gov/pub/irs-irbs/irb15-21.pdf*).

(3) *Relief from technical termination.* In the event of a technical termination under section 708(b)(1)(B) of a partnership that satisfies the requirements of paragraph (g)(2) of this section without regard to the technical termination, the resulting partnership will be treated as the partnership that satisfies the requirements of paragraph (g)(2) of this section for purposes of applying the Transition Period.

[T.D. 9817, 82 FR 8338, Jan. 24, 2017]

§§ 1.7872–1—1.7872–4 [Reserved]

§ 1.7872–5 Exempted loans.

(a) *In general*—(1) *General rule.* Except as provided in paragraph (a)(2) of this section, notwithstanding any other provision of section 7872 and the regulations under that section, section 7872 does not apply to the loans listed in paragraph (b) of this section because the interest arrangements do not have a significant effect on the Federal tax liability of the borrower or the lender.

(2) *No exemption for tax avoidance loans*. If a taxpayer structures a transaction to be a loan described in paragraph (b) of this section and one of the principal purposes of so structuring the transaction is the avoidance of Federal tax, then the transaction will be recharacterized as a tax avoidance loan as defined in section 7872(c)(1)(D).

(b) *List of exemptions*. Except as provided in paragraph (a) of this section, the following transactions are exempt from section 7872:

(1) through (15) [Reserved] For further guidance, see §1.7872–5T(b)(1) through (15).

(16) An exchange facilitator loan (within the meaning of §1.468B–6(c)(1)) if the amount of the exchange funds (as defined in §1.468B–6(b)(2)) treated as loaned does not exceed $2,000,000 and the duration of the loan is 6 months or less. The Commissioner may increase this $2,000,000 loan exemption amount in published guidance of general applicability, see §601.601(d)(2) of this chapter.

(c) [Reserved] For further guidance, see §1.7872–5T(c).

(d) *Effective/applicability date*. This section applies to exchange facilitator loans issued on or after October 8, 2008.

[T.D. 9413, 73 FR 39622, July 10, 2008]

§ 1.7872–5T Exempted loans (temporary).

(a) *In general*—(1) *General rule*. Except as provided in paragraph (a)(2) of this section, notwithstanding any other provision of section 7872 and the regulations thereunder, section 7872 does not apply to the loans listed in paragraph (b) of this section because the interest arrangements do not have a significant effect on the Federal tax liability of the borrower or the lender.

(2) *No exemption for tax avoidance loans*. If a taxpayer structures a transaction to be a loan described in paragraph (b) of this section and one of the principal purposes of so structuring the transaction is the avoidance of Federal tax, then the transaction will be recharacterized as a tax avoidance loan as defined in section 7872 (c)(1)(D).

(b) *List of exemptions*. Except as provided in paragraph (a) of this section, the following transactions are exempt from section 7872:

(1) Loans which are made available by the lender to the general public on the same terms and conditions and which are consistent with the lender's customary business practice;

(2) Accounts or withdrawable shares with a bank (as defined in section 581), or an institution to which section 591 applies, or a credit union, made in the ordinary course of its business;

(3) Acquisitions of publicly traded debt obligations for an amount equal to the public trading price at the time of acquisition;

(4) Loans made by a life insurance company (as defined in section 816 (a)), in the ordinary course of its business, to an insured, under a loan right contained in a life insurance policy and in which the cash surrender values are used as collateral for the loans;

(5) Loans subsidized by the Federal, State (including the District of Columbia), or Municipal government (or any agency or instrumentality thereof), and which are made available under a program of general application to the public;

(6) Employee-relocation loans that meet the requirements of paragraph (c)(1) of this section;

(7) Obligations the interest on which is excluded from gross income under section 103;

(8) Obligations of the United States government;

(9) Gift loans to a charitable organization (described in section 170(c)), but only if at no time during the taxable year will the aggregate outstanding amount of gift loans by the lender to that organization exceed $250,000. Charitable organizations which are effectively controlled, within the meaning of §1.482–1(a)(1), by the same person or persons shall be considered one charitable organization for purposes of this limitation.

(10) Loans made to or from a foreign person that meet the requirements of paragraph (c)(2) of this section;

(11) Loans made by a private foundation or other organization described in section 170(c), the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B);

(12) Indebtedness subject to section 482, but such indebtedness is exempt

from the application of section 7872 only during the interest-free period, if any, determined under § 1.482–2(a)(1)(iii) with respect to intercompany trade receivables described in § 1.482–2(a)(1)(ii)(A)(*ii*). See also § 1.482–2(a)(3);

(13) All money, securities, and property—

(i) Received by a futures commission merchant or registered broker/dealer or by a clearing organization (A) to margin, guarantee or secure contracts for future delivery on or subject to the rules of a qualified board or exchange (as defined in section 1256(g)(7)), or (B) to purchase, margin, guarantee or secure options contracts traded on or subject to the rules of a qualified board or exchange, so long as the amounts so received to purchase, margin, guarantee or secure such contracts for future delivery or such options contracts are reasonably necessary for such purposes and so long as any commissions received by the futures commission merchant, registered broker-dealer, or clearing organization are not reduced for those making deposits of money, and all money accruing to account holders as the result of such futures and options contacts or

(ii) Received by a clearing organization from a member thereof as a required deposit to a clearing fund, guaranty fund, or similar fund maintained by the clearing organization to protect it against defaults by members.

(14) Loans the interest arrangements of which the taxpayer is able to show have no significant effect on any Federal tax liability of the lender or the borrower, as described in paragraph (c)(3) of this section; and

(15) Loans, described in revenue rulings or revenue procedures issued under section 7872(g)(1)(C), if the Commissioner finds that the factors justifying an exemption for such loans are sufficiently similar to the factors justifying the exemptions contained in this section.

(c) *Special rules*—(1) *Employee-relocation loans*—(i) *Mortgage loans*. In the case of a compensation-related loan to an employee, where such loan is secured by a mortgage on the new principal residence (within the meaning of section 217 and the regulations thereunder) of the employee, acquired in connection with the transfer of that employee to a new principal place of work (which meets the requirements in section 217(c) and the regulations thereunder), the loan will be exempt from section 7872 if the following conditions are satisfied:

(A) The loan is a demand loan or is a term loan the benefits of the interest arrangements of which are not transferable by the employee and are conditioned on the future performance of substantial services by the employee;

(B) The employee certifies to the employer that the employee reasonably expects to be entitled to and will itemize deductions for each year the loan is outstanding; and

(C) The loan agreement requires that the loan proceeds be used only to purchase the new principal residence of the employee.

(ii) *Bridge loans*. In the case of a compensation-related loan to an employee which is not described in paragraph (c)(1)(i) of this section, and which is used to purchase a new principal residence (within the meaning of section 217 and the regulations thereunder) of the employee acquired in connection with the transfer of that employee to a new principal place of work (which meets the requirements in section 217(c) and the regulations thereunder), the loan will be exempt from section 7872 if the following conditions are satisfied:

(A) The conditions contained in paragraphs (c)(1)(i) (A), (B), and (C) of this section;

(B) The loan agreement provides that the loan is payable in full within 15 days after the date of the sale of the employee's immediately former principal residence;

(C) The aggregate principal amount of all outstanding loans described in this paragraph (c)(1)(ii) to an employee is no greater than the employer's reasonable estimate of the amount of the equity of the employee and the employee's spouse in the employee's immediately former principal residence, and

(D) The employee's immediately former principal residence is not converted to business or investment use.

(2) *Below-market loans involving foreign persons*. (i) Section 7872 shall not

apply to a below-market loan (other than a compensation-related loan or a corporation-shareholder loan where the borrower is a shareholder that is not a C corporation as defined in section 1361(a)(2)) if the lender is a foreign person and the borrower is a U.S. person unless the interest income imputed to the foreign lender (without regard to this paragraph) would be effectively connected with the conduct of a U.S. trade or business within the meaning of section 864(c) and the regulations thereunder and not exempt from U.S. income taxation under an applicable income tax treaty.

(ii) Section 7872 shall not apply to a below-market loan where both the lender and the borrower are foreign persons unless the interest income imputed to the lender (without regard to this paragraph) would be effectively connected with the conduct of a U.S. trade or business within the meaning of section 864(c) and the regulations thereunder and not exempt from U.S. income taxation under an applicable income tax treaty.

(iii) For purposes of this section, the term ''foreign person'' means any person that is not a U.S. person.

(3) *Loans without significant tax effect.* Whether a loan will be considered to be a loan the interest arrangements of which have a significant effect on any Federal tax liability of the lender or the borrower will be determined according to all of the facts and circumstances. Among the factors to be considered are—

(i) Whether items of income and deduction generated by the loan offset each other;

(ii) The amount of such items;

(iii) The cost to the taxpayer of complying with the provisions of section 7872 if such section were applied; and

(iv) Any non-tax reasons for deciding to structure the transaction as a below-market loan rather than a loan with interest at a rate equal to or greater than the applicable Federal rate and a payment by the lender to the borrower.

(26 U.S.C. 7872)

[T.D. 8045, 50 FR 33520, Aug. 20, 1985, as amended by T.D. 8093, 51 FR 25033, July 10, 1986; 51 FR 28553, Aug. 8, 1986; T.D. 8204, 53 FR 18282, May 23, 1988]

§ 1.7872–15 Split-dollar loans.

(a) *General rules*—(1) *Introduction.* This section applies to split-dollar loans as defined in paragraph (b)(1) of this section. If a split-dollar loan is not a below-market loan, then, except as provided in this section, the loan is governed by the general rules for debt instruments (including the rules for original issue discount (OID) under sections 1271 through 1275 and the regulations thereunder). If a split-dollar loan is a below-market loan, then, except as provided in this section, the loan is governed by section 7872. The timing, amount, and characterization of the imputed transfers between the lender and borrower of a below-market split-dollar loan depend upon the relationship between the parties and upon whether the loan is a demand loan or a term loan. For additional rules relating to the treatment of split-dollar life insurance arrangements, *see* § 1.61–22.

(2) *Loan treatment*—(i) *General rule.* A payment made pursuant to a split-dollar life insurance arrangement is treated as a loan for Federal tax purposes, and the owner and non-owner are treated, respectively, as the borrower and the lender, if—

(A) The payment is made either directly or indirectly by the non-owner to the owner (including a premium payment made by the non-owner directly or indirectly to the insurance company with respect to the policy held by the owner);

(B) The payment is a loan under general principles of Federal tax law or, if it is not a loan under general principles of Federal tax law (for example, because of the nonrecourse nature of the obligation or otherwise), a reasonable person nevertheless would expect the payment to be repaid in full to the non-owner (whether with or without interest); and

(C) The repayment is to be made from, or is secured by, the policy's death benefit proceeds, the policy's cash surrender value, or both.

(ii) *Payments that are only partially repayable.* For purposes of § 1.61–22 and this section, if a non-owner makes a payment pursuant to a split-dollar life insurance arrangement and the non-owner is entitled to repayment of some

but not all of the payment, the payment is treated as two payments: One that is repayable and one that is not. Thus, paragraph (a)(2)(i) of this section refers to the repayable payment.

(iii) *Treatment of payments that are not split-dollar loans. See* §1.61–22(b)(5) for the treatment of payments by a non-owner that are not split-dollar loans.

(iv) *Examples.* The provisions of this paragraph (a)(2) are illustrated by the following examples:

Example 1. Assume an employee owns a life insurance policy under a split-dollar life insurance arrangement, the employer makes premium payments on this policy, there is a reasonable expectation that the payments will be repaid, and the repayments are secured by the policy. Under paragraph (a)(2)(i) of this section, each premium payment is a loan for Federal tax purposes.

Example 2. (i) Assume an employee owns a life insurance policy under a split-dollar life insurance arrangement and the employer makes premium payments on this policy. The employer is entitled to be repaid 80 percent of each premium payment, and the repayments are secured by the policy. Under paragraph (a)(2)(ii) of this section, the taxation of 20 percent of each premium payment is governed by §1.61–22(b)(5). If there is a reasonable expectation that the remaining 80 percent of a payment will be repaid in full, then, under paragraph (a)(2)(i) of this section, the 80 percent is a loan for Federal tax purposes.

(ii) If less than 80 percent of a premium payment is reasonably expected to be repaid, then this paragraph (a)(2) does not cause any of the payment to be a loan for Federal tax purposes. If the payment is not a loan under general principles of Federal tax law, the taxation of the entire premium payment is governed by §1.61–22(b)(5).

(3) *No de minimis exceptions.* For purposes of this section, section 7872 is applied to a split-dollar loan without regard to the *de minimis* exceptions in section 7872(c)(2) and (3).

(4) *Certain interest provisions disregarded*—(i) *In general.* If a split-dollar loan provides for the payment of interest and all or a portion of the interest is to be paid directly or indirectly by the lender (or a person related to the lender), then the requirement to pay the interest (or portion thereof) is disregarded for purposes of this section. All of the facts and circumstances determine whether a payment to be made by the lender (or a person related to the lender) is sufficiently independent from the split-dollar loan for the payment to not be an indirect payment of the interest (or a portion thereof) by the lender (or a person related to the lender).

(ii) *Examples.* The provisions of this paragraph (a)(4) are illustrated by the following examples:

Example 1. (i) On January 1, 2009, Employee *B* issues a split-dollar term loan to Employer *Y*. The split-dollar term loan provides for five percent interest, compounded annually. Interest and principal on the split-dollar term loan are due at maturity. On January 1, 2009, *B* and *Y* also enter into a fully vested non-qualified deferred compensation arrangement that will provide a payment to *B* in an amount equal to the accrued but unpaid interest due at the maturity of the split-dollar term loan.

(ii) Under paragraph (a)(4)(i) of this section, *B*'s requirement to pay interest on the split-dollar term loan is disregarded for purposes of this section, and the split-dollar term loan is treated as a loan that does not provide for interest for purposes of this section.

Example 2. (i) On January 1, 2004, Employee *B* and Employer *Y* enter into a fully vested non-qualified deferred compensation arrangement that will provide a payment to *B* equal to *B*'s salary in the three years preceding the retirement of *B*. On January 1, 2009, *B* and *Y* enter into a split-dollar life insurance arrangement and, under the arrangement, *B* issues a split-dollar term loan to *Y* on that date. The split-dollar term loan provides for five percent interest, compounded annually. Interest and principal on the split-dollar term loan are due at maturity. Over the period in which the non-qualified deferred compensation arrangement is effective, the terms and conditions of *B*'s non-qualified deferred compensation arrangement do not change in a way that indicates that the payment of the non-qualified deferred compensation is related to *B*'s requirement to pay interest on the split-dollar term loan. No other facts and circumstances exist to indicate that the payment of the non-qualified deferred compensation is related to *B*'s requirement to pay interest on the split-dollar term loan.

(ii) The facts and circumstances indicate that the payment by *Y* of non-qualified deferred compensation is independent from *B*'s requirement to pay interest under the split-dollar term loan. Under paragraph (a)(4)(i) of this section, the fully vested non-qualified deferred compensation does not cause *B*'s requirement to pay interest on the split-dollar term loan to be disregarded for purposes of this section. For purposes of this section, the split-dollar term loan is treated as a loan

that provides for stated interest of five percent, compounded annually.

(b) *Definitions.* For purposes of this section, the terms *split-dollar life insurance arrangement*, *owner*, and *non-owner* have the same meanings as provided in §1.61–22(b) and (c). In addition, the following definitions apply for purposes of this section:

(1) A *split-dollar loan* is a loan described in paragraph (a)(2)(i) of this section.

(2) A *split-dollar demand loan* is any split-dollar loan that is payable in full at any time on the demand of the lender (or within a reasonable time after the lender's demand).

(3) A *split-dollar term loan* is any split-dollar loan other than a split-dollar demand loan. See paragraph (e)(5) of this section for special rules regarding certain split-dollar term loans payable on the death of an individual, certain split-dollar term loans conditioned on the future performance of substantial services by an individual, and gift split-dollar term loans.

(c) *Interest deductions for split-dollar loans.* The borrower may not deduct any qualified stated interest, OID, or imputed interest on a split-dollar loan. *See* sections 163(h) and 264(a). In certain circumstances, an indirect participant may be allowed to deduct qualified stated interest, OID, or imputed interest on a deemed loan. See paragraph (e)(2)(iii) of this section (relating to indirect loans).

(d) *Treatment of split-dollar loans providing for nonrecourse payments*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, if a payment on a split-dollar loan is nonrecourse to the borrower, the payment is a contingent payment for purposes of this section. *See* paragraph (j) of this section for the treatment of a split-dollar loan that provides for one or more contingent payments.

(2) *Exception for certain loans with respect to which the parties to the split-dollar life insurance arrangement make a representation*—(i) *Requirement.* An otherwise noncontingent payment on a split-dollar loan that is nonrecourse to the borrower is not a contingent payment under this section if the parties to the split-dollar life insurance arrangement represent in writing that a reasonable person would expect that all payments under the loan will be made.

(ii) *Time and manner for providing written representation.* The Commissioner may prescribe the time and manner for providing the written representation required by paragraph (d)(2)(i) of this section. Until the Commissioner prescribes otherwise, the written representation that is required by paragraph (d)(2)(i) of this section must meet the requirements of this paragraph (d)(2)(ii). Both the borrower and the lender must sign the representation not later than the last day (including extensions) for filing the Federal income tax return of the borrower or lender, whichever is earlier, for the taxable year in which the lender makes the first split-dollar loan under the split-dollar life insurance arrangement. This representation must include the names, addresses, and taxpayer identification numbers of the borrower, lender, and any indirect participants. Unless otherwise stated therein, this representation applies to all subsequent split-dollar loans made pursuant to the split-dollar life insurance arrangement. Each party should retain an original of the representation as part of its books and records and should attach a copy of this representation to its Federal income tax return for any taxable year in which the lender makes a loan to which the representation applies.

(e) *Below-market split-dollar loans*—(1) *Scope*—(i) *In general.* This paragraph (e) applies to below-market split-dollar loans enumerated under section 7872(c)(1), which include gift loans, compensation-related loans, and corporation-shareholder loans. The characterization of a split-dollar loan under section 7872(c)(1) and of the imputed transfers under section 7872(a)(1) and (b)(1) depends upon the relationship between the lender and the borrower or the lender, borrower, and any indirect participant. For example, if the lender is the borrower's employer, the split-dollar loan is generally a compensation-related loan, and any imputed transfer from the lender to the borrower is generally a payment of compensation. The loans covered by this paragraph (e) include indirect loans between the parties. *See* paragraph (e)(2)

of this section for the treatment of certain indirect split-dollar loans. *See* paragraph (f) of this section for the treatment of any stated interest or OID on split-dollar loans. *See* paragraph (j) of this section for additional rules that apply to a split-dollar loan that provides for one or more contingent payments.

(ii) *Significant-effect split-dollar loans.* If a direct or indirect below-market split-dollar loan is not enumerated in section 7872(c)(1)(A), (B), or (C), the loan is a significant-effect loan under section 7872(c)(1)(E).

(2) *Indirect split-dollar loans*—(i) *In general.* If, based on all the facts and circumstances, including the relationship between the borrower or lender and some third person (the indirect participant), the effect of a below-market split-dollar loan is to transfer value from the lender to the indirect participant and from the indirect participant to the borrower, then the below-market split-dollar loan is restructured as two or more successive below-market loans (the deemed loans) as provided in this paragraph (e)(2). The transfers of value described in the preceding sentence include (but are not limited to) a gift, compensation, a capital contribution, and a distribution under section 301 (or, in the case of an S corporation, under section 1368). The deemed loans are—

(A) A deemed below-market split-dollar loan made by the lender to the indirect participant; and

(B) A deemed below-market split-dollar loan made by the indirect participant to the borrower.

(ii) *Application.* Each deemed loan is treated as having the same provisions as the original loan between the lender and borrower, and section 7872 is applied to each deemed loan. Thus, for example, if, under a split-dollar life insurance arrangement, an employer (lender) makes an interest-free split-dollar loan to an employee's child (borrower), the loan is restructured as a deemed compensation-related below-market split-dollar loan from the lender to the employee (the indirect participant) and a second deemed gift below-market split-dollar loan from the employee to the employee's child. In appropriate circumstances, section 7872(d)(1) may limit the interest that accrues on a deemed loan for Federal income tax purposes. For loan arrangements between husband and wife, *see* section 7872(f)(7).

(iii) *Limitations on investment interest for purposes of section 163(d).* For purposes of section 163(d), the imputed interest from the indirect participant to the lender that is taken into account by the indirect participant under this paragraph (e)(2) is not investment interest to the extent of the excess, if any, of—

(A) The imputed interest from the indirect participant to the lender that is taken into account by the indirect participant; over

(B) The imputed interest to the indirect participant from the borrower that is recognized by the indirect participant.

(iv) *Examples.* The provisions of this paragraph (e)(2) are illustrated by the following examples:

Example 1. (i) On January 1, 2009, Employer *X* and Individual *A* enter into a split-dollar life insurance arrangement under which *A* is named as the policy owner. *A* is the child of *B*, an employee of *X*. On January 1, 2009, *X* makes a $30,000 premium payment, repayable upon demand without interest. Repayment of the premium payment is fully recourse to *A*. The payment is a below-market split-dollar demand loan. *A*'s net investment income for 2009 is $1,100, and there are no other outstanding loans between *A* and *B*. Assume that the blended annual rate for 2009 is 5 percent, compounded annually.

(ii) Based on the relationships among the parties, the effect of the below-market split-dollar loan from *X* to *A* is to transfer value from *X* to *B* and then to transfer value from *B* to *A*. Under paragraph (e)(2) of this section, the below-market split-dollar loan from *X* to *A* is restructured as two deemed below-market split-dollar demand loans: a compensation-related below-market split-dollar loan between *X* and *B* and a gift below-market split-dollar loan between *B* and *A*. Each of the deemed loans has the same terms and conditions as the original loan.

(iii) Under paragraph (e)(3) of this section, the amount of forgone interest deemed paid to *B* by *A* in 2009 is $1,500 ([$30,000 × 0.05]—0). Under section 7872(d)(1), however, the amount of forgone interest deemed paid to *B* by *A* is limited to $1,100 (*A*'s net investment income for the year). Under paragraph (e)(2)(iii) of this section, *B*'s deduction under section 163(d) in 2009 for interest deemed paid on *B*'s deemed loan from *X* is limited to $1,100 (the interest deemed received from *A*).

Example 2. (i) The facts are the same as the facts in *Example 1,* except that *T,* an irrevocable life insurance trust established for the benefit of *A* (*B*'s child), is named as the policy owner. *T* is not a grantor trust.

(ii) Based on the relationships among the parties, the effect of the below-market split-dollar loan from *X* to *T* is to transfer value from *X* to *B* and then to transfer value from *B* to *T.* Under paragraph (e)(2) of this section, the below-market split-dollar loan from *X* to *T* is restructured as two deemed below-market split-dollar demand loans: a compensation-related below-market split-dollar loan between *X* and *B* and a gift below-market split-dollar loan between *B* and *T.* Each of the deemed loans has the same terms and conditions as the original loan.

(iii) Under paragraph (e)(3) of this section, the amount of forgone interest deemed paid to *B* by *T* in 2009 is $1,500 ([$30,000 × 0.05]—0). Section 7872(d)(1) does not apply because *T* is not an individual. The amount of forgone interest deemed paid to *B* by *T* is $1,500. Under paragraph (e)(2)(iii) of this section, *B*'s deduction under section 163(d) in 2009 for interest deemed paid on *B*'s deemed loan from *X* is $1,500 (the interest deemed received from *T*).

(3) *Split-dollar demand loans*—(i) *In general.* This paragraph (e)(3) provides rules for testing split-dollar demand loans for sufficient interest, and, if the loans do not provide for sufficient interest, rules for the calculation and treatment of forgone interest on these loans. *See* paragraph (g) of this section for additional rules that apply to a split-dollar loan providing for certain variable rates of interest.

(ii) *Testing for sufficient interest.* Each calendar year that a split-dollar demand loan is outstanding, the loan is tested to determine if the loan provides for sufficient interest. A split-dollar demand loan provides for sufficient interest for the calendar year if the rate (based on annual compounding) at which interest accrues on the loan's adjusted issue price during the year is no lower than the blended annual rate for the year. (The Internal Revenue Service publishes the blended annual rate in the Internal Revenue Bulletin in July of each year (*see* § 601.601(d)(2)(ii) of this chapter).) If the loan does not provide for sufficient interest, the loan is a below-market split-dollar demand loan for that calendar year. *See* paragraph (e)(3)(iii) of this section to determine the amount and treatment of forgone interest for each calendar year the loan is below-market.

(iii) *Imputations*—(A) *Amount of forgone interest.* For each calendar year, the amount of forgone interest on a split-dollar demand loan is treated as transferred by the lender to the borrower and as retransferred as interest by the borrower to the lender. This amount is the excess of—

(*1*) The amount of interest that would have been payable on the loan for the calendar year if interest accrued on the loan's adjusted issue price at the blended annual rate (determined in paragraph (e)(3)(ii) of this section) and were payable annually on the day referred to in paragraph (e)(3)(iii)(B) of this section; over

(*2*) Any interest that accrues on the loan during the year.

(B) *Timing of transfers of forgone interest—*(*1*) *In general.* Except as provided in paragraphs (e)(3)(iii)(B)(*2*) and (*3*) of this section, the forgone interest (as determined under paragraph (e)(3)(iii)(A) of this section) that is attributable to a calendar year is treated as transferred by the lender to the borrower (and retransferred as interest by the borrower to the lender) on the last day of the calendar year and is accounted for by each party to the split-dollar loan in a manner consistent with that party's method of accounting.

(*2*) *Exception for death, liquidation, or termination of the borrower.* In the taxable year in which the borrower dies (in the case of a borrower who is a natural person) or is liquidated or otherwise terminated (in the case of a borrower other than a natural person), any forgone interest is treated, for both the lender and the borrower, as transferred and retransferred on the last day of the borrower's final taxable year.

(3) *Exception for repayment of below-market split-dollar loan.* Any forgone interest is treated, for both the lender and the borrower, as transferred and retransferred on the day the split-dollar loan is repaid in full.

(4) *Split-dollar term loans*—(i) *In general.* Except as provided in paragraph (e)(5) of this section, this paragraph (e)(4) provides rules for testing split-dollar term loans for sufficient interest

and, if the loans do not provide for sufficient interest, rules for imputing payments on these loans. *See* paragraph (g) of this section for additional rules that apply to a split-dollar loan providing for certain variable rates of interest.

(ii) *Testing a split-dollar term loan for sufficient interest.* A split-dollar term loan is tested on the day the loan is made to determine if the loan provides for sufficient interest. A split-dollar term loan provides for sufficient interest if the imputed loan amount equals or exceeds the amount loaned. The imputed loan amount is the present value of all payments due under the loan, determined as of the date the loan is made, using a discount rate equal to the AFR in effect on that date. The AFR used for purposes of the preceding sentence must be appropriate for the loan's term (short-term, mid-term, or long-term) and for the compounding period used in computing the present value. *See* section 1274(d)(1). If the split-dollar loan does not provide for sufficient interest, the loan is a below-market split-dollar term loan subject to paragraph (e)(4)(iv) of this section.

(iii) *Determining loan term.* This paragraph (e)(4)(iii) provides rules to determine the term of a split-dollar term loan for purposes of paragraph (e)(4)(ii) of this section. The term of the loan determined under this paragraph (e)(4)(iii) (other than paragraph (e)(4)(iii)(C) of this section) applies to determine the split-dollar loan's term, payment schedule, and yield for all purposes of this section.

(A) *In general.* Except as provided in paragraph (e)(4)(iii)(B), (C), (D) or (E) of this section, the term of a split-dollar term loan is based on the period from the date the loan is made until the loan's stated maturity date.

(B) *Special rules for certain options*—(*1*) *Payment schedule that minimizes yield.* If a split-dollar term loan is subject to one or more unconditional options that are exercisable at one or more times during the term of the loan and that, if exercised, require payments to be made on the split-dollar loan on an alternative payment schedule (for example, an option to extend or an option to call a split-dollar loan), then the rules of this paragraph (e)(4)(iii)(B)(*1*) determine the term of the loan. However, this paragraph (e)(4)(iii)(B)(*1*) applies only if the timing and amounts of the payments that comprise each payment schedule are known as of the issue date. For purposes of determining a split-dollar loan's term, the borrower is projected to exercise or not exercise an option or combination of options in a manner that minimizes the loan's overall yield. Similarly, the lender is projected to exercise or not exercise an option or combination of options in a manner that minimizes the loan's overall yield. If different projected patterns of exercise or non-exercise produce the same minimum yield, the parties are projected to exercise or not exercise an option or combination of options in a manner that produces the longest term.

(*2*) *Change in circumstances.* If the borrower (or lender) does or does not exercise the option as projected under paragraph (e)(4)(iii)(B)(*1*) of this section, the split-dollar loan is treated for purposes of this section as retired and reissued on the date the option is or is not exercised for an amount of cash equal to the loan's adjusted issue price on that date. The reissued loan must be retested using the appropriate AFR in effect on the date of reissuance to determine whether it is a below-market loan.

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

Example 1. Employee *B* issues a 10-year split-dollar term loan to Employer *Y*. *B* has the right to prepay the loan at the end of year 5. Interest is payable on the split-dollar loan at 1 percent for the first 5 years and at 10 percent for the remaining 5 years. Under paragraph (e)(4)(iii)(B)(*1*) of this section, this arrangement is treated as a 5-year split-dollar term loan from *Y* to *B*, with interest payable at 1 percent.

Example 2. The facts are the same as the facts in *Example 1*, except that B does not in fact prepay the split-dollar loan at the end of year 5. Under paragraph (e)(4)(iii)(B)(*2*) of this section, the first loan is treated as retired at the end of year 5 and a new 5-year split-dollar term loan is issued at that time, with interest payable at 10 percent.

Example 3. Employee *A* issues a 10-year split-dollar term loan on which the lender, Employer *X*, has the right to demand payment at the end of year 2. Interest is payable on the split-dollar loan at 7 percent each year that the loan is outstanding. Under

paragraph (e)(4)(iii)(B)(*1*) of this section, this arrangement is treated as a 10-year split-dollar term loan because the exercise of *X*'s put option would not reduce the yield of the loan (the yield of the loan is 7 percent, compounded annually, whether or not *X* demands payment).

(C) *Split-dollar term loans providing for certain variable rates of interest.* If a split-dollar term loan is subject to paragraph (g) of this section (a split-dollar loan that provides for certain variable rates of interest), the term of the loan for purposes of paragraph (e)(4)(ii) of this section is determined under paragraph (g)(3)(ii) of this section.

(D) *Split-dollar loans payable upon the death of an individual.* If a split-dollar term loan is described in paragraph (e)(5)(ii)(A) or (v)(A) of this section, the term of the loan for purposes of paragraph (e)(4)(ii) of this section is determined under paragraph (e)(5)(ii)(C) or (v)(B)(*2*) of this section, whichever is applicable.

(E) *Split-dollar loans conditioned on the future performance of substantial services by an individual.* If a split-dollar term loan is described in paragraph (e)(5)(iii)(A)(*1*) or (v)(A) of this section, the term of the loan for purposes of paragraph (e)(4)(ii) of this section is determined under paragraph (e)(5)(iii)(C) or (v)(B)(*2*) of this section, whichever is applicable.

(iv) *Timing and amount of imputed transfer in connection with below-market split-dollar term loans.* If a split-dollar term loan is a below-market loan, then the rules applicable to below-market term loans under section 7872 apply. In general, the loan is recharacterized as consisting of two portions: an imputed loan amount (as defined in paragraph (e)(4)(ii) of this section) and an imputed transfer from the lender to the borrower. The imputed transfer occurs at the time the loan is made (for example, when the lender makes a premium payment on a life insurance policy) and is equal to the excess of the amount loaned over the imputed loan amount.

(v) *Amount treated as OID.* In the case of any below-market split-dollar term loan described in this paragraph (e)(4), for purposes of applying sections 1271 through 1275 and the regulations thereunder, the issue price of the loan is the amount determined under §1.1273–2, reduced by the amount of the imputed transfer described in paragraph (e)(4)(iv) of this section. Thus, the loan is generally treated as having OID in an amount equal to the amount of the imputed transfer described in paragraph (e)(4)(iv) of this section, in addition to any other OID on the loan (determined without regard to section 7872(b)(2)(A) or this paragraph (e)(4)).

(vi) *Example.* The provisions of this paragraph (e)(4) are illustrated by the following example:

Example. (i) On July 1, 2009, Corporation *Z* and Shareholder *A* enter into a split-dollar life insurance arrangement under which *A* is named as the policy owner. On July 1, 2009, *Z* makes a $100,000 premium payment, repayable without interest in 15 years. Repayment of the premium payment is fully recourse to *A*. The premium payment is a split-dollar term loan. Assume the long-term AFR (based on annual compounding) at the time the loan is made is 7 percent.

(ii) Based on a 15-year term and a discount rate of 7 percent, compounded annually (the long-term AFR), the present value of the payments under the loan is $36,244.60, determined as follows: $\$100,000/[1 + (0.07/1)]^{15}$. This loan is a below-market split-dollar term loan because the imputed loan amount of $36,244.60 (the present value of the amount required to be repaid to *Z*) is less than the amount loaned ($100,000).

(iii) In accordance with section 7872(b)(1) and paragraph (e)(4)(iv) of this section, on the date that the loan is made, *Z* is treated as transferring to *A* $63,755.40 (the excess of $100,000 (amount loaned) over $36,244.60 (imputed loan amount)). Under section 7872 and paragraph (e)(1)(i) of this section, *Z* is treated as making a section 301 distribution to *A* on July 1, 2009, of $63,755.40. *Z* must take into account as OID an amount equal to the imputed transfer. See §1.1272–1 for the treatment of OID.

(5) *Special rules for certain split-dollar term loans*—(i) *In general.* This paragraph (e)(5) provides rules for split-dollar loans payable on the death of an individual, split-dollar loans conditioned on the future performance of substantial services by an individual, and gift term loans. These split-dollar loans are split-dollar term loans for purposes of determining whether the loan provides for sufficient interest. If, however, the loan is a below-market split-dollar loan, then, except as provided in paragraph (e)(5)(v) of this section, forgone interest is determined annually, similar to a demand loan, but using an AFR

that is appropriate for the loan's term and that is determined when the loan is issued.

(ii) *Split-dollar loans payable not later than the death of an individual*—(A) *Applicability*. This paragraph (e)(5)(ii) applies to a split-dollar term loan payable not later than the death of an individual.

(B) *Treatment of loan*. A split-dollar loan described in paragraph (e)(5)(ii)(A) of this section is tested under paragraph (e)(4)(ii) of this section to determine if the loan provides for sufficient interest. If the loan provides for sufficient interest, then section 7872 does not apply to the loan, and the interest on the loan is taken into account under paragraph (f) of this section. If the loan does not provide for sufficient interest, then section 7872 applies to the loan, and the loan is treated as a below-market demand loan subject to paragraph (e)(3)(iii) of this section. For each year that the loan is outstanding, however, the rate used in the determination of forgone interest under paragraph (e)(3)(iii) of this section is not the blended annual rate but rather is the AFR (based on annual compounding) appropriate for the loan's term as of the month in which the loan is made. *See* paragraph (e)(5)(ii)(C) of this section to determine the loan's term.

(C) *Term of loan*. For purposes of paragraph (e)(5)(ii)(B) of this section, the term of a split-dollar loan payable on the death of an individual (including the death of the last survivor of a group of individuals) is the individual's life expectancy as determined under the appropriate table in §1.72–9 on the day the loan is made. If a split-dollar loan is payable on the earlier of the individual's death or another term determined under paragraph (e)(4)(iii) of this section, the term of the loan is whichever term is shorter.

(D) *Retirement and reissuance of loan*. If a split-dollar loan described in paragraph (e)(5)(ii)(A) of this section remains outstanding longer than the term determined under paragraph (e)(5)(ii)(C) of this section because the individual outlived his or her life expectancy, the split-dollar loan is treated for purposes of this section as retired and reissued as a split-dollar demand loan at that time for an amount of cash equal to the loan's adjusted issue price on that date. However, the loan is not retested at that time to determine whether the loan provides for sufficient interest. For purposes of determining forgone interest under paragraph (e)(5)(ii)(B) of this section, the appropriate AFR for the reissued loan is the AFR determined under paragraph (e)(5)(ii)(B) of this section on the day the loan was originally made.

(iii) *Split-dollar loans conditioned on the future performance of substantial services by an individual*—(A) *Applicability*—(*1*) *In general*. This paragraph (e)(5)(iii) applies to a split-dollar term loan if the benefits of the interest arrangements of the loan are not transferable and are conditioned on the future performance of substantial services (within the meaning of section 83) by an individual.

(*2*) *Exception*. Notwithstanding paragraph (e)(5)(iii)(A)(*1*) of this section, this paragraph (e)(5)(iii) does not apply to a split-dollar loan described in paragraph (e)(5)(v)(A) of this section (regarding a split-dollar loan that is payable on the later of a term certain and the date on which the condition to perform substantial future services by an individual ends).

(B) *Treatment of loan*. A split-dollar loan described in paragraph (e)(5)(iii)(A)(*1*) of this section is tested under paragraph (e)(4)(ii) of this section to determine if the loan provides for sufficient interest. Except as provided in paragraph (e)(5)(iii)(D) of this section, if the loan provides for sufficient interest, then section 7872 does not apply to the loan and the interest on the loan is taken into account under paragraph (f) of this section. If the loan does not provide for sufficient interest, then section 7872 applies to the loan and the loan is treated as a below-market demand loan subject to paragraph (e)(3)(iii) of this section. For each year that the loan is outstanding, however, the rate used in the determination of forgone interest under paragraph (e)(3)(iii) of this section is not the blended annual rate but rather is the AFR (based on annual compounding) appropriate for the loan's term as of the month in which the loan is made. *See* paragraph (e)(5)(iii)(C) of this section to determine the loan's term.

(C) *Term of loan*. The term of a split-dollar loan described in paragraph (e)(5)(iii)(A)(*1*) of this section is based on the period from the date the loan is made until the loan's stated maturity date. However, if a split-dollar loan described in paragraph (e)(5)(iii)(A)(*1*) of this section does not have a stated maturity date, the term of the loan is presumed to be seven years.

(D) *Retirement and reissuance of loan*. If a split-dollar loan described in paragraph (e)(5)(iii)(A)(*1*) of this section remains outstanding longer than the term determined under paragraph (e)(5)(iii)(C) of this section because of the continued performance of substantial services, the split-dollar loan is treated for purposes of this section as retired and reissued as a split-dollar demand loan at that time for an amount of cash equal to the loan's adjusted issue price on that date. The loan is retested at that time to determine whether the loan provides for sufficient interest.

(iv) *Gift split-dollar term loans*—(A) *Applicability*. This paragraph (e)(5)(iv) applies to gift split-dollar term loans.

(B) *Treatment of loan*. A split-dollar loan described in paragraph (e)(5)(iv)(A) of this section is tested under paragraph (e)(4)(ii) of this section to determine if the loan provides for sufficient interest. If the loan provides for sufficient interest, then section 7872 does not apply to the loan and the interest on the loan is taken into account under paragraph (f) of this section. If the loan does not provide for sufficient interest, then section 7872 applies to the loan and the loan is treated as a below-market demand loan subject to paragraph (e)(3)(iii) of this section. For each year that the loan is outstanding, however, the rate used in the determination of forgone interest under paragraph (e)(3)(iii) of this section is not the blended annual rate but rather is the AFR (based on annual compounding) appropriate for the loan's term as of the month in which the loan is made. *See* paragraph (e)(5)(iv)(C) of this section to determine the loan's term.

(C) *Term of loan*. For purposes of paragraph (e)(5)(iv)(B) of this section, the term of a gift split-dollar term loan is the term determined under paragraph (e)(4)(iii) of this section.

(D) *Limited application for gift split-dollar term loans*. The rules of paragraph (e)(5)(iv)(B) of this section apply to a gift split-dollar term loan only for Federal income tax purposes. For purposes of Chapter 12 of the Internal Revenue Code (relating to the gift tax), gift below-market split-dollar term loans are treated as term loans under section 7872(b) and paragraph (e)(4) of this section. *See* section 7872(d)(2).

(v) *Split-dollar loans payable on the later of a term certain and another specified date*—(A) *Applicability*. This paragraph (e)(5)(v) applies to any split-dollar term loan payable upon the later of a term certain or—

(*1*) The death of an individual; or

(*2*) For a loan described in paragraph (e)(5)(iii)(A)(*1*) of this section, the date on which the condition to perform substantial future services by an individual ends.

(B) *Treatment of loan*—(*1*) *In general*. A split-dollar loan described in paragraph (e)(5)(v)(A) of this section is a split-dollar term loan, subject to paragraph (e)(4) of this section.

(*2*) *Term of the loan*. The term of a split-dollar loan described in paragraph (e)(5)(v)(A) of this section is the term certain.

(*3*) *Appropriate AFR*. The appropriate AFR for a split-dollar loan described in paragraph (e)(5)(v)(A) of this section is based on a term of the longer of the term certain or the loan's expected term as determined under either paragraph (e)(5) (ii) or (iii) of this section, whichever is applicable.

(C) *Retirement and reissuance*. If a split-dollar loan described in paragraph (e)(5)(v)(A) of this section remains outstanding longer than the term certain, the split-dollar loan is treated for purposes of this section as retired and reissued at the end of the term certain for an amount of cash equal to the loan's adjusted issue price on that date. The reissued loan is subject to paragraph (e)(5) (ii) or (iii) of this section, whichever is applicable. However, the loan is not retested at that time to determine whether the loan provides for sufficient interest. For purposes of paragraph (e)(3)(iii) of this section, the appropriate AFR for the reissued loan

is the AFR determined under paragraph (e)(5)(v)(B)(*3*) of this section on the day the loan was originally made.

(vi) *Example.* The provisions of this paragraph (e)(5) are illustrated by the following example:

Example. (i) On January 1, 2009, Corporation *Y* and Shareholder *B*, a 65 year-old male, enter into a split-dollar life insurance arrangement under which *B* is named as the policy owner. On January 1, 2009, *Y* makes a $100,000 premium payment, repayable, without interest, from the death benefits of the underlying contract upon *B*'s death. The premium payment is a split-dollar term loan. Repayment of the premium payment is fully recourse to *B*. Assume the long-term AFR (based on annual compounding) at the time of the loan is 7 percent. Both *Y* and *B* use the calendar year as their taxable years.

(ii) Based on Table 1 in §1.72–9, the expected term of the loan is 15 years. Under paragraph (e)(5)(ii)(C) of this section, the long-term AFR (based on annual compounding) is the appropriate test rate. Based on a 15-year term and a discount rate of 7 percent, compounded annually (the long-term AFR), the present value of the payments under the loan is $36,244.60, determined as follows: $\$100{,}000/[1 + (0.07/1)]^{15}$. Under paragraph (e)(5)(ii)(B) of this section, this loan is a below-market split-dollar term loan because the imputed loan amount of $36,244.60 (the present value of the amount required to be repaid to *Y*) is less than the amount loaned ($100,000).

(iii) Under paragraph (e)(5)(ii)(B) of this section, the amount of forgone interest for 2009 (and each subsequent full calendar year that the loan remains outstanding) is $7,000, which is the amount of interest that would have been payable on the loan for the calendar year if interest accrued on the loan's adjusted issue price ($100,000) at the long-term AFR (7 percent, compounded annually). Under section 7872 and paragraph (e)(1)(i) of this section, on December 31, 2009, *Y* is treated as making a section 301 distribution to *B* of $7,000. In addition, *Y* has $7,000 of imputed interest income for 2009.

(f) *Treatment of stated interest and OID for split-dollar loans*—(1) *In general.* If a split-dollar loan provides for stated interest or OID, the loan is subject to this paragraph (f), regardless of whether the split-dollar loan has sufficient interest. Except as otherwise provided in this section, split-dollar loans are subject to the same Internal Revenue Code and regulatory provisions for stated interest and OID as other loans. For example, the lender of a split-dollar loan that provides for stated interest must account for any qualified stated interest (as defined in §1.1273–1(c)) under its regular method of accounting (for example, an accrual method or the cash receipts and disbursements method). *See* §1.446–2 to determine the amount of qualified stated interest that accrues during an accrual period. In addition, the lender must account under §1.1272–1 for any OID on a split-dollar loan. However, §1.1272–1(c) does not apply to any split-dollar loan. *See* paragraph (h) of this section for a subsequent waiver, cancellation, or forgiveness of stated interest on a split-dollar loan.

(2) *Term, payment schedule, and yield.* The term of a split-dollar term loan determined under paragraph (e)(4)(iii) of this section (other than paragraph (e)(4)(iii)(C) of this section) applies to determine the split-dollar loan's term, payment schedule, and yield for all purposes of this section.

(g) *Certain variable rates of interest*—(1) *In general.* This paragraph (g) provides rules for a split-dollar loan that provides for certain variable rates of interest. If this paragraph (g) does not apply to a variable rate split-dollar loan, the loan is subject to the rules in paragraph (j) of this section for split-dollar loans that provide for one or more contingent payments.

(2) *Applicability*—(i) *In general.* Except as provided in paragraph (g)(2)(ii) of this section, this paragraph (g) applies to a split-dollar loan that is a variable rate debt instrument (within the meaning of §1.1275–5) and that provides for stated interest at a qualified floating rate (or rates).

(ii) *Interest rate restrictions.* This paragraph (g) does not apply to a split-dollar loan if, as a result of interest rate restrictions (such as an interest rate cap), the expected yield of the loan taking the restrictions into account is significantly less than the expected yield of the loan without regard to the restrictions. Conversely, if reasonably symmetric interest rate caps and floors or reasonably symmetric governors are fixed throughout the term of the loan, these restrictions generally do not prevent this paragraph (g) from applying to the loan.

(3) *Testing for sufficient interest*—(i) *Demand loan*. For purposes of paragraph (e)(3)(ii) of this section (regarding testing a split-dollar demand loan for sufficient interest), a split-dollar demand loan is treated as if it provided for a fixed rate of interest for each accrual period to which a qualified floating rate applies. The projected fixed rate for each accrual period is the value of the qualified floating rate as of the beginning of the calendar year that contains the last day of the accrual period.

(ii) *Term loan*. For purposes of paragraph (e)(4)(ii) of this section (regarding testing a split-dollar term loan for sufficient interest), a split-dollar term loan subject to this paragraph (g) is treated as if it provided for a fixed rate of interest for each accrual period to which a qualified floating rate applies. The projected fixed rate for each accrual period is the value of the qualified floating rate on the date the split-dollar term loan is made. The term of a split-dollar loan that is subject to this paragraph (g)(3)(ii) is determined using the rules in §1.1274–4(c)(2). For example, if the loan provides for interest at a qualified floating rate that adjusts at varying intervals, the term of the loan is determined by reference to the longest interval between interest adjustment dates. *See* paragraph (e)(5) of this section for special rules relating to certain split-dollar term loans, such as a split-dollar term loan payable not later than the death of an individual.

(4) *Interest accruals and imputed transfers*. For purposes of paragraphs (e) and (f) of this section, the projected fixed rate or rates determined under paragraph (g)(3) of this section are used for purposes of determining the accrual of interest each period and the amount of any imputed transfers. Appropriate adjustments are made to the interest accruals and any imputed transfers to take into account any difference between the projected fixed rate and the actual rate.

(5) *Example*. The provisions of this paragraph (g) are illustrated by the following example:

Example. (i) On January 1, 2010, Employer *V* and Employee *F* enter into a split-dollar life insurance arrangement under which *F* is named as the policy owner. On January 1, 2010, *V* makes a $100,000 premium payment, repayable in 15 years. The premium payment is a split-dollar term loan. Under the arrangement between the parties, interest is payable on the split-dollar loan each year on January 1, starting January 1, 2011, at a rate equal to the value of 1-year LIBOR as of the payment date. The short-term AFR (based on annual compounding) at the time of the loan is 7 percent. Repayment of both the premium payment and the interest due thereon is nonrecourse to *F*. However, the parties made a representation under paragraph (d)(2) of this section. Assume that the value of 1-year LIBOR on January 1, 2010, is 8 percent, compounded annually.

(ii) The loan is subject to this paragraph (g) because the loan is a variable rate debt instrument that bears interest at a qualified floating rate. Because the interest rate is reset each year, under paragraph (g)(3)(ii) of this section, the short-term AFR (based on annual compounding) is the appropriate test rate used to determine whether the loan provides for sufficient interest. Moreover, under paragraph (g)(3)(ii) of this section, to determine whether the loan provides for sufficient interest, the loan is treated as if it provided for a fixed rate of interest equal to 8 percent, compounded annually. Based on a discount rate of 7 percent, compounded annually (the short-term AFR), the present value of the payments under the loan is $109,107.91. The loan provides for sufficient interest because the loan's imputed loan amount of $109,107.91 (the present value of the payments) is more than the amount loaned of $100,000. Therefore, the loan is not a below-market split-dollar term loan, and interest on the loan is taken into account under paragraph (f) of this section.

(h) *Adjustments for interest paid at less than the stated rate*—(1) *Application*—(i) *In general*. To the extent required by this paragraph (h), if accrued but unpaid interest on a split-dollar loan is subsequently waived, cancelled, or forgiven by the lender, then the waiver, cancellation, or forgiveness is treated as if, on that date, the interest had in fact been paid to the lender and retransferred by the lender to the borrower. The amount deemed transferred and retransferred is determined under paragraph (h) (2) or (3) of this section. Except as provided in paragraph (h)(1)(iv) of this section, the amount treated as retransferred by the lender to the borrower under paragraph (h) (2) or (3) of this section is increased by the

deferral charge determined under paragraph (h)(4) of this section. To determine the character of any retransferred amount, *see* paragraph (e)(1)(i) of this section. *See* § 1.61–22(b)(6) for the treatment of amounts other than interest on a split-dollar loan that are waived, cancelled, or forgiven by the lender.

(ii) *Certain split-dollar term loans.* For purposes of this paragraph (h), a split-dollar term loan described in paragraph (e)(5) of this section (for example, a split-dollar term loan payable not later than the death of an individual) is subject to the rules of paragraph (h)(3) of this section.

(iii) *Payments treated as a waiver, cancellation, or forgiveness.* For purposes of this paragraph (h), if a payment by the lender (or a person related to the lender) to the borrower is, in substance, a waiver, cancellation, or forgiveness of accrued but unpaid interest, the payment by the lender (or person related to the lender) is treated as an amount retransferred to the borrower by the lender under this paragraph (h) and is subject to the deferral charge in paragraph (h)(4) of this section to the extent that the payment is, in substance, a waiver, cancellation, or forgiveness of accrued but unpaid interest.

(iv) *Treatment of certain nonrecourse split-dollar loans.* For purposes of this paragraph (h), if the parties to a split-dollar life insurance arrangement make the representation described in paragraph (d)(2) of this section and the interest actually paid on the split-dollar loan is less than the interest required to be accrued on the split-dollar loan, the excess of the interest required to be accrued over the interest actually paid is treated as waived, cancelled, or forgiven by the lender under this paragraph (h). However, the amount treated as retransferred under paragraph (h)(1)(i) of this section is not increased by the deferral charge in paragraph (h)(4) of this section.

(2) *Split-dollar term loans.* In the case of a split-dollar term loan, the amount of interest deemed transferred and retransferred for purposes of paragraph (h)(1) of this section is determined as follows:

(i) If the loan's stated rate is less than or equal to the appropriate AFR (the AFR used to test the loan for sufficient interest under paragraph (e) of this section), the amount of interest deemed transferred and retransferred pursuant to this paragraph (h) is the excess of the amount of interest payable at the stated rate over the interest actually paid.

(ii) If the loan's stated rate is greater than the appropriate AFR (the AFR used to test the loan for sufficient interest under paragraph (e) of this section), the amount of interest deemed transferred and retransferred pursuant to this paragraph (h) is the excess, if any, of the amount of interest payable at the AFR over the interest actually paid.

(3) *Split-dollar demand loans.* In the case of a split-dollar demand loan, the amount of interest deemed transferred and retransferred for purposes of paragraph (h)(1) of this section is equal to the aggregate of—

(i) For each year that the split-dollar demand loan was outstanding in which the loan was a below-market split-dollar demand loan, the excess of the amount of interest payable at the stated rate over the interest actually paid allocable to that year; plus

(ii) For each year that the split-dollar demand loan was outstanding in which the loan was not a below-market split-dollar demand loan, the excess, if any, of the amount of interest payable at the appropriate rate used for purposes of imputation for that year over the interest actually paid allocable to that year.

(4) *Deferral charge.* The Commissioner may prescribe the method for determining the deferral charge treated as retransferred by the lender to the borrower under paragraph (h)(1) of this section. Until the Commissioner prescribes otherwise, the deferral charge is determined under paragraph (h)(4)(i) of this section for a split-dollar term loan subject to paragraph (h)(2) of this section and under paragraph (h)(4)(ii) of this section for a split-dollar demand loan subject to paragraph (h)(3) of this section.

(i) *Split-dollar term loan.* The deferral charge for a split-dollar term loan subject to paragraph (h)(2) of this section

is determined by multiplying the hypothetical underpayment by the applicable underpayment rate, compounded daily, for the period from the date the split-dollar loan was made to the date the interest is waived, cancelled, or forgiven. The hypothetical underpayment is equal to the amount determined under paragraph (h)(2) of this section, multiplied by the highest rate of income tax applicable to the borrower (for example, the highest rate in effect under section 1 for individuals) for the taxable year in which the split-dollar term loan was made. The applicable underpayment rate is the average of the quarterly underpayment rates in effect under section 6621(a)(2) for the period from the date the split-dollar loan was made to the date the interest is waived, cancelled, or forgiven.

(ii) *Split-dollar demand loan.* The deferral charge for a split-dollar demand loan subject to paragraph (h)(3) of this section is the sum of the following amounts determined for each year the loan was outstanding (other than the year in which the waiver, cancellation, or forgiveness occurs): For each year the loan was outstanding, multiply the hypothetical underpayment for the year by the applicable underpayment rate, compounded daily, for the applicable period. The hypothetical underpayment is equal to the amount determined under paragraph (h)(3) of this section for each year, multiplied by the highest rate of income tax applicable to the borrower for that year (for example, the highest rate in effect under section 1 for individuals). The applicable underpayment rate is the average of the quarterly underpayment rates in effect under section 6621(a)(2) for the applicable period. The applicable period for a year is the period of time from the last day of that year until the date the interest is waived, cancelled, or forgiven.

(5) *Examples.* The provisions of this paragraph (h) are illustrated by the following examples:

Example 1. (i) On January 1, 2009, Employer *Y* and Employee *B* entered into a split-dollar life insurance arrangement under which *B* is named as the policy owner. On January 1, 2009, *Y* made a $100,000 premium payment, repayable on December 31, 2011, with interest of 5 percent, compounded annually. The premium payment is a split-dollar term loan. Assume the short-term AFR (based on annual compounding) at the time the loan was made was 5 percent. Repayment of both the premium payment and the interest due thereon was fully recourse to *B*. On December 31, 2011, *Y* is repaid $100,000 but *Y* waives the remainder due on the loan ($15,762.50). Both *Y* and *B* use the calendar year as their taxable years.

(ii) When the split-dollar term loan was made, the loan was not a below-market loan under paragraph (e)(4)(ii) of this section. Under paragraph (f) of this section, *Y* was required to accrue compound interest of 5 percent each year the loan remained outstanding. *B*, however, was not entitled to any deduction for this interest under paragraph (c) of this section.

(iii) Under paragraph (h)(1) of this section, the waived amount is treated as if, on December 31, 2011, it had in fact been paid to *Y* and was then retransferred by *Y* to *B*. The amount deemed transferred to *Y* and retransferred to *B* equals the excess of the amount of interest payable at the stated rate ($15,762.50) over the interest actually paid ($0), or $15,762.50. In addition, the amount deemed retransferred to *B* is increased by the deferral charge determined under paragraph (h)(4) of this section. Because of the employment relationship between *Y* and *B*, the total retransferred amount is treated as compensation paid by *Y* to *B*.

Example 2. (i) On January 1, 2009, Employer *Y* and Employee *B* entered into a split-dollar life insurance arrangement under which *B* is named as the policy owner. On January 1, 2009, *Y* made a $100,000 premium payment, repayable on the demand of *Y*, with interest of 7 percent, compounded annually. The premium payment is a split-dollar demand loan. Assume the blended annual rate (based on annual compounding) in 2009 was 5 percent and in 2010 was 6 percent. Repayment of both the premium payment and the interest due thereon was fully recourse to *B*. On December 31, 2010, *Y* demands repayment and is repaid its $100,000 premium payment in full; however, *Y* waives all interest due on the loan. Both *Y* and *B* use the calendar year as their taxable years.

(ii) For each year that the split-dollar demand loan was outstanding, the loan was not a below-market loan under paragraph (e)(3)(ii) of this section. Under paragraph (f) of this section, *Y* was required to accrue compound interest of 7 percent each year the loan remained outstanding. *B*, however, was not entitled to any deduction for this interest under paragraph (c) of this section.

(iii) Under paragraph (h)(1) of this section, a portion of the waived interest is treated as if, on December 31, 2010, it had in fact been paid to *Y* and was then retransferred by *Y* to *B*. The amount of interest deemed transferred to *Y* and retransferred to *B* equals the

excess, if any, of the amount of interest payable at the blended annual rate for each year the loan is outstanding over the interest actually paid with respect to that year. For 2009, the interest payable at the blended annual rate is $5,000 ($100,000 × 0.05). For 2010, the interest payable at the blended annual rate is $6,000 ($100,000 × 0.06). Therefore, the amount of interest deemed transferred to *Y* and retransferred to *B* equals $11,000. In addition, the amount deemed retransferred to *B* is increased by the deferral charge determined under paragraph (h)(4) of this section. Because of the employment relationship between *Y* and *B,* the total retransferred amount is treated as compensation paid by *Y* to *B.*

(i) [Reserved]

(j) *Split-dollar loans that provide for contingent payments*—(1) *In general.* Except as provided in paragraph (j)(2) of this section, this paragraph (j) provides rules for a split-dollar loan that provides for one or more contingent payments. This paragraph (j), rather than §1.1275–4, applies to split-dollar loans that provide for one or more contingent payments.

(2) *Exceptions*—(i) *Certain contingencies.* For purposes of this section, a split-dollar loan does not provide for contingent payments merely because—

(A) The loan provides for options described in paragraph (e)(4)(iii)(B) of this section (for example, certain call options, put options, and options to extend); or

(B) The loan is described in paragraph (e)(5) of this section (relating to certain split-dollar term loans, such as a split-dollar term loan payable not later than the death of an individual).

(ii) *Insolvency and default.* For purposes of this section, a payment is not contingent merely because of the possibility of impairment by insolvency, default, or similar circumstances. However, if any payment on a split-dollar loan is nonrecourse to the borrower, the payment is a contingent payment for purposes of this paragraph (j) unless the parties to the arrangement make the written representation provided for in paragraph (d)(2) of this section.

(iii) *Remote and incidental contingencies.* For purposes of this section, a payment is not a contingent payment merely because of a contingency that, as of the date the split-dollar loan is made, is either remote or incidental (within the meaning of §1.1275–2(h)).

(iv) *Exceptions for certain split-dollar loans.* This paragraph (j) does not apply to a split-dollar loan described in §1.1272–1(d) (certain debt instruments that provide for a fixed yield) or a split-dollar loan described in paragraph (g) of this section (relating to split-dollar loans providing for certain variable rates of interest).

(3) *Contingent split-dollar method*—(i) *In general.* If a split-dollar loan provides for one or more contingent payments, then the parties account for the loan under the contingent split-dollar method. In general, except as provided in this paragraph (j), this method is the same as the noncontingent bond method described in §1.1275–4(b).

(ii) *Projected payment schedule*—(A) *Determination of schedule.* No comparable yield is required to be determined. The projected payment schedule for the loan includes all noncontingent payments and a projected payment for each contingent payment. The projected payment for a contingent payment is the lowest possible value of the payment. The projected payment schedule, however, must produce a yield that is not less than zero. If the projected payment schedule produces a negative yield, the schedule must be reasonably adjusted to produce a yield of zero.

(B) *Split-dollar term loans payable upon the death of an individual.* If a split-dollar term loan described in paragraph (e)(5)(ii)(A) or (v)(A)(*1*) of this section provides for one or more contingent payments, the projected payment schedule is determined based on the term of the loan as determined under paragraph (e)(5)(ii)(C) or (v)(B)(*2*) of this section, whichever is applicable.

(C) *Certain split-dollar term loans conditioned on the future performance of substantial services by an individual.* If a split-dollar term loan described in paragraph (e)(5)(iii)(A)(*1*) or (v)(A)(*2*) of this section provides for one or more contingent payments, the projected payment schedule is determined based on the term of the loan as determined under paragraph (e)(5)(iii)(C) or (v)(B)(*2*) of this section, whichever is applicable.

(D) *Demand loans.* If a split-dollar demand loan provides for one or more contingent payments, the projected

payment schedule is determined based on a reasonable assumption as to when the lender will demand repayment.

(E) *Borrower/lender consistency.* Contrary to §1.1275–4(b)(4)(iv), the lender rather than the borrower is required to determine the projected payment schedule and to provide the schedule to the borrower and to any indirect participant as described in paragraph (e)(2) of this section. The lender's projected payment schedule is used by the lender, the borrower, and any indirect participant to compute interest accruals and adjustments.

(iii) *Negative adjustments.* If the issuer of a split-dollar loan is not allowed to deduct interest or OID (for example, because of section 163(h) or 264), then the issuer is not required to include in income any negative adjustment carryforward determined under §1.1275–4(b)(6)(iii)(C) on the loan, except to the extent that at maturity the total payments made over the life of the loan are less than the issue price of the loan.

(4) *Application of section 7872*—(i) *Determination of below-market status.* The yield based on the projected payment schedule determined under paragraph (j)(3) of this section is used to determine whether the loan is a below-market split-dollar loan under paragraph (e) of this section.

(ii) *Adjustment upon the resolution of a contingent payment.* To the extent that interest has accrued under section 7872 on a split-dollar loan and the interest would not have accrued under this paragraph (j) in the absence of section 7872, the lender is not required to recognize income under §1.1275–4(b) for a positive adjustment and the borrower is not treated as having interest expense for a positive adjustment. To the same extent, there is a reversal of the tax consequences imposed under paragraph (e) of this section for the prior imputed transfer from the lender to the borrower. This reversal is taken into account in determining adjusted gross income.

(5) *Examples.* The following examples illustrate the rules of this paragraph (j). For purposes of this paragraph (j)(5), assume that the contingent payments are neither remote nor incidental. The examples are as follows:

Example 1. (i) On January 1, 2010, Employer *T* and Employee *G* enter into a split-dollar life insurance arrangement under which *G* is named as the policy owner. On January 1, 2010, *T* makes a $100,000 premium payment. On December 31, 2013, *T* will be repaid an amount equal to the premium payment plus an amount based on the increase, if any, in the price of a specified commodity for the period the loan is outstanding. The premium payment is a split-dollar term loan. Repayment of both the premium payment and the interest due thereon is recourse to *G*. Assume that the appropriate AFR for this loan, based on annual compounding, is 7 percent. Both *T* and *G* use the calendar year as their taxable years.

(ii) Under this paragraph (j), the split-dollar term loan between *T* and *G* provides for a contingent payment. Therefore, the loan is subject to the contingent split-dollar method. Under this method, the projected payment schedule for the loan provides for a noncontingent payment of $100,000 and a projected payment of $0 for the contingent payment (because it is the lowest possible value of the payment) on December 31, 2013.

(iii) Based on the projected payment schedule and a discount rate of 7 percent, compounded annually (the appropriate AFR), the present value of the payments under the loan is $76,289.52. Under paragraphs (e)(4) and (j)(4)(i) of this section, the loan does not provide for sufficient interest because the loan's imputed loan amount of $76,289.52 (the present value of the payments) is less than the amount loaned of $100,000. Therefore, the loan is a below-market split-dollar term loan and the loan is recharacterized as consisting of two portions: an imputed loan amount of $76,289.52 and an imputed transfer of $23,710.48 (amount loaned of $100,000 minus the imputed loan amount of $76,289.52).

(iv) In accordance with section 7872(b)(1) and paragraph (e)(4)(iv) of this section, on the date the loan is made, *T* is treated as transferring to *G* $23,710.48 (the imputed transfer) as compensation. In addition, *T* must take into account as OID an amount equal to the imputed transfer. See §1.1272–1 for the treatment of OID.

Example 2. (i) Assume, in addition to the facts in *Example 1*, that on December 31, 2013, *T* receives $115,000 (its premium payment of $100,000 plus $15,000).

(ii) Under the contingent split-dollar method, when the loan is repaid, there is a $15,000 positive adjustment ($15,000 actual payment minus $0 projected payment). Under paragraph (j)(4) of this section, because *T* accrued imputed interest under section 7872 on this split-dollar loan to *G* and this interest would not have accrued in the absence of section 7872, *T* is not required to include the positive adjustment in income, and *G* is not treated as having interest expense for the positive

adjustment. To the same extent, *T* must include in income, and *G* is entitled to deduct, $15,000 to reverse their respective prior tax consequences imposed under paragraph (e) of this section (*T*'s prior deduction for imputed compensation deemed paid to *G* and *G*'s prior inclusion of this amount). *G* takes the reversal into account in determining adjusted gross income. That is, the $15,000 is an ''above-the-line'' deduction, whether or not *G* itemizes deductions.

Example 3. (i) Assume the same facts as in *Example 2*, except that on December 31, 2013, *T* receives $127,000 (its premium payment of $100,000 plus $27,000).

(ii) Under the contingent split-dollar method, when the loan is repaid, there is a $27,000 positive adjustment ($27,000 actual payment minus $0 projected payment). Under paragraph (j)(4) of this section, because *T* accrued imputed interest of $23,710.48 under section 7872 on this split-dollar loan to *G* and this interest would not have accrued in the absence of section 7872, *T* is not required to include $23,710.48 of the positive adjustment in income, and *G* is not treated as having interest expense for the positive adjustment. To the same extent, in 2013, *T* must include in income, and *G* is entitled to deduct, $23,710.48 to reverse their respective prior tax consequences imposed under paragraph (e) of this section (*T*'s prior deduction for imputed compensation deemed paid to *G* and *G*'s prior inclusion of this amount). *G* and *T* take these reversals into account in determining adjusted gross income. Under the contingent split-dollar method, *T* must include in income $3,289.52 upon resolution of the contingency ($27,000 positive adjustment minus $23,710.48).

(k) *Payment ordering rule.* For purposes of this section, a payment made by the borrower to or for the benefit of the lender pursuant to a split-dollar life insurance arrangement is applied to all direct and indirect split-dollar loans in the following order—

(1) A payment of interest to the extent of accrued but unpaid interest (including any OID) on all outstanding split-dollar loans in the order the interest accrued;

(2) A payment of principal on the outstanding split-dollar loans in the order in which the loans were made;

(3) A payment of amounts previously paid by a non-owner pursuant to a split-dollar life insurance arrangement that were not reasonably expected to be repaid by the owner; and

(4) Any other payment with respect to a split-dollar life insurance arrangement, other than a payment taken into account under paragraphs (k)(1), (2), and (3) of this section.

(l) [Reserved]

(m) *Repayments received by a lender.* Any amount received by a lender under a life insurance contract that is part of a split-dollar life insurance arrangement is treated as though the amount had been paid to the borrower and then paid by the borrower to the lender. Any amount treated as received by the borrower under this paragraph (m) is subject to other provisions of the Internal Revenue Code as applicable (for example, sections 72 and 101(a)). The lender must take the amount into account as a payment received with respect to a split-dollar loan, in accordance with paragraph (k) of this section. No amount received by a lender with respect to a split-dollar loan is treated as an amount received by reason of the death of the insured.

(n) *Effective date*—(1) *General rule.* This section applies to any split-dollar life insurance arrangement entered into after September 17, 2003. For purposes of this section, an arrangement is entered into as determined under §1.61–22(j)(1)(ii).

(2) *Modified arrangements treated as new arrangements.* If an arrangement entered into on or before September 17, 2003 is materially modified (within the meaning of §1.61–22(j)(2)) after September 17, 2003, the arrangement is treated as a new arrangement entered into on the date of the modification.

[T.D. 9092, 68 FR 54352, Sept. 17, 2003]

§ 1.7872–16 Loans to an exchange facilitator under § 1.468B–6.

(a) *Exchange facilitator loans.* This section provides rules in applying section 7872 to an exchange facilitator loan (within the meaning of §1.468B–6(c)(1)). For purposes of this section, the terms *deferred exchange*, *exchange agreement*, *exchange facilitator*, *exchange funds*, *qualified intermediary*, *replacement property*, and *taxpayer* have the same meanings as in §1.468B–6(b).

(b) *Treatment as demand loans.* For purposes of section 7872, except as provided in paragraph (d) of this section, an exchange facilitator loan is a demand loan.

(c) *Treatment as compensation-related loans.* If an exchange facilitator loan is

a below-market loan, the loan is a compensation-related loan under section 7872(c)(1)(B).

(d) *Applicable Federal rate (AFR) for exchange facilitator loans.* For purposes of section 7872, in the case of an exchange facilitator loan, the applicable Federal rate is the lower of the short-term AFR in effect under section 1274(d)(1) (as of the day on which the loan is made), compounded semiannually, or the 91-day rate. For purposes of the preceding sentence, the 91-day rate is equal to the investment rate on a 13-week (generally 91-day) Treasury bill with an issue date that is the same as the date that the exchange facilitator loan is made or, if the two dates are not the same, with an issue date that most closely precedes the date that the exchange facilitator loan is made.

(e) *Use of approximate method permitted.* The taxpayer and exchange facilitator may use the approximate method to determine the amount of forgone interest on any exchange facilitator loan.

(f) *Exemption for certain below-market exchange facilitator loans.* If an exchange facilitator loan is a below-market loan, the loan is not eligible for the exemptions from section 7872 listed under §1.7872–5T. However, the loan may be eligible for the exemption from section 7872 under §1.7872–5(b)(16) (relating to exchange facilitator loans in which the amount treated as loaned does not exceed $2,000,000).

(g) *Effective/applicability date.* This section applies to exchange facilitator loans issued on or after October 8, 2008.

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

Example. (i) T enters into a deferred exchange with QI, a qualified intermediary. The exchange is governed by an exchange agreement. The exchange funds held by QI pursuant to the exchange agreement are treated as loaned to QI under §1.468B–6(c)(1). The loan between T and QI is an exchange facilitator loan. The exchange agreement between T and QI provides that no earnings will be paid to T. On December 1, 2008, T transfers property to QI, QI transfers the property to a purchaser for $2,100,000, and QI deposits $2,100,000 in a money market account. On March 1, 2009, QI uses $2,100,000 of the funds in the account to purchase replacement property identified by T, and transfers the replacement property to T. The amount loaned for purposes of section 7872 is $2,100,000 and the loan is outstanding for three months. For purposes of section 7872, under paragraph (d) of this section, T uses the 91-day rate, which is 4 percent, compounded semi-annually. T uses the approximate method for purposes of section 7872.

(ii) Under paragraphs (b) and (c) of this section, the loan from T to QI is a compensation-related demand loan. Because there is no interest payable on the loan from T to QI, the loan is a below-market loan under section 7872. The loan is not exempt under §1.7872–5(b)(16) because the amount treated as loaned exceeds $2,000,000. Under section 7872(e)(2), the amount of forgone interest on the loan for 2008 is $7000 ($2,100,000*.04/2*1/6). Under section 7872(e)(2), the amount of forgone interest for 2009 is $14,000 ($2,100,000*.04/2*2/6). The $7000 for 2008 is deemed transferred as compensation by T to QI and retransferred as interest by QI to T on December 31, 2008. The $14,000 for 2009 is deemed transferred as compensation by T to QI and retransferred as interest by QI to T on March 1, 2009.

[T.D. 9413, 73 FR 39622, July 10, 2008]

§ 1.7874–1 Disregard of affiliate-owned stock.

(a) *Scope.* Section 7874(c)(2)(A) provides that stock of the foreign acquiring corporation held by members of the expanded affiliated group shall not be taken into account in determining ownership for purposes of section 7874(a)(2)(B)(ii). This section provides rules under section 7874(c)(2)(A). The rules provided in this section are also subject to section 7874(c)(4). For definitions that apply for purposes of this section, see 1.7874–12.

(b) *General rule.* Except as provided in paragraph (c) of this section, for purposes of determining the ownership percentage described in section 7874(a)(2)(B)(ii), stock held by one or more members of the EAG is not included in either the numerator or the denominator of the ownership fraction.

(c) *Exceptions to general rule*—(1) *Overview.* Stock held by one or more members of the EAG shall be included in the denominator, but not in the numerator, of the ownership fraction, if the domestic entity acquisition qualifies as an *internal group restructuring* or results in a *loss of control*, as described in paragraph (c)(2) and (c)(3) of this section. For rules addressing the interaction of this section and other rules, see paragraph (d) of this section.

(2) *Internal group restructuring.* For purposes of paragraph (c)(1) of this section, a domestic entity acquisition qualifies as an internal group restructuring if:

(i) Before the domestic entity acquisition, 80 percent or more of the stock (by vote and value) or the capital and profits interest, as applicable, of the domestic entity was held directly or indirectly by the corporation that is the common parent of the EAG after the acquisition; and

(ii) After the domestic entity acquisition, 80 percent or more of the stock (by vote and value) of the foreign acquiring corporation is held directly or indirectly by such common parent.

(iii) *Special rule.* If §1.7874–6(c)(2) applies for purposes of applying section 7874(c)(2)(A) and this section, then, for purposes of paragraph (c)(2) of this section (and so much of paragraph (c)(1) of this section as relates to paragraph (c)(2) of this section), the determination of the EAG after the domestic entity acquisition, as well as the determination of stock held by one or more members of the EAG after the domestic entity acquisition, is made without regard to one or more transfers (other than by issuance), in a transaction (or series of transactions) after and related to the acquisition, of stock of the acquiring foreign corporation by one or more members of the foreign-parented group described in §1.7874–6(c)(2)(i).

(3) *Loss of control.* For purposes of paragraph (c)(1) of this section, the domestic entity acquisition results in a loss of control if after the acquisition, the former domestic entity shareholders or former domestic entity partners do not hold, in the aggregate, directly or indirectly, more than 50 percent of the stock (by vote or value) of any member of the EAG.

(d) *Interaction of expanded affiliated group rules with other rules*—(1) *Exclusion rules.* Stock that is excluded from the denominator of the ownership fraction pursuant to §1.7874–4(b), 1.7874–7(b), 1.7874–8(b), 1.7874–9(b), or section 7874(c)(4) is taken into account for purposes of determining whether an entity is a member of the expanded affiliated group for purposes of applying section 7874(c)(2)(A) and paragraph (b) of this section and determining whether a domestic entity acquisition qualifies as an internal group restructuring or results in a loss of control, as described in paragraphs (c)(2) and (3) of this section, respectively. However, such stock is excluded from the denominator of the ownership fraction regardless of whether it otherwise would be included in the denominator of the ownership fraction as a result of the application of paragraph (c) of this section. See *Example 8* and *Example 9* of §1.7874–4(i) for illustrations of the application of this paragraph (d)(1).

(2) *NOCD rule.* Stock of the foreign acquiring corporation treated as received by former domestic entity shareholders or former domestic entity partners, as applicable, under §1.7874–10(b) is not taken into account for purposes of determining whether an entity is a member of the expanded affiliated group for purposes of applying section 7874(c)(2)(A) and paragraph (b) of this section and determining whether a domestic entity acquisition qualifies as an internal group restructuring or results in a loss of control, as described in paragraphs (c)(2) and (3) of this section, respectively. However, such stock is included in the numerator and denominator of the ownership fraction, except to the extent that it is treated as held by a member of the EAG and is excluded from the numerator or both the numerator and the denominator, as applicable, under section 7874(c)(2)(A) or paragraphs (b) or (c) of this section.

(e) *Treatment of certain hook stock.* This paragraph applies to stock of a corporation that is held by an entity in which at least 50 percent of the stock (by vote or value) or at least 50 percent of the capital or profits interest, as applicable, in such entity, is held directly or indirectly by the corporation. The stock to which this paragraph applies shall not be included in either the numerator or denominator of any fraction for the following purposes:

(1) For applying paragraph (c)(1) of this section; and

(2) For determining whether the domestic entity acquisition qualifies as an internal group restructuring (described in paragraph (c)(2) of this section) or results in a loss of control (described in paragraph (c)(3) of this section).

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

(g) *Treatment of transactions related to the acquisition.* Except as provided in paragraph (c)(2)(iii) of this section, all transactions that are related to an acquisition are taken into account in applying this section.

(h) *Examples.* The application of this section is illustrated by the following examples. It is assumed that all transactions in the examples occur after March 4, 2003. In all the examples, if an entity or other person is not described as either domestic or foreign, it may be either domestic or foreign. In addition, each entity has only a single class of equity outstanding. Finally, the analysis of the following examples is limited to a discussion of issues under section 7874, even though the examples may raise other issues (for example, under section 367).

Example 1. Disregard of hook stock. (i) *Facts.* USS, a domestic corporation, has 100 shares of stock outstanding. USS's stock is held by a group of individuals. Pursuant to a plan, USS forms FS, a foreign corporation, and transfers to FS the stock of several wholly owned foreign corporations, in exchange for 90 shares of FS stock. FS then forms Merger Sub, a domestic corporation. Under a merger agreement and state law, Merger Sub merges into USS, with USS surviving the merger. In exchange for their USS stock, the former shareholders of USS receive, in the aggregate, 100 shares of newly issued FS stock. As a result of the merger FS holds 100 percent of the USS stock. USS continues to hold 90 shares of FS stock.

(ii) *Analysis.* FS has indirectly acquired substantially all the properties held directly or indirectly by USS pursuant to a plan. After the acquisition, the former shareholders of USS hold 100 shares of FS stock by reason of holding stock in USS, and USS holds 90 shares of FS stock. Under paragraph (b) of this section, the 90 shares of FS stock held by USS, a member of the EAG, are not included in either the numerator or the denominator of the ownership fraction. Accordingly, the ownership fraction is 100/100. If the condition in section 7874(a)(2)(B)(iii) is satisfied, FS is a surrogate foreign corporation which is treated as a domestic corporation under section 7874(b).

Example 2. Internal group restructuring; wholly owned corporation. (i) *Facts.* P, a corporation, owns all 100 outstanding shares of USS, a domestic corporation. USS forms FS, a foreign corporation, and transfers all its assets to FS in exchange for all 100 shares of the stock of FS, in a reorganization described in section 368(a)(1). P exchanges its USS stock for FS stock under section 354.

(ii) *Analysis.* FS has directly acquired substantially all the properties held directly or indirectly by USS pursuant to a plan. The acquisition is an internal group restructuring described in paragraph (c)(2) of this section because P, the common parent of the EAG after the acquisition, held directly or indirectly 80 percent or more of the stock (by vote and value) of USS before the acquisition, and after the acquisition, P holds directly or indirectly 80 percent or more of the stock (by vote and value) of FS. Accordingly, under paragraph (c)(1) of this section, the FS stock held by P is included in the denominator, but not in the numerator of the ownership fraction. Therefore, the ownership fraction is 0/100. FS is not a surrogate foreign corporation.

Example 3. Internal group restructuring; wholly owned corporation. (i) *Facts.* The facts are the same as in *Example 2*, except that USS does not transfer any of its assets to FS. Instead, P transfers all 100 shares of USS stock to FS in exchange for all 100 shares of FS stock.

(ii) *Analysis.* FS has indirectly acquired substantially all the properties held directly or indirectly by USS pursuant to a plan. The acquisition is an internal group restructuring described in paragraph (c)(2) of this section because P, the common parent of the EAG after the acquisition, held directly or indirectly 80 percent or more of the stock (by vote and value) of USS before the acquisition, and after the acquisition, P holds directly or indirectly 80 percent or more of the stock (by vote and value) of FS. Accordingly, under paragraph (c)(1) of this section, the FS stock held by P is included in the denominator, but not in the numerator of the ownership fraction. Accordingly, the ownership fraction is 0/100. FS is not a surrogate foreign corporation.

Example 4. Internal group restructuring; less than wholly owned corporation. (i) *Facts.* The facts are the same as in *Example 3*, except that P holds 85 shares of USS stock. The remaining 15 shares of USS stock are held by A, a person unrelated to P. P and A transfer their shares of USS stock to FS in exchange for 85 and 15 shares of FS stock, respectively.

(ii) *Analysis.* FS has indirectly acquired substantially all the properties held directly or indirectly by USS pursuant to a plan. The acquisition is an internal group restructuring described in paragraph (c)(2) of this section because P, the common parent of the EAG after the acquisition, held directly or indirectly 80 percent or more of the stock (by

vote and value) of USS before the acquisition, and after the acquisition P holds directly or indirectly 80 percent or more of the stock (by vote and value) of FS. Therefore, under paragraph (c)(1) of this section, the FS stock held by P is included in the denominator, but not in the numerator of the ownership fraction. Accordingly, the ownership fraction is 15/100. FS is not a surrogate foreign corporation.

Example 5. Internal group restructuring exception not applicable; less than 80 percent owned corporation. (i) *Facts.* The facts are the same as in Example 2, except that P owns 55 shares of USS stock, and A, a person unrelated to P, holds 45 shares of USS stock. P and A exchange their shares of USS stock for 55 shares and 45 shares of FS stock, respectively.

(ii) *Analysis.* FS has acquired substantially all the properties held directly or indirectly by USS pursuant to a plan. P, the common parent of the EAG after the acquisition, did not hold directly or indirectly 80 percent or more of the stock (by vote and value) of USS before the acquisition, and after the acquisition P does not hold directly or indirectly 80 percent or more of the stock (by vote and value) of FS. Thus, the acquisition is not an internal group restructuring described in paragraph (c)(1) of this section, and the general rule of paragraph (b) of this section applies. Under paragraph (b) of this section, the FS stock held by P, a member of the EAG, is not included in either the numerator or the denominator of the ownership fraction. Accordingly, the ownership fraction is 45/45. If the condition in section 7874(a)(2)(B)(iii) is satisfied, FS is a surrogate foreign corporation which is treated as a domestic corporation under section 7874(b).

Example 6. Internal group restructuring; hook stock. (i) *Facts.* USS, a domestic corporation, has 100 shares of stock outstanding. P, a corporation, holds 80 shares of USS stock. The remaining 20 shares of USS stock are held by A, a person unrelated to P. USS owns all 30 outstanding shares of FS, a foreign corporation. Pursuant to a plan, FS forms Merger Sub, a domestic corporation. Under a merger agreement and state law, Merger Sub merges into USS, with USS surviving the merger as a subsidiary of FS. In exchange for their USS stock, P and A, the former shareholders of USS, respectively receive 56 and 14 shares of FS stock. USS continues to hold 30 shares of FS stock.

(ii) *Analysis.* FS has indirectly acquired substantially all the properties held directly or indirectly by USS pursuant to a plan. Under paragraph (b) of this section, the shares of FS stock held by P and USS, both of which are members of the EAG, are not included in either the numerator or denominator of the ownership fraction, unless the acquisition results in an internal group restructuring or loss of control of USS such that the exception of paragraph (c)(1) of this section applies. In determining whether the acquisition of USS is an internal group restructuring, under paragraph (e)(2) of this section, the FS stock held by USS is disregarded. Because P held directly or indirectly 80 percent or more of the stock (by vote and value) of USS before the acquisition, and after the acquisition P holds directly or indirectly 80 percent or more of the stock (by vote and value) of FS (when disregarding the FS stock held by USS), the acquisition is an internal group restructuring and the exception of paragraph (c)(1) of this section applies. Accordingly, when determining whether FS is a surrogate foreign corporation, the FS stock held by P is included in the denominator, but not the numerator of the ownership fraction. However, under paragraph (b) of this section, the FS stock held by USS is not included in either the numerator or denominator of the ownership fraction. Accordingly, the ownership fraction is 14/70, or 20 percent, since only the stock held by A is included in the numerator, and the stock held by both P and A is included in the denominator. Accordingly, FS is not a surrogate foreign corporation.

Example 7. Loss of control. (i) *Facts.* P, a corporation, holds all the outstanding stock of USS, a domestic corporation. B, a corporation unrelated to P, holds all 60 outstanding shares of FS, a foreign corporation. P transfers to FS all the outstanding stock of USS in exchange for 40 newly issued shares of FS.

(ii) *Analysis.* FS has indirectly acquired substantially all the properties held directly or indirectly by USS pursuant to a plan. After the acquisition, B holds 60 percent of the outstanding shares of the FS stock. Accordingly, B, FS and USS are members of an EAG. After the acquisition, P does not hold directly or indirectly more than 50 percent of the stock (by vote or value) of any member of the EAG and, thus, the acquisition results in a loss of control described in paragraph (c)(3) of this section. Accordingly, under paragraph (c)(1) of this section, the FS stock owned by B is included in the denominator, but not in the numerator, of the ownership fraction. Therefore, the ownership fraction is 40/100. FS is not a surrogate foreign corporation.

Example 8. Internal group restructuring; partnership. (i) *Facts.* LLC, a Delaware limited liability company, is engaged in the conduct of a trade or business. P, a corporation, holds 90 percent of the interests of LLC. A, a person unrelated to P, holds 10 percent of the interests of LLC. LLC has not elected to be treated as an association taxable as a corporation. P and A transfer their interests in LLC to FS, a newly formed foreign corporation, in exchange for 90 shares and 10 shares, respectively, of FS's stock, which are all of the outstanding shares of FS. Accordingly, LLC becomes a disregarded entity.

(ii) *Analysis.* Prior to the FS's acquisition of the interests of LLC, LLC was a domestic partnership for Federal income tax purposes. FS has acquired substantially all the properties constituting a trade or business of LLC pursuant to a plan. After the acquisition, P holds 90 percent of FS's stock (by vote and value) by reason of holding a capital and profits interest in LLC, and A holds 10 percent of FS's stock (by vote and value) by reason of holding a capital and profits interest in LLC. The internal group restructuring exception under paragraph (c)(2) of this section applies, because before the acquisition, P held 80 percent or more of the capital and profits interest in LLC, and after the acquisition, P holds 80 percent or more of the stock (by vote and value) of FS. Under paragraph (c)(1) of this section, the FS stock held by P is included in the denominator, but not the numerator, of the ownership fraction. Accordingly, the ownership fraction is 10/100. FS is not a surrogate foreign corporation.

(i) *Applicability dates*—(1) *In general.* Except as otherwise provided, this section shall apply to domestic entity acquisitions completed on or after May 20, 2008. This section shall not, however, apply to a domestic entity acquisition that was completed on or after May 20, 2008, provided such acquisition was entered into pursuant to a written agreement which was (subject to customary conditions) binding prior to May 20, 2008, and at all times thereafter (binding commitment). For purposes of the preceding sentence, a binding commitment shall include entering into options and similar interests in connection with one or more written agreements described in the preceding sentence. Notwithstanding the general application of this paragraph, taxpayers may elect to apply this section to domestic entity acquisitions completed before May 20, 2008, but must apply it consistently to all acquisitions within its scope. Paragraph (f) of this section shall apply to domestic entity acquisitions completed on or after June 7, 2012. See §1.7874–1T(e), as contained in 26 CFR part 1 revised as of April 1, 2012, for completed before June 7, 2012.

(2) *Applicability date of certain provisions of this section.* Except as provided in this paragraph (i)(2), paragraph (c)(2)(iii) of this section applies to domestic entity acquisitions completed on or after April 4, 2016. Except as provided in this paragraph (i)(2), paragraph (d) of this section (interaction of EAG rules with other rules) applies to domestic entity acquisitions completed on or after July 12, 2018. See §§1.7874–4(h) and 1.7874–7T(e), as contained in 26 CFR part 1 revised as of April 1, 2017, for certain coordination rules for domestic entity acquisitions completed before July 12, 2018. Except as provided in this paragraph (i)(2), paragraph (g) of this section applies to domestic entity acquisitions completed on or after September 22, 2014. For domestic entity acquisitions completed before April 4, 2016, however, taxpayers may elect to consistently apply paragraphs (c)(2)(iii) and (g) of this section, and §1.7874–6(c)(2), (d)(2), and (f)(2)(ii). In addition, for domestic entity acquisitions completed before July 12, 2018, taxpayers may elect to consistently apply paragraph (d) of this section.

[T.D. 9399, 73 FR 29057, May 20, 2008, as amended by T.D. 9453, 74 FR 27926, June 12, 2009; T.D. 9591, 77 FR 34791, June 12, 2012; T.D. 9654, 79 FR 3100, Jan. 17, 2014; T.D. 9761, 81 FR 20894, Apr. 8, 2016; T.D. 9812, 82 FR 5401, Jan. 18, 2017; T.D. 9834, 83 FR 32543, July 12, 2018]

§ 1.7874–2 Surrogate foreign corporation.

(a) *Scope.* This section provides rules for determining whether a foreign corporation is treated as a surrogate foreign corporation under section 7874(a)(2)(B). Paragraph (b) of this section provides definitions and special rules. Paragraph (c) of this section provides rules to determine whether a foreign corporation has acquired properties held by a domestic corporation (or a partnership). Paragraph (d) of this section provides rules that apply when two or more foreign corporations complete, in the aggregate, a domestic entity acquisition. Paragraph (e) of this section provides rules that apply when, pursuant to a plan, a single foreign corporation completes more than one domestic entity acquisition. Paragraph (f) of this section provides rules to identify the stock of a foreign corporation that is held by reason of holding stock in a domestic corporation (or an interest in a domestic partnership). Paragraph (g) of this section provides rules that treat certain publicly traded

foreign partnerships as foreign corporations for purposes of section 7874. Paragraph (h) of this section provides rules concerning the treatment of certain options (or similar interests) for purposes of section 7874. Paragraph (i) of this section provides rules that treat certain interests (including debt, stock, or a partnership interest) as stock of a foreign corporation for purposes of section 7874. Paragraph (j) of this section provides rules concerning the conversion of a foreign corporation to a domestic corporation by reason of section 7874(b). Paragraph (k) of this section provides examples that illustrate the rules of this section. Paragraph (l) of this section provides the applicability dates of this section. For additional definitions that apply for purposes of this section, see §1.7874–12.

(b) *Definitions and special rules.* In addition to the definitions in §1.7874–12, the following definitions and special rules apply for purposes of this section.

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

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

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

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

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

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

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

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

(7) A *former initial acquiring corporation shareholder* of an initial acquiring corporation means any person that held stock in the initial acquiring corporation before the subsequent acquisition, including any person that holds stock in the initial acquiring corporation both before and after the subsequent acquisition.

(8) An *initial acquisition* means, with respect to a subsequent acquisition, a domestic entity acquisition occurring, pursuant to a plan that includes the subsequent acquisition (or a series of related transactions), before the subsequent acquisition.

(9) An *initial acquiring corporation* means, with respect to an initial acquisition, the foreign acquiring corporation.

(10) A *subsequent acquisition* means, with respect to an initial acquisition, a transaction occurring, pursuant to a plan that includes the initial acquisition (or a series of related transactions), after the initial acquisition in which a foreign corporation directly or indirectly acquires (within the meaning of paragraph (c)(4)(ii) of this section) substantially all of the properties held directly or indirectly by the initial acquiring corporation.

(11) A *subsequent acquiring corporation* means, with respect to a subsequent acquisition, the foreign corporation that directly or indirectly acquires substantially all of the properties held directly or indirectly by the initial acquiring corporation.

(12) *Special rule regarding initial acquisitions.* With respect to an initial acquisition, the determination of the ownership percentage described in section 7874(a)(2)(B)(ii) is made without regard to the subsequent acquisition and all related transactions occurring after the subsequent acquisition.

(13) *Special rule regarding subsequent acquisitions.* With respect to a subsequent acquisition (or a similar acquisition under the principles of paragraph (c)(4)(i) of this section) that is an inversion transaction, the applicable period begins on the first date that properties are acquired as part of the initial acquisition.

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

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

(ii) An acquisition of an interest in a partnership. See *Example 2* of paragraph (k) of this section for an illustration of the rules of this paragraph (c)(1)(ii).

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

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

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

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

(4) *Multiple-step acquisitions*—(i) *Rule.* A subsequent acquisition is treated as a domestic entity acquisition, and the subsequent acquiring corporation is treated as a foreign acquiring corporation. See *Example 21* of paragraph (k) of this section for an illustration of this rule. See also paragraph (f)(1)(iv) of this section (treating certain stock of the subsequent acquiring corporation as stock of a foreign corporation that is held by reason of holding stock of, or a partnership interest in, the domestic entity).

(ii) *Acquisition of property pursuant to a subsequent acquisition.* In determining whether a foreign corporation directly or indirectly acquires substantially all of the properties held directly or indirectly by an initial acquiring corporation, the principles of section 7874(a)(2)(B)(i) apply, including paragraph (c) of this section other than paragraph (c)(2) of this section. For this purpose, the principles of paragraph (c)(1) of this section, including paragraph (b)(5) of this section, apply by substituting the term ''foreign'' for ''domestic'' wherever it appears.

(iii) *Additional related transactions.* If, pursuant to the same plan (or a series of related transactions), a foreign corporation directly or indirectly acquires (under the principles of paragraph (c)(4)(ii) of this section) substantially

all of the properties directly or indirectly held by a subsequent acquiring corporation in a transaction occurring after the subsequent acquisition, then the principles of paragraph (c)(4)(i) of this section apply to such transaction (and any subsequent transaction or transactions occurring pursuant to the plan (or the series of related transactions)).

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

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

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

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

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

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

(iv) Stock of a subsequent acquiring corporation received by a former initial acquiring corporation shareholder pursuant to a subsequent acquisition in exchange for, or with respect to, stock of an initial acquiring corporation that is held by reason of holding stock of, or a partnership interest in, a domestic entity.

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

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

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

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

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

(i) At the time of the domestic entity acquisition; or

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

(3) *Surrogate foreign corporation to which section 7874(b) applies.* If paragraph (g)(1) of this section applies to a publicly traded foreign partnership and the foreign corporation is a surrogate foreign corporation to which section 7874(b) applies, the publicly traded foreign partnership shall be treated as a domestic corporation for purposes of the Internal Revenue Code (Code). See paragraph (g)(6) of this section for the timing and treatment of the conversion of the publicly traded foreign partnership to a domestic corporation. See *Example 11* of paragraph (k) of this section for an illustration of the rules of this paragraph (g)(3).

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

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

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

distribution of the stock of the domestic corporation to the partners in liquidation of the partnership shall be determined under all relevant provisions of the Code and general tax principles.

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

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

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

(i) In the case of a domestic corporation or a domestic partnership, immediately before the domestic entity acquisition.

(ii) In the case of a foreign corporation or foreign partnership, immediately after the domestic entity acquisition.

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

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

(ii) At the time of the domestic entity acquisition, the probability of the option being exercised is remote.

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

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

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

(i) The interest provides the holder distribution rights that are substantially similar in all material respects to the distribution rights provided by stock in the foreign corporation. For

this purpose, distribution rights include rights to dividends (or partnership distributions), distributions in redemption of the interest (in whole or in part), distributions in liquidation, or other similar distributions that represent a return on, or of, the holder's investment in the interest.

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

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

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

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

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

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

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

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

(i) DC1 and DC2 are domestic corporations.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(ii) *Analysis*. Under paragraph (c)(1)(i) of this section, for purposes of section 7874(a)(2)(B)(i), FA is treated as acquiring all of the properties held by DC1 and DC2 on the date of the stock acquisition. Under paragraph (e) of this section, because pursuant to the same plan FA acquired substantially all of the properties held by DC1 and DC2, for purposes of determining whether FA shall be treated as a surrogate foreign corporation, DC1 and DC2 shall be treated as a single domestic corporation, of which individuals A

and B are former domestic entity shareholders. Thus, individuals A and B are treated as holding all 100 shares of the FA stock by reason of holding stock of such domestic corporation, and the ownership fraction under section 7874(a)(2)(B)(ii) is 100/100, or 100%.

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

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

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

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

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

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

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

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

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

Country A when compared to the total business activities of the expanded affiliated group.

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

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

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

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

(ii) *Analysis.* Under paragraphs (h)(1) of this section, for purposes of section 7874, individual C is treated as owning FA stock with a $50x value. This amount represents individual C's claim on the equity of FA after the domestic entity acquisition ($70x value of FA stock that may be acquired pursuant to the warrant, less the $20x exercise price), without taking into account the $20x individual C would be required to provide to FA upon the exercise of the warrant. Thus, for purposes of section 7874, the value of the stock of FA immediately after the transaction is $650x ($600x of FA stock, plus C's $50x claim on the equity of FA). C's warrant is not taken into account for purposes of determining the voting power of FA under section 7874.

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

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

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

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

for purposes of determining the voting power of FA under section 7874.

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

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

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

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

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

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

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

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

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

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

Example 21, Application of multiple-step acquisition rule. (i) *Facts.* Individual A owns all 70 shares of stock of DC1, a domestic corporation. Individual B owns all 30 shares of stock of F1, a foreign corporation that is a tax resident (as described in §1.7874–3(d)(11)) of Country X. Pursuant to a reorganization described in section 368(a)(1)(D), DC1 transfers all of its properties to F1 solely in exchange for 70 newly issued voting shares of F1 stock (DC1 acquisition) and distributes the F1 stock to Individual A in liquidation pursuant to section 361(c)(1). Pursuant to a plan that includes the DC1 acquisition, F2, a newly formed foreign corporation that is also a tax resident of Country X, acquires 100 percent of the stock of F1 solely in exchange for 100 newly issued shares of F2 stock (F1 acquisition). After the F1 acquisition, Individual A owns 70 shares of F2 stock, Individual B owns 30 shares of F2 stock, F2 owns all 100 shares of F1 stock, and F1 owns all the properties held by DC1 immediately before the DC1 acquisition. In addition, the form of the transaction is respected for U.S. federal income tax purposes.

(ii) *Analysis*—(A) The DC1 acquisition is a domestic entity acquisition, and F1 is a foreign acquiring corporation, because F1 directly acquires 100 percent of the properties of DC1. In addition, the 70 shares of F1 stock received by A pursuant to the DC1 acquisition in exchange for Individual A's DC1 stock are stock of a foreign corporation that is held by reason of holding stock in DC1. As a result, those 70 shares are included in both the numerator and the denominator of the ownership fraction when applying section 7874 to the DC1 acquisition.

(B) The DC1 acquisition is also an initial acquisition because it is a domestic entity acquisition that, pursuant to a plan that includes the F1 acquisition, occurs before the F1 acquisition (which, as described in paragraph (ii)(C) of this *Example 21,* is a subsequent acquisition). Thus, F1 is the initial acquiring corporation.

(C) The F1 acquisition is a subsequent acquisition because it occurs, pursuant to a plan that includes the DC1 acquisition, after the DC1 acquisition and, pursuant to the F1 acquisition, F2 acquires 100 percent of the stock of F1 and therefore is treated under paragraph (c)(4)(ii) of this section (which applies the principles of section 7874(a)(2)(B)(i) with certain modifications) as indirectly acquiring substantially all of the properties held directly or indirectly by F1. Thus, F2 is the subsequent acquiring corporation.

(D) Under paragraph (c)(4)(i) of this section, the F1 acquisition is treated as a domestic entity acquisition, and F2 is treated as a foreign acquiring corporation. In addition, under paragraph (f)(1)(iv) of this section, the 70 shares of F2 stock received by Individual A (a former initial acquiring corporation shareholder) pursuant to the F1 acquisition in exchange for Individual A's F1 stock are stock of a foreign corporation that is held by reason of holding stock in DC1. As a result, those 70 shares are included in both the numerator and the denominator of the ownership fraction when applying section 7874 to the F1 acquisition.

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

(2) *Applicability date of certain provisions of this section.* Paragraphs (a), (b)(7) through (13), (c)(2) and (4), and (f)(1)(iv) of this section, as well as the introductory text of paragraph (f)(1) and *Example 21* of paragraph (k)(2), apply to domestic entity acquisitions completed on or after April 4, 2016.

[T.D. 9591, 77 FR 34791, June 12, 2012, as amended by T.D. 9761, 81 FR 20894, Apr. 8, 2016; T.D. 9834, 83 FR 32544, July 12, 2018]

§ 1.7874–3 Substantial business activities.

(a) *Scope.* This section provides rules regarding when an expanded affiliated group will be considered to have substantial business activities in the relevant foreign country when compared to the total business activities of the expanded affiliated group for purposes of section 7874(a)(2)(B)(iii). Paragraph (b) of this section describes the general rule for determining whether the expanded affiliated group has substantial business activities in the relevant foreign country when compared to its total business activities. Paragraph (c) of this section describes certain items that are not taken into account as located or derived in the relevant foreign country. Paragraph (d) of this section provides definitions and certain rules of application. Paragraph (e) of this section provides rules regarding the treatment of partnerships for purposes of this section. Paragraph (f) of this section provides the effective/applicability dates.

(b) *General rule.* The expanded affiliated group will be considered to have substantial business activities in the relevant foreign country on the completion date when compared to the total business activities of the expanded affiliated group only if, subject to paragraph (c) of this section, each of the requirements of this paragraph (b) are satisfied.

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

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

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

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

(4) *Tax residence of foreign acquiring corporation.* The foreign acquiring corporation is a tax resident of the relevant foreign country. However, this paragraph (b)(4) does not apply if the relevant foreign country does not impose corporate income tax.

(c) *Items not to be considered*—(1) *General rule.* Except to the extent provided in paragraph (c)(2) of this section, the following items are not taken into account in the numerator, but are taken into account in the denominator, for each of the tests described in paragraphs (b)(1) through (3) of this section:

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

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

(iii) Any group assets or group employees located in, or group income derived in, the relevant foreign country if such group assets or group employees, or the business activities to which such group income is attributable, are subsequently transferred to another country in connection with a plan that existed at the time of the domestic entity acquisition .

(2) *Transfers of properties to the expanded affiliated group.* Any group assets, group employees, or group income attributable to business activities that are associated with property that is transferred to the expanded affiliated group in a transfer that is disregarded under section 7874(c)(4) are not taken into account in the numerator or the denominator for each of the tests described in paragraphs (b)(1) through (3) of this section.

(d) *Definitions and special rules.* In addition to the definitions in § 1.7874–12, the following definitions and special rules apply for purposes of this section.

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

(i) The completion date; or

(ii) The last day of the month immediately preceding the month that includes the completion date.

(2) The term *employee compensation* means all amounts incurred by members of the expanded affiliated group that directly relate to services performed by group employees (including, for example, wages, salaries, deferred compensation, employee benefits, and employer payroll taxes). Employee compensation with respect to a particular group employee is treated as incurred when it would be deductible by the employer as compensation, and the amount of employee compensation equals the amount that would be deductible by the employer as compensation. Both the timing and the amount of the deduction for employee compensation must be determined for all group employees under U.S. federal income tax principles or for all group employees based on the relevant tax laws. Employee compensation is determined in U.S. dollars, translated, if necessary, using the weighted average exchange rate (as defined in §1.989(b)–1) for the testing period.

(3) The term *group assets* means tangible personal property or real property used or held for use in the active conduct of a trade or business by members of the expanded affiliated group, provided such property is either owned or, in the circumstances described below, rented by members of the expanded affiliated group at the close of the completion date. A group asset is considered to be located in the relevant foreign country only if the asset was physically present in such country at the close of the completion date and the asset was physically present in such country for more time than in any other country during the testing period. Notwithstanding the foregoing, a group asset that is mobile in nature and is used in a transportation activity, such as a vessel, an aircraft, or a motor vehicle, is considered to be located in the relevant foreign country if the asset was physically present in such country for more time than in any other country during the testing period, regardless of whether the asset was physically present in such country at the close of the completion date. Group assets must be valued on a gross basis (that is, not reduced by liabilities) by consistently using for all group assets of the expanded affiliated group either the adjusted tax basis or fair market value determined in U.S. dollars, translated, if necessary, at the spot rate determined under the principles of §1.988–1(d)(1), (2), and (4). Tangible personal property or real property that is rented by members of the expanded affiliated group from a person other than a member of the expanded affiliated group is also treated as a group asset, provided such property is used in the active conduct of a trade or business and is being rented by members of the expanded affiliated group at the close of the completion date. For purposes of this section, a group asset that is rented is valued at eight times the net annual rent paid or accrued with respect to the property by members of the expanded affiliated group.

(4) The term *group employees* means all individuals who are employees of members of the expanded affiliated group. Whether individuals are employees must be determined for all members of the expanded affiliated group under U.S. federal tax principles or for all members of the expanded affiliated group based on the relevant tax laws. A group employee is considered to be based in the relevant foreign country only if the employee spent more time providing services in such country than in any other single country during the testing period.

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

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

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

(8) The term *relevant financial statements* means financial statements prepared consistently for all members of the expanded affiliated group in accordance with either U.S. Generally Accepted Accounting Principles (U.S. GAAP) or the International Financial Reporting Standards (IFRS) used for the expanded affiliated group's consolidated financial statements, but, if, after the domestic entity acquisition, financial statements will not be prepared consistently for all members of the expanded affiliated group in accordance with either U.S. GAAP or IFRS, then, for each member, financial statements prepared in accordance with either U.S. GAAP or IFRS. The relevant financial statements must take into account all items of income generated by all members of the expanded affiliated group for the entire testing period.

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

(10) The term *relevant tax law* means, for purposes of determining whether a particular individual who performs services for a member of the expanded affiliated group is an employee for purposes of paragraph (d)(6) of this section and the timing and amount of employee compensation for a particular employee of a member of the expanded affiliated group for purposes of paragraph (d)(3) of this section, the tax law to which the member is subject. Notwithstanding the foregoing, if the tax law to which a member is subject does not distinguish between whether an individual is an employee, or, for example, an independent contractor, then for this purpose the relevant tax law is considered to be U.S. federal tax law.

(11) The term *tax resident* means, with respect to a foreign country, a body corporate liable to tax under the laws of the country as a resident.

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

(e) *Treatment of partnerships*—(1) *Stock held by a partnership.* In determining the members of the expanded affiliated group for purposes of this section, each partner in a partnership, as determined without regard to the application of paragraph (e)(2) of this section, shall be treated as holding its proportionate share of the stock held by the partnership, as determined under the rules and principles of sections 701 through 777.

(2) *Business activities of a partnership.* For purposes of this section, if one or more members of the expanded affiliated group, as determined after the application of paragraph (e)(1) of this section, own, in the aggregate, more than 50 percent (by value) of the interests in a partnership, the partnership will be treated as a corporation that is a member of the expanded affiliated group. Thus, all items of such a partnership are taken into account for purposes of this section. No items of a partnership are taken into account for purposes of this section unless the partnership is treated as a member of the expanded affiliated group pursuant to this paragraph (e)(2).

(f) *Applicability dates*—(1) *General rule.* Except as otherwise provided in paragraph (f)(2) of this section, this section applies to domestic entity acquisitions that are completed on or after June 3, 2015. For acquisitions completed before June 3, 2015, see §1.7874–3T as contained in 26 CFR part 1 revised as of April 1, 2016.

(2) *Paragraphs (b)(4), (d)(8), and (d)(11) of this section.* The first sentence of paragraph (b)(4) of this section applies to domestic entity acquisitions completed on or after November 19, 2015, and the second sentence applies to domestic entity acquisitions completed on or after July 12, 2018. Paragraph (d)(8) of this section applies to domestic entity acquisitions completed on or after April 4, 2016. Paragraph (d)(11) of this section applies to domestic entity

acquisitions completed on or after July 12, 2018. For domestic entity acquisitions completed on or after June 3, 2015, and before April 4, 2016, however, taxpayers may elect to apply paragraph (d)(8) of this section. For domestic entity acquisitions completed on or after November 19, 2015, and before July 12, 2018, taxpayers may elect to apply the second sentence of paragraph (b)(4) and paragraph (d)(11) of this section.

[T.D. 9720, 80 FR 31841, June 4, 2015, as amended by T.D. 9761, 81 FR 20896, Apr. 8, 2016; T.D. 9834, 83 FR 32546, July 12, 2018]

§ 1.7874–4 Disregard of certain stock related to the domestic entity acquisition.

(a) *Scope.* This section identifies certain stock of the foreign acquiring corporation that is disregarded in determining the ownership fraction and modifies the scope of section 7874(c)(2)(B). Paragraph (b) of this section sets forth the general rule that certain stock of the foreign acquiring corporation, and only such stock, is treated as stock described in section 7874(c)(2)(B) and therefore is excluded from the denominator of the ownership fraction. Paragraph (c) of this section identifies the stock of the foreign acquiring corporation that is subject to paragraph (b) of this section. Paragraph (d) of this section provides a de minimis exception to the application of the general exclusion rule of paragraph (b) of this section. Paragraph (e) of this section provides rules for transfers of stock of the foreign acquiring corporation in satisfaction of, or in exchange for the assumption of, one or more obligations of the transferor. Paragraph (f) of this section provides rules for certain transfers of stock of the foreign acquiring corporation involving multiple properties or obligations. Paragraph (g) of this section provides rules for the treatment of partnerships, and paragraph (h) of this section provides definitions. Paragraph (h) of this section provides definitions. Paragraph (i) of this section provides examples illustrating the application of the rules of this section. Paragraph (j) of this section provides dates of applicability. See §1.7874–1(d)(1) for rules addressing the interaction of this section with the expanded affiliated group rules of section 7874(c)(2)(A) and §1.7874–1.

(b) *Exclusion of disqualified stock under section 7874(c)(2)(B).* Except as provided in paragraph (d) of this section, disqualified stock (as determined under paragraph (c) of this section) is treated as stock described in section 7874(c)(2)(B) and therefore is not included in the denominator of the ownership fraction. Section 7874(c)(2)(B) shall not apply to exclude stock from the denominator of the ownership fraction that is not disqualified stock.

(c) *Disqualified stock*—(1) *General rule.* Except as provided in paragraph (c)(2) of this section, disqualified stock is stock of the foreign acquiring corporation (other than stock described in §1.7874–2(f)) that is transferred in an exchange described in paragraph (c)(1)(i) or (ii) of this section that is related to the domestic entity acquisition. This paragraph (c) applies without regard to whether the stock of the foreign acquiring corporation is publicly traded at the time of the transfer or at any other time.

(i) *Exchanged for nonqualified property.* The stock is transferred to a person other than the domestic entity in exchange for nonqualified property. See *Example 1*, *Example 2*, *Example 6*, *Example 8*, and *Example 9* of paragraph (i) of this section for illustrations of the application of this paragraph (c)(1)(i).

(ii) *Exchanged for property with associated obligations*—(A) *General rule.* Subject to the limitation provided in in paragraph (c)(1)(ii)(B) of this section, the stock is transferred by a person (transferor) to another person (transferee) in exchange for property (exchanged property) and, pursuant to the same plan (or series of related transactions), the transferee subsequently transfers such stock (or, if the transferee exchanges such stock for other property, such other property) in satisfaction of, or in exchange for the assumption of, one or more obligations of the transferee or a person related (within the meaning of section 267 or 707(b)) to the transferee. See *Example 6* and *Example 10* of paragraph (i) of this section for illustrations of the application of paragraph (c)(1)(ii) of this section.

(B) *Limitation.* The amount of stock treated as transferred in an exchange described in paragraph (c)(2)(ii)(A) of this section shall not exceed—

(*1*) With respect to a transferee that is the domestic entity, the proportionate share of obligations associated with the exchanged property (determined based on the fair market value of the exchanged property relative to the fair market value of all properties with which the obligations are associated) that, pursuant to the same plan (or series of related transactions), is not assumed by the transferor.

(*2*) With respect to any other transferee, the proportionate share of obligations associated with the exchanged property (determined based on the fair market value of the exchanged property relative to the fair market value of all properties with which the obligations are associated) that, pursuant to the same plan (or series of related transactions), is not assumed by the transferor, multiplied by a fraction, the numerator of which is the amount of exchanged property that is qualified property, and the denominator of which is the total amount of exchanged property.

(C) *Associated obligations.* For purposes of paragraph (c)(1)(ii) of this section, an obligation is associated with property if, for example, the obligation arose from the conduct of a trade or business in which the property has been used, regardless of whether the obligation is a non-recourse obligation.

(2) *Stock transferred in an exchange that does not increase the fair market value of the assets or decrease the amount of liabilities of the foreign acquiring corporation.* Stock is disqualified stock only to the extent that the transfer of the stock in the exchange increases the fair market value of the assets of the foreign acquiring corporation or decreases the amount of its liabilities. This paragraph (c)(2) is applied to an exchange without regard to any other exchange described in paragraph (c)(1)(i) or (ii) of this section or any other transaction related to the domestic entity acquisition. See *Example 4* and *Example 7* of paragraph (i) of this section for illustrations of the application of this paragraph (c)(2).

(d) *Exception to exclusion of disqualified stock*—(1) *De minimis ownership.* Except as provided in paragraph (d)(2) of this section, paragraph (b) of this section does not apply if both:

(i) The ownership percentage described in section 7874(a)(2)(B)(ii), determined without regard to the application of paragraph (b) of this section and §§ 1.7874–7(b) and 1.7874–10(b), is less than five (by vote and value); and

(ii) On the completion date, each five percent former domestic entity shareholder or five percent former domestic entity partner, as applicable, owns (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) less than five percent (by vote and value) of the stock of (or a partnership interest in) each member of the expanded affiliated group. For this purpose, a five percent former domestic entity shareholder (or five percent former domestic entity partner) is a former domestic entity shareholder (or former domestic entity partner) that, before the domestic entity acquisition, owned (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) at least five percent (by vote and value) of the stock of (or a partnership interest in) the domestic entity. See *Example 5* of this paragraph (i) for an illustration of this paragraph (d).

(2) *Stock issued to avoid the purposes of section 7874.* The exception in paragraph (d)(1) of this section does not apply to disqualified stock that is transferred in a transaction (or series of transactions) related to the domestic entity acquisition with a principal purpose of avoiding the purposes of section 7874.

(e) *Satisfaction or assumption of obligations.* Except to the extent stock is treated as disqualified stock as a result of being described in paragraph (c)(1)(ii) of this section, this paragraph (e) applies if, in a transaction related to the domestic entity acquisition, stock of the foreign acquiring corporation is transferred to a person other than the domestic entity in exchange for the satisfaction or the assumption of one or more obligations of the transferor. In such a case, solely for purposes of this section, the stock of the

foreign acquiring corporation is treated as if it is transferred in exchange for an amount of cash equal to the fair market value of such stock.

(f) *Transactions involving multiple properties*. For purposes of this section, if stock and other property are exchanged for qualified property and nonqualified property, the stock is treated as transferred in exchange for the qualified property or nonqualified property, respectively, based on the relative fair market value of the property. See also §1.7874–2(f)(2) (allocating stock of a foreign acquiring corporation between an interest in the domestic entity and other property).

(g) *Treatment of partnerships*. For purposes of this section, if one or more members of the expanded affiliated group own, in the aggregate, more than 50 percent (by value) of the interests in a partnership, such partnership is treated as a corporation that is a member of the expanded affiliated group.

(h) *Definitions*. In addition to the definitions in §1.7874–12, the following definitions apply for purposes of this section:

(1) *Marketable securities* has the meaning set forth in section 453(f)(2), except that the term marketable securities does not include stock of a corporation or an interest in a partnership that becomes a member of the expanded affiliated group in a transaction (or series of transactions) related to the domestic entity acquisition. See *Example 4* of paragraph (i) of this section for an illustration of this paragraph (h)(1).

(2) *Nonqualified property* is property described in paragraphs (h)(2)(i) through (iv) of this section. Thus, stock in a corporation or an interest in a partnership is nonqualified property to the extent provided in paragraph (h)(2)(ii) or (iv) of this section. Qualified property is property other than nonqualified property.

(i) Cash or cash equivalents.

(ii) Marketable securities, within the meaning of paragraph (h)(1) of this section.

(iii) An obligation owed by any of the following:

(A) A member of the expanded affiliated group, unless the holder of the obligation immediately before the domestic entity acquisition and any related transaction (or its successor) is a member of the expanded affiliated group after the domestic entity acquisition and all related transactions. See *Example 6* of paragraph (i) of this section for an illustration of this paragraph (h)(2)(iii)(A).

(B) A former domestic entity shareholder or former domestic entity partner of the domestic entity that owns (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) at least five percent (by vote or value) of the stock of, or partnership interests in, the domestic entity before the domestic entity acquisition.

(C) A person, other than a member of the expanded affiliated group, that, before or after the domestic entity acquisition, either owns (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) at least five percent (by vote or value) of the stock of (or partnership interests in) or is related (within the meaning of section 267 or 707(b)) to—

(*1*) A member of the expanded affiliated group; or

(*2*) A person described in paragraph (h)(2)(iii)(B) of this section.

(iv) Any other property acquired with a principal purpose of avoiding the purposes of section 7874, regardless of whether the transaction involves an indirect transfer of property described in paragraph (h)(2)(i), (ii), or (iii) of this section. See *Example 2* and *Example 3* of paragraph (i) of this section for illustrations of the application of this paragraph (h)(2)(iv).

(3) An *obligation* means any fixed or contingent obligation to make a payment or provide value without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code. An obligation includes, but is not limited to, a debt obligation, an environmental obligation, a tort obligation, a contract obligation (including an obligation to provide goods or services), a pension obligation, an obligation under a short sale, and an obligation under derivative financial instruments such as options, forward contracts, futures contracts, and swaps. An obligation does not include any obligation treated as

stock for purposes of section 7874 (see, for example, § 1.7874–2(i), which treats certain interests, including certain creditor claims, as stock).

(4) A *transfer* is, with respect to stock of the foreign acquiring corporation, an issuance, sale, distribution, exchange, or any other disposition of such stock.

(i) *Examples.* The following examples illustrate the application of the rules of this section. For purposes of the examples, unless otherwise indicated, assume the following facts in addition to the facts stated in the examples:

(1) FA, FMS, FS, and FT are foreign corporations, all of which have only one class of stock issued and outstanding;

(2) DMS and DT are domestic corporations;

(3) P and R are corporations that may be either domestic or foreign;

(4) PRS is a partnership with individual partners;

(5) The de minimis ownership exception in paragraph (d)(1) of this section does not apply;

(6) None of the shareholders or partners in the entities described in the examples are related persons with respect to each other;

(7) All transactions described in each example occur pursuant to the same plan;

(8) No property is acquired with a principal purpose of avoiding the purposes of section 7874;

(9) FA, FMS, FS, and FT are tax residents in the same foreign country;

(10) For purposes of determining the ownership fraction, no shares of FA stock are excluded from the denominator pursuant to § 1.7874–7(b) (which disregards stock attributable to passive assets); and

(11) For purposes of determining the ownership fraction, no shares of FA stock are treated as received by former shareholders of DT pursuant to § 1.7874–10(b) (which disregards certain distributions).

Example 1. Stock transferred in exchange for marketable securities—(i) *Facts.* Individual A wholly owns DT. PRS transfers marketable securities (within the meaning of paragraph (h)(1) of this section) to FA, a newly formed corporation, in exchange solely for 25 shares of FA stock. Then Individual A transfers all the DT stock to FA in exchange solely for 75 shares of FA stock.

(ii) *Analysis.* Under paragraph (h)(2)(ii) of this section, the marketable securities constitute nonqualified property. Accordingly, the 25 shares of FA stock transferred by FA to PRS in exchange for the marketable securities constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for the marketable securities increases the fair market value of the assets of FA by the fair market value of the marketable securities transferred. Under paragraph (b) of this section, the 25 shares of FA stock transferred to PRS are not included in the denominator of the ownership fraction. See also section 7874(c)(4). Accordingly, the only FA stock included in the ownership fraction is the FA stock transferred to Individual A in exchange for the DT stock, and that FA stock is included in both the numerator and the denominator of the ownership fraction. Thus, the ownership fraction is 75/75.

Example 2. Stock transferred in exchange for property acquired with a principal purpose of avoiding the purposes of section 7874—(i) *Facts.* Individual A wholly owns DT. PRS transfers marketable securities (within the meaning of paragraph (h)(1) of this section) to FT, a newly formed corporation, in exchange solely for all the FT stock. Then PRS transfers the FT stock to FA, a newly formed corporation, in exchange solely for 25 shares of FA stock. Finally, Individual A transfers all the DT stock to FA in exchange solely for 75 shares of FA stock. FA acquires the FT stock with a principal purpose of avoiding the purposes of section 7874.

(ii) *Analysis.* Under paragraph (h)(2)(iv) of this section, the FT stock constitutes nonqualified property because a principal purpose of FA acquiring the FT stock is to avoid the purposes of section 7874. Accordingly, the 25 shares of FA stock transferred by FA to PRS in exchange for the FT stock constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for the FT stock increases the fair market value of FA's assets by the fair market value of the FT stock. Under paragraph (b) of this section, the 25 shares of FA stock transferred to PRS are not included in the denominator of the ownership fraction. Furthermore, even in the absence of paragraph (h)(2)(iv) of this section, the transfer of marketable securities to FT would be disregarded pursuant to section 7874(c)(4). Accordingly, the only FA stock included in the ownership fraction is the FA

stock transferred to Individual A in exchange for the DT stock, and that FA stock is included in both the numerator and the denominator of the ownership fraction. Thus, the ownership fraction is 75/75.

Example 3. Stock transferred in exchange for property acquired with a principal purpose of avoiding the purposes of section 7874—(i) *Facts.* DT is a publicly traded corporation. PRS is a foreign partnership that is unrelated to DT. PRS transfers certain business assets (PRS properties) to FA, a newly formed foreign corporation, in exchange solely for 25 shares of FA stock. The shareholders of DT transfer all of their DT stock to FA in exchange solely for the remaining 75 shares of FA stock (DT acquisition). None of the PRS properties is property described in paragraph (h)(2)(i) through (iii) of this section, but FA acquires the PRS properties with a principal purpose of avoiding the purposes of section 7874.

(ii) *Analysis.* Under paragraph (h)(2)(iv) of this section, the PRS properties transferred to FA constitute nonqualified property, because FA acquires the PRS properties in a transaction related to the DT acquisition with a principal purpose of avoiding the purposes of section 7874. Accordingly, the 25 shares of FA stock transferred by FA to PRS in exchange for the PRS properties constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Paragraph (c)(2) of this section does not apply to reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for the PRS properties increases the fair market value of FA's assets by the fair market value of the PRS properties. Accordingly, pursuant to paragraph (b) of this section, the 25 shares of FA stock transferred to PRS in exchange for the PRS properties are not included in the denominator of the ownership fraction. Furthermore, even in the absence of paragraph (h)(2)(iv) of this section, the transfer of the PRS properties to FA would be disregarded pursuant to section 7874(c)(4). Therefore, the only FA stock included in the ownership fraction is the FA stock transferred to the former domestic entity shareholders of DT in exchange for their DT stock, and that FA stock is included in both the numerator and the denominator of the ownership fraction. Thus, the ownership fraction is 75/75.

Example 4. Stock transferred in exchange for stock of a foreign corporation that becomes a member of the expanded affiliated group—(i) *Facts.* FT, a publicly traded corporation, forms FA, and then FA forms DMS and FMS. FMS merges with and into FT, with FT surviving the merger (FMS–FT merger). Pursuant to the FMS–FT merger, the FT shareholders exchange their FT stock solely for 100 shares of FA stock and FT becomes a wholly owned subsidiary of FA. Following the FMS–FT merger, DMS merges with and into DT, also a publicly traded corporation, with DT surviving the merger (DT acquisition). Pursuant to the DT acquisition, the DT shareholders exchange their DT stock solely for the remaining 100 shares of FA stock, and DT becomes a wholly owned subsidiary of FA. After the completion of the plan, FA wholly owns FT and DT, DMS and FMS cease to exist, and the stock of FA is publicly traded.

(ii) *Analysis.* Because FT becomes a member of the expanded affiliated group that includes FA in a transaction related to the DT acquisition, the FT stock does not constitute marketable securities (within the meaning of paragraph (h)(1) of this section) and therefore does not constitute nonqualified property pursuant to paragraph (h)(2)(ii) of this section. Accordingly, no FA stock is disqualified stock described in paragraph (c)(1) of this section and therefore the FA stock transferred in exchange for the FT stock and DT stock is included in the denominator of the ownership fraction. Thus, the ownership fraction is 100/200.

(iii) *Alternative facts.* The facts are the same as in paragraph (i) of this *Example 4*, except that, instead of undertaking the FMS–FT merger, FT merges with and into FA with FA surviving the merger (FT–FA merger). Pursuant to the FT–FA merger, the FT shareholders exchange their FT stock solely for 100 shares of FA stock. At the time of the FT–FA merger, FT does not hold nonqualified property and has no obligations. Accordingly, FA stock transferred by FA to FT in exchange for the property of FT is not disqualified stock described in paragraph (c)(1) of this section. Furthermore, pursuant to paragraph (c)(2) of this section, the 100 shares of FA stock transferred by FT to the shareholders of FT in exchange for their FT stock do not constitute disqualified stock described in paragraph (c)(1) of this section. Although the FT stock is nonqualified property (the FT stock constitutes marketable securities within the meaning of paragraph (h)(2)(ii) of this section because the stock of FT is publicly traded and FT is not a member of the expanded affiliated group that includes FA after the DT acquisition), under paragraph (c)(2) of this section, the transfer of FA stock by FT to the shareholders of FT neither increases the fair market value of the assets of FA nor decreases the liabilities of FA. Accordingly, no FA stock is disqualified stock described in paragraph (c)(1) of this section and, therefore, the FA stock transferred in exchange for the assets of FT and the DT stock is included in the denominator of the ownership fraction. Thus, the ownership fraction is 100/200.

Example 5. De minimis exception—(i) *Facts.* Individual A wholly owns DT. The fair market value of the DT stock is $100x. PRS transfers $96x of cash to FA, a newly formed

corporation, in exchange solely for 96 shares of FA stock. Then Individual A transfers the DT stock to FA in exchange for $96x of cash and 4 shares of FA stock (DT acquisition).

(ii) *Analysis.* Under paragraph (h)(2)(i) of this section, cash constitutes nonqualified property. Accordingly, the 96 shares of FA stock transferred by FA to PRS in exchange for $96x of cash constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Furthermore, paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for $96x of cash increases the fair market value of the assets of FA by $96x. However, without regard to the application of paragraph (b) of this section and §§1.7874–7(b) and 1.7874–10(b), the ownership percentage described in section 7874(a)(2)(B)(ii) would be less than 5 (by vote and value), or 4 (4/100, or 4 shares of FA stock held by Individual A by reason of owning the DT stock, determined under §1.7874–2(f)(2), over 100 shares of FA stock outstanding after the DT acquisition). Furthermore, after the DT acquisition and all related transactions, Individual A owns less than 5% (by vote and value, applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) of the stock of FA and DT (the members of the expanded affiliated group that includes FA). Accordingly, the de minimis exception in paragraph (d)(1) of this section applies and therefore paragraph (b) of this section does not apply to exclude the FA stock transferred to PRS from the denominator of the ownership fraction. Therefore, the FA stock transferred to Individual A and PRS is included in the denominator of the ownership fraction. Thus, the ownership fraction is 4/100.

Example 6. Obligation of the expanded affiliated group satisfied with stock—(i) *Facts.* Individual A wholly owns DT. The stock of DT held by Individual A has a fair market value of $75x. Individual A also holds an obligation of DT with a value and face amount of $25x. DT holds property with a value of $100x, and the $25x obligation is associated with the property. FA, a newly formed corporation, transfers 100 shares of FA stock to Individual A in exchange for all the DT stock and the $25x obligation of DT.

(ii) *Analysis.* Under paragraph (h)(2)(iii)(A) of this section, the $25x obligation of DT constitutes nonqualified property because DT is a member of the expanded affiliated group that includes FA, and Individual A (the holder of the obligation immediately before the domestic entity acquisition and any related transaction) is not a member of the EAG after the domestic entity acquisition and all related transactions. Thus, the shares of FA stock transferred by FA to Individual A in exchange for the obligation of DT constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Under §1.7874–2(f)(2), Individual A is treated as receiving 75 shares of FA stock in exchange for the DT stock (100 x $75x/$100x) and 25 shares of FA stock in exchange for the obligation of DT (100 x $25x/$100x). Thus, 25 shares of FA stock constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock for the $25x obligation increases the fair market value of FA's assets by $25x. Therefore, under paragraph (b) of this section, the 25 shares of FA stock transferred to Individual A in exchange for the obligation of DT are not included in the denominator of the ownership fraction. Accordingly, the only FA stock included in the ownership fraction is the 75 shares of FA stock transferred to Individual A in exchange for the DT stock, and that FA stock is included in both the numerator and the denominator of the ownership fraction. Thus, the ownership fraction is 75/75.

(iii) *Alternative facts.* The facts are the same as in paragraph (i) of this *Example 6,* except that instead of acquiring the stock of DT and the $25x obligation of DT, FA acquires the $100x of property from DT in exchange solely for 100 shares of FA stock. DT distributes 75 shares of FA stock to Individual A in exchange for Individual A's DT stock and transfers 25 shares of FA stock to Individual A in satisfaction of DT's obligation to Individual A, and liquidates. The 25 shares of FA stock transferred by FA to DT in exchange for the property of DT and then transferred by DT in satisfaction of DT's obligation to Individual A constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(ii) of this section. Paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(ii) of this section because the transfer of FA stock in exchange for the property of DT increases the fair market value of FA's assets by $100x (although the amount of disqualified stock is limited to 25 shares of FA stock in this case). Therefore, under paragraph (b) of this section, the 25 shares of FA stock that constitute disqualified stock are not included in the denominator of the ownership fraction. Accordingly, only 75 shares of FA stock are included in the ownership fraction, and that FA stock is included in both the numerator and the denominator of the ownership fraction. Thus, the ownership fraction is 75/75.

Example 7. ''Over-the-top'' stock transfer—(i) *Facts.* Individual A wholly owns DT. Individual B holds all 100 outstanding shares of FA stock. Individual C acquires 20 shares of FA stock from Individual B for cash, and

then FA acquires all of the stock of DT from Individual A in exchange solely for 100 shares of FA stock.

(ii) *Analysis.* Under paragraph (h)(2)(i) of this section, cash constitutes nonqualified property. Accordingly, absent the application of paragraph (c)(2) of this section, the 20 shares of FA stock transferred by Individual B to Individual C in exchange for cash would constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Nevertheless, because Individual B's sale of FA stock neither increases the assets of FA nor decreases the liabilities of FA, such FA stock is not disqualified stock by reason of paragraph (c)(2) of this section. Accordingly, paragraph (b) of this section does not apply to exclude the 20 shares of FA stock sold by Individual B to Individual C, and that FA stock is included in the denominator of the ownership fraction. The 100 shares of FA stock received by Individual A are the only shares included in the numerator of the ownership fraction. Thus, the ownership fraction is 100/200.

Example 8. Interaction with internal group restructuring rule—(i) *Facts.* P holds 85 shares of DT stock. The remaining 15 shares of DT stock are held by Individual A. P and Individual A transfer their shares of DT stock to FA, a newly formed corporation, in exchange for 85 and 15 shares of FA stock, respectively (DT acquisition), and PRS transfers $75x of cash to FA in exchange for the remaining 75 shares of FA stock.

(ii) *Analysis.* Under paragraph (h)(2)(i) of this section, cash constitutes nonqualified property. Accordingly, the 75 shares of FA stock transferred by FA to PRS in exchange for $75x of cash constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Furthermore, paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for $75x of cash increases the fair market value of the assets of FA by $75x. Therefore, under paragraph (b) of this section, the 75 shares of FA stock transferred to PRS are not included in the denominator of the ownership fraction. Although PRS's shares of FA stock are excluded from the denominator of the ownership fraction under paragraph (b) of this section, under 1.7874–1(d)(1), such shares of FA stock nonetheless are taken into account for purposes of determining whether P is a member of the expanded affiliated group that includes FA and for purposes of determining whether the DT acquisition qualifies as an internal group restructuring. Because P holds 48.6% of the FA stock (85/175) after the DT acquisition and all transactions related to the DT acquisition, it is not a member of the expanded affiliated group that includes FA. In addition, the DT acquisition does not qualify as an internal group restructuring described in §1.7874–1(c)(2) because P does not hold, directly or indirectly, 80% or more of the shares of FA stock (by vote and value) after the DT acquisition and all transactions related to the DT acquisition. Therefore, the FA stock held by P (along with the FA stock held by Individual A) is included in the numerator and the denominator of the ownership fraction. Thus, the ownership fraction is 100/100.

Example 9. Interaction with loss of control rule—(i) *Facts.* P wholly owns DT. P transfers all of its shares of DT stock to FA, a newly formed corporation, in exchange for 49 shares of FA stock (DT acquisition), and R transfers marketable securities (within the meaning of paragraph (h)(1) of this section) to FA in exchange for the remaining 51 shares of FA stock.

(ii) *Analysis.* Under paragraph (h)(2)(ii) of this section, the marketable securities constitute nonqualified property. Accordingly, the shares of FA stock transferred by FA to R in exchange for the marketable securities constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for the marketable securities increases the fair market value of the assets of FA by the fair market value of the marketable securities transferred. Therefore, under paragraph (b) of this section, the shares of FA stock transferred to R are not included in the denominator of the ownership fraction. Although under paragraph (b) of this section R's shares of FA stock are excluded from the denominator of the ownership fraction, under 1.7874–1(d)(1), such stock is taken into account for purposes of determining whether P or R is a member of the expanded affiliated group that includes FA. Because P holds 49% of the shares of FA stock (49/100), P is not a member of the expanded affiliated group that includes FA, and P's FA stock is included in both the numerator and the denominator of the ownership fraction. Because R holds 51% of the shares of FA stock (51/100), R is a member of the expanded affiliated group that includes FA and, before taking into account §1.7874–1(c), R's FA stock would be excluded from the numerator and denominator of the ownership fraction under section 7874(c)(2)(A) and §1.7874–1(b). However, the DT acquisition results in a loss of control described in §1.7874–1(c)(3) because P does not hold, in the aggregate, directly or indirectly, more than 50% of the shares of stock (by vote or value) of R, FA, or DT after the acquisition. Accordingly, the FA stock held by R would be included in the denominator of the ownership fraction under §1.7874–1(c)(1).

Nevertheless, the FA stock held by R is excluded from the denominator of the ownership fraction under paragraph (b) of this section and §1.7874–1(d)(1). Thus, the ownership fraction is 49/49.

(iii) *Alternative facts.* The facts are the same as in paragraph (i) of this *Example 9,* except that, in exchange for 51 shares of FA stock, R transfers marketable securities (within the meaning of paragraph (h)(1) of this section) with a value equal to that of 16 shares of FA stock and qualified property (within the meaning of paragraph (h)(2) of this section) with a value equal to that of 35 shares of FA stock. Accordingly, 16 of the 51 shares of FA stock transferred to R constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section, and 35 of such shares do not constitute disqualified stock. Paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for the marketable securities increases the fair market value of the assets of FA by the fair market value of the marketable securities transferred. Therefore, under paragraph (b) of this section, 16 of the 51 shares of FA stock transferred to R are not included in the denominator of the ownership fraction. Although 16 of the 51 shares of FA stock that are transferred to R are excluded from the denominator of the ownership fraction, under§1.7874–1(d)(1), all 51 of R's shares of FA stock are taken into account for purposes of determining whether P or R is a member of the expanded affiliated group that includes FA. Because P holds 49% of the shares of FA stock (49/100), it is not a member of the expanded affiliated group that includes FA, and its FA stock is included in both the numerator and the denominator of the ownership fraction. Because R holds 51% of the shares of FA stock (51/100), it is a member of the expanded affiliated group that includes FA and, before taking into account §1.7874–1(c), its FA stock is excluded from the numerator and denominator of the ownership fraction under section 7874(c)(2)(A) and §1.7874–1(b). However, the DT acquisition results in a loss of control described in §1.7874–1(c)(3) because P does not hold, in the aggregate, directly or indirectly, more than 50% of the shares of stock (by vote or value) of R, FA, or DT after the acquisition. Accordingly, the 51 shares of FA stock held by R would be included in the denominator of the ownership fraction under §1.7874–1(c)(1). Nevertheless, the 16 shares of FA stock that constitute disqualified stock are excluded from the denominator of the ownership fraction under paragraph (b) of this section and §1.7874–1(d)(1). In addition, the 35 shares of FA stock received by R that do not constitute disqualified stock are included in the denominator. Thus, the ownership fraction is 49/84.

Example 10. Stock issued in lieu of assuming associated obligation—(i) *Facts.* Individual A wholly owns DT. The stock of DT has a fair market value of $100x. Individual B wholly owns FT, a foreign corporation, which conducts two businesses, Business C and Business D. Business C comprises property with a gross fair market value of $70x and $20x of associated obligations. Business D comprises property with a gross fair market value of $45x and $35x of associated obligations. Individual A transfers all of the shares of DT stock to FA, a newly formed corporation, in exchange for $100x of FA stock (DT acquisition). In transactions related to the DT acquisition, FA acquires all of the Business C property from FT in exchange for $70x of FA stock and then FT transfers $30x of the FA stock to its creditors in satisfaction of $30x of its obligations. None of the Business C property is nonqualified property.

(ii) *Analysis.* Under paragraph (c)(1) of this section by reason of paragraph (c)(1)(ii) of this section, the $30x of FA stock transferred to FT (the transferee) in exchange for the Business C property (the exchanged property) and then transferred by FT in satisfaction of $30x of its obligations is disqualified stock, except to the extent limited by paragraph (c)(1)(ii)(B) of this section. Under paragraph (c)(1)(ii)(B)(*1*) of this section, the proportionate share of obligations associated with the exchanged property that is not assumed by FA must be determined. The proportionate share of obligations associated with the exchanged property is $20x, calculated as $20x (the obligations associated with the Business C properties) multiplied by $70x/$70x (the fair market value of the exchanged property, $70x, relative to the fair market value of all the Business C property, $70x). The proportionate share of obligations associated with the exchanged property that is not assumed by FA is $20x, calculated as the proportionate share of obligations associated with the exchanged property ($20x) less the obligations assumed by FA ($0x). Under paragraph (c)(1)(ii)(B)(*2*) of this section, the amount of disqualified stock is limited to the proportionate share of obligations associated with the exchanged property that is not assumed ($20x) multiplied by a fraction, which in this case is $70x/$70x (the amount of exchanged property that is qualified property, $70x, divided by the total amount of exchanged property, $70x). Accordingly, $20x of FA stock is disqualified stock under paragraph (c)(1) of this section by reason of paragraph (c)(1)(ii) of this section. Paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(ii) of this section because the transfer of the FA stock in exchange for the exchanged property increases the fair market value of FA's assets by $70x

(although the amount of disqualified stock is limited to $20x of FA stock in this case). Therefore, under paragraph (b) of this section, the $20x of FA stock that constitutes disqualified stock is not included in the denominator of the ownership fraction. Accordingly, only $150x of FA stock is included in the denominator of the ownership fraction, calculated as the $100x of FA stock received by Individual A plus the $70x of FA stock received by FT less the $20x of FA stock that is disqualified stock. Thus, the ownership fraction is $100x/$150x. The result would be the same if, in transactions related to the DT acquisition, FT instead sold the $30x of FA stock for $30x cash and then transferred the cash in satisfaction of $30x of its obligations.

(iii) *Alternative facts*. The facts are the same as in paragraph (i) of this *Example 10*, except that FA acquires only $42x of the Business C property in exchange for $30x of FA stock and the assumption of $12x of the obligations associated with the Business C property. Under paragraph (c)(1) of this section by reason of paragraph (c)(1)(ii) of this section, the $30x of FA stock transferred to FT (the transferee) in exchange for the Business C property (the exchanged property) and then transferred by FT in satisfaction of $30x of its obligations is disqualified stock, except to the extent limited by paragraph (c)(1)(ii)(B) of this section. Under paragraph (c)(1)(ii)(B)(*1*) of this section, the proportionate share of obligations associated with the exchanged property that is not assumed by FA must be determined. The proportionate share of obligations associated with the exchanged property is $12x, calculated as $20x (the obligations associated with the Business C property) multiplied by $42x/$70x (the fair market value of the exchanged property, $42x, relative to the fair market value of all the Business C property, $70x). The proportionate share of obligations associated with the exchanged property that is not assumed by FA is $0, calculated as the proportionate share of obligations associated with the exchanged property ($12x) less the obligations assumed by FA ($12x). Accordingly, as a result of the application of paragraph (c)(1)(ii)(B)(*2*) of this section, no FA stock is disqualified stock under paragraph (c)(1) of this section by reason of paragraph (c)(1)(ii) of this section. As a result, $130x of FA stock is included in the denominator of the ownership fraction, calculated as the $100x of FA stock received by Individual A plus the $30x of FA stock received by FT. Thus, the ownership fraction is $100x/$130x.

(j) *Applicability dates*—(1) *General rule*. Except to the extent otherwise provided in paragraph (j) of this section, this section applies to domestic entity acquisitions completed on or after September 17, 2009. Paragraphs (h)(1) and (h)(2)(iv) of this section apply to domestic entity acquisitions completed on or after November 19, 2015. Paragraph (d)(1)(i) of this section applies to domestic entity acquisitions completed on or after April 4, 2016. Paragraphs (c)(1)(ii), (h)(2)(iii), and (h)(3) of this section apply to domestic entity acquisitions completed on or after January 13, 2017. For domestic entity acquisitions completed before November 19, 2015, see §1.7874–4T(i)(6) and (i)(7)(iv) (the predecessors of paragraphs (h)(1) and (h)(2)(iv) of this section) as contained in 26 CFR part 1 revised as of April 1, 2016. For domestic entity acquisitions completed on or after September 22, 2014, and before April 4, 2016, see §1.7874–4T(d)(1)(i) as contained in 26 CFR part 1 revised as of April 1, 2016. For domestic entity acquisitions completed before January 13, 2017, see §1.7874–4T(c)(1)(ii), (i)(7)(iii) (the predecessor of paragraph (h)(2)(iii) of this section), and (i)(8) (the predecessor of paragraph (h)(3) of this section) as contained in 26 CFR part 1 revised as of April 1, 2016. Paragraph (d)(1)(ii) of this section applies to domestic entity acquisitions completed on or after July 12, 2018, though taxpayers may elect to consistently apply paragraph (d)(1)(ii) of this section to domestic entity acquisitions completed before July 12, 2018. For domestic entity acquisitions completed before July 12, 2018, see §1.7874–4(d)(1)(ii) as contained in 26 CFR part 1 revised as of April 1, 2017.

(2) *Transitional rules for domestic entity acquisitions completed on or after September 17, 2009, but before January 16, 2014*. For domestic entity acquisitions completed on or after September 17, 2009, but before January 16, 2014, except as provided in paragraph (j)(3) of this section, this section shall be applied with the following modifications:

(i) Nonqualified property does not include property described in paragraph (h)(2)(iii) of this section.

(ii) A transfer is limited to an issuance of stock of the foreign acquiring corporation.

(iii) The determination of whether stock of the foreign acquiring corporation is described in paragraph (c)(1) of this section is made without regard to

paragraphs (c)(1)(ii), (c)(2), and (e) of this section.

(iv) Paragraph (d) of this section and §1.7874–1(d)(1)do not apply.

(3) *Election for domestic entity acquisitions completed on or after September 17, 2009, and before January 13, 2017.* If, pursuant to paragraph (j)(1) or (2) of this section, a paragraph of this section would not otherwise apply to a domestic entity acquisition completed on or after September 17, 2009, and before January 13, 2017 (transition period), a taxpayer may elect to apply the paragraph if the taxpayer applies the paragraph consistently to all acquisitions completed during the transition period. The election is made by applying the paragraph to all such acquisitions on a timely filed original return (including extensions) or an amended return filed no later than six months after January 13, 2017. A separate statement or form evidencing the election need not be filed.

[T.D. 9812, 82 FR 5394, Jan. 18, 2017; 82 FR 42233, Sept. 7, 2017; T.D. 9834, 83 FR 32547, July 12, 2018]

§ 1.7874–5 Effect of certain transfers of stock related to the acquisition.

(a) *General rule.* Stock of a foreign acquiring corporation that is described in section 7874(a)(2)(B)(ii) shall not cease to be so described as a result of any subsequent transfer of the stock by the former domestic entity shareholder or former domestic entity partner that received such stock, even if the subsequent transfer is related to the domestic entity acquisition.

(b) *Example.* The rule of this section is illustrated by the following example:

Example. (i) *Facts.* Individual A wholly owns DT, a domestic corporation. FA, a newly formed foreign corporation, acquires all of the stock of DT from Individual A in exchange solely for 100 shares of FA stock. Pursuant to a binding commitment that was entered into in connection with FA's acquisition of the DT stock, Individual A sells 25 shares of FA stock to B, an unrelated person, in exchange for cash. For federal income tax purposes, the form of the steps of the transaction is respected.

(ii) *Analysis.* Under §1.7874–2(f)(1), the 100 shares of FA stock received by Individual A are stock of a foreign corporation (FA) that is held by reason of holding stock in a domestic corporation (DT). Accordingly, such stock is described in section 7874(a)(2)(B)(ii). Under paragraph (a) of this section, all 100 shares of FA stock retain their status as being described in section 7874(a)(2)(B)(ii), even though Individual A sells 25 of the 100 shares in connection with the acquisition described in section 7874(a)(2)(B)(i) pursuant to the binding commitment. Therefore, all 100 of the shares of FA stock are included in both the numerator and denominator of the ownership fraction.

(c) *Certain transfers involving expanded affiliated group members.* For rules addressing whether certain stock is treated as held by members of the expanded affiliated group for purposes of applying section 7874(c)(2)(A) and §1.7874–1, see §1.7874–6.

(d) *Definitions.* The definitions provided in §1.7874–12 apply for purposes of this section.

(e) *Applicability dates.* This section applies to domestic entity acquisitions that are completed on or after January 16, 2014.

[T.D. 9812, 82 FR 5400, Jan. 18, 2017, as amended by T.D. 9834, 83 FR 32548, July 12, 2018]

§ 1.7874–6 Stock transferred by members of the EAG.

(a) *Scope.* This section provides rules regarding whether transferred stock is treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and §1.7874–1. Paragraph (b) of this section sets forth the general rule under which transferred stock is not treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and §1.7874–1. Paragraph (c) of this section provides exceptions to the general rule. Paragraph (d) of this section provides rules regarding the treatment of partnerships, and paragraph (e) of this section provides rules regarding transactions related to the acquisition. Paragraph (f) of this section provides definitions. Paragraph (g) of this section provides examples illustrating the application of the rules of this section. Paragraph (h) of this section provides dates of applicability.

(b) *General rule.* Except as provided in paragraph (c) of this section, transferred stock is not treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and §1.7874–1. Transferred stock that is not treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A)

and § 1.7874–1 is included in the numerator and the denominator of the ownership fraction. See § 1.7874–5(a).

(c) *Exceptions.* Transferred stock is treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and § 1.7874–1 if paragraph (c)(1) or (2) of this section applies. Transferred stock that is treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and § 1.7874–1 is excluded from the numerator of the ownership fraction and, depending upon the application of § 1.7874–1(c), may be excluded from the denominator of the ownership fraction. See § 1.7874–1(b) and (c).

(1) *Transfers involving a U.S.-parented group.* This paragraph (c)(1) applies if the following conditions are satisfied:

(i) Before the domestic entity acquisition, the transferring corporation is a member of a U.S.-parented group.

(ii) After the domestic entity acquisition, each of the transferring corporation (or its successor), any person that holds transferred stock, and the foreign acquiring corporation are members of a U.S.-parented group the common parent of which—

(A) Before the domestic entity acquisition, was a member of the U.S.-parented group described in paragraph (c)(1)(i) of this section; or

(B) Is a corporation that was formed in a transaction related to the domestic entity acquisition, provided that, immediately after the corporation was formed (and without regard to any related transactions), the corporation was a member of the U.S.-parented group described in paragraph (c)(1)(i) of this section.

(2) *Transfers involving a foreign-parented group.* This paragraph (c)(2) applies if the following conditions are satisfied:

(i) Before the domestic entity acquisition, the transferring corporation and the domestic entity are members of the same foreign-parented group.

(ii) After the domestic entity acquisition, the transferring corporation—

(A) Is a member of the EAG; or

(B) Would be a member of the EAG absent one or more transfers (other than by issuance), in a transaction (or series of transactions) after and related to the domestic entity acquisition, of stock of the foreign acquiring corporation by one or more members of the foreign-parented group described in paragraph (c)(2)(i) of this section.

(d) *Treatment of partnerships*—(1) *Stock held by a partnership.* For purposes of this section, each partner in a partnership, as determined without regard to the application of paragraph (d)(2) of this section, is treated as holding its proportionate share of the stock held by the partnership, as determined under the rules and principles of sections 701 through 777.

(2) *Partnership treated as corporation.* For purposes of this section, if one or more members of an affiliated group, as determined after the application of paragraph (d)(1) of this section, own, in the aggregate, more than 50 percent (by value) of the interests in a partnership, the partnership will be treated as a corporation that is a member of the affiliated group.

(e) *Treatment of transactions related to the acquisition.* Except as provided in paragraphs (c)(1)(ii)(B) and (c)(2)(ii)(B) of this section, all transactions that are related to a domestic entity acquisition are taken into account in applying this section.

(f) *Definitions.* In addition to the definitions provided in § 1.7874–12, the following definitions apply for purposes of this section.

(1) A *foreign-parented group* means an affiliated group that has a foreign corporation as the common parent corporation. A *member of the foreign-parented group* is an entity included in the foreign-parented group.

(2) *Transferred stock*—(i) *In general.* Transferred stock means stock of the foreign acquiring corporation described in section 7874(a)(2)(B)(ii) that is received by a transferring corporation and, in a transaction (or series of transactions) related to the domestic entity acquisition, is subsequently transferred.

(ii) *Special rule.* This paragraph (f)(2)(ii) applies in certain cases in which a transferring corporation receives stock of the foreign acquiring corporation described in section 7874(a)(2)(B)(ii) that has the same terms as other stock of the foreign acquiring corporation that is received by

the transferring corporation in a transaction (or series of transactions) related to the domestic entity acquisition or that is owned by the transferring corporation prior to the domestic entity acquisition (the stock described in this sentence, collectively, *fungible stock*). Pursuant to this paragraph (f)(2)(ii), if, in a transaction (or series of transactions) related to the domestic entity acquisition, the transferring corporation subsequently transfers less than all of the fungible stock, a pro rata portion of the stock subsequently transferred is treated as consisting of stock of the foreign acquiring corporation described in section 7874(a)(2)(B)(ii). The pro rata portion is based, at the time of the subsequent transfer, on the relative fair market value of the fungible stock that is stock of the foreign acquiring corporation described in section 7874(a)(2)(B)(ii) to the fair market value of all the fungible stock.

(3) A *transferring corporation* means a corporation that is a former domestic entity shareholder or former domestic entity partner.

(4) A *U.S.-parented group* means an affiliated group that has a domestic corporation as the common parent corporation. A *member of the U.S.-parented group* is an entity included in the U.S.-parented group, including the common parent corporation.

(g) *Examples*. The following examples illustrate the application of this section.

Example 1. U.S.-parented group exception not available—(i) *Facts*. USP, a domestic corporation wholly owned by Individual A, owns all the stock of DT, a domestic corporation, as well as other property. The DT stock does not represent substantially all of the property of USP for purposes of section 7874. Pursuant to a reorganization described in section 368(a)(1)(D), USP transfers all the DT stock to FA, a newly formed foreign corporation, in exchange for 100 shares of FA stock (DT acquisition) and distributes the FA stock to Individual A pursuant to section 361(c)(1).

(ii) *Analysis*. The 100 FA shares received by USP are stock of a foreign acquiring corporation described in section 7874(a)(2)(B)(ii) and, under §1.7874–5(a), the shares retain their status as such even though USP subsequently distributes the shares to Individual A pursuant to section 361(c)(1). Thus, the 100 FA shares are included in the ownership fraction, unless the shares are treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and §1.7874–1 and are excluded from the ownership fraction under those rules. For purposes of applying section 7874(c)(2)(A) and §1.7874–1, the 100 FA shares, which constitute transferred stock under paragraph (f)(2) of this section, are treated as held by members of the EAG only if an exception in paragraph (c) of this section applies. See paragraph (b) of this section. The U.S.-parented group exception described in paragraph (c)(1) of this section does not apply. Although before the DT acquisition, USP (the transferring corporation) is a member of a U.S.-parented group of which USP is the common parent, after the DT acquisition, and taking into account all transactions related to the acquisition, each of USP, Individual A (the person that holds the transferred stock), and FA (the foreign acquiring corporation) are not members of a U.S.-parented group described in paragraph (c)(1)(ii)(A) or (B) of this section. Accordingly, because the 100 FA shares are not treated as held by members of the EAG, those shares are included in the numerator and the denominator of the ownership fraction. Therefore, the ownership fraction is 100/100.

Example 2. U.S.-parented group exception available—(i) *Facts*. USP, a domestic corporation wholly owned by Individual A, owns all the stock of USS, a domestic corporation, and USS owns all the stock of FT, a foreign corporation. FT owns all the stock of DT, a domestic corporation. FT does not own any other property and has no liabilities. Pursuant to a reorganization described in section 368(a)(1)(F), FT transfers all of its DT stock to FA, a newly formed foreign corporation, in exchange for 100 shares of FA stock (DT acquisition) and distributes the FA stock to USS in liquidation pursuant to section 361(c)(1). In a transaction after and related to the DT acquisition, USP sells 60 percent of the stock of USS (by vote and value) to Individual B.

(ii) *Analysis*. The 100 FA shares received by FT are stock of a foreign acquiring corporation described in section 7874(a)(2)(B)(ii) and, under §1.7874–5(a), the shares retain their status as such even though FT subsequently distributes the shares to USS pursuant to section 361(c)(1). Thus, the 100 FA shares are included in the ownership fraction, unless the shares are treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and §1.7874–1 and are excluded from the ownership fraction under those rules. For purposes of applying section 7874(c)(2)(A) and §1.7874–1, the 100 FA shares, which constitute transferred stock under paragraph (f)(2) of this section, are treated as held by members of the EAG only if an exception in paragraph (c) of this section applies. See paragraph (b) of this section. The

U.S.-parented group exception described in paragraph (c)(1) of this section applies. The requirement set forth in paragraph (c)(1)(i) of this section is satisfied because before the DT acquisition, FT (the transferring corporation) is a member of a U.S.-parented group of which USP is the common parent (the USP group). The requirement set forth in paragraph (c)(1)(ii) of this section is satisfied because after the DT acquisition, and taking into account all transactions related to the acquisition, each of FA (which is both the successor to FT, the transferring corporation, and the foreign acquiring corporation) and USS (the person that holds the transferred stock) are members of a U.S.-parented group of which USS (a member of the USP group before the DT acquisition) is the common parent. Moreover, the DT acquisition qualifies as an internal group restructuring under §1.7874–1(c)(2). The requirement set forth in §1.7874–1(c)(2)(i) is satisfied because before the DT acquisition, 80 percent or more of the stock (by vote and value) of DT was held directly or indirectly by USS (the corporation that after the acquisition, and taking into account all transactions related to the acquisition, is the common parent of the EAG). The requirement set forth in §1.7874–1(c)(2)(ii) is satisfied because after the acquisition, and taking into account all transactions related to the acquisition, 80 percent or more of the stock (by vote and value) of FA (the foreign acquiring corporation) is held directly or indirectly by USS. Therefore, the 100 FA shares are excluded from the numerator, but included in the denominator, of the ownership fraction. Accordingly, the ownership fraction is 0/100.

Example 3. U.S.-parented group exception available—(i) *Facts.* USP, a domestic corporation wholly owned by Individual A, owns all the stock of USS, a domestic corporation, and USS owns all the stock of DT, also a domestic corporation. DT owns all the stock of FT, a foreign corporation. The FT stock represents substantially all of the property of DT for purposes of section 7874. Pursuant to a reorganization described in section 368(a)(1)(D), DT transfers all the FT stock to FA, a newly formed foreign corporation, in exchange for 100 shares of FA stock (DT acquisition) and distributes the FA stock to USS pursuant to section 361(c)(1). In a related transaction, USS distributes all the FA stock to USP under section 355(c)(1). Lastly, in another related transaction and pursuant to a divisive reorganization described in section 368(a)(1)(D), USP transfers all the stock of USS and FA to DP, a newly formed domestic corporation, in exchange for all the stock of DP and distributes the DP stock to Individual A pursuant to section 361(c)(1).

(ii) *Analysis.* The 100 FA shares received by USS are stock of a foreign acquiring corporation described in section 7874(a)(2)(B)(ii) and, under §1.7874–5(a), the shares retain their status as such even though USS subsequently transfers the shares to USP. Thus, the 100 FA shares are included in the ownership fraction, unless the shares are treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and §1.7874–1 and are excluded from the ownership fraction under those rules. For purposes of applying section 7874(c)(2)(A) and §1.7874–1, the 100 FA shares, which constitute transferred stock under paragraph (f)(2) of this section, are treated as held by members of the EAG only if an exception in paragraph (c) of this section applies. See paragraph (b) of this section. The U.S.-parented group exception described in paragraph (c)(1) of this section applies. The requirement set forth in paragraph (c)(1)(i) of this section is satisfied because before the DT acquisition, USS (the transferring corporation) is a member of a U.S.-parented group of which USP is the common parent (the USP group). The requirement set forth in paragraph (c)(1)(ii) of this section is satisfied because after the DT acquisition, and taking into account all transactions related to the acquisition, each of USS, DP (the person that holds the transferred stock), and FA (the foreign acquiring corporation) are members of a U.S.-parented group of which DP (a corporation that was formed in a transaction related to the DT acquisition and that, immediately after it was formed (but without regard to any related transactions) was a member of the USP group) is the common parent. Therefore, the 100 FA shares are excluded from the numerator and the denominator of the ownership fraction. Accordingly, the ownership fraction is 0/0.

Example 4. Foreign-parented group exception—(i) *Facts.* Individual A owns all the stock of FT, a foreign corporation, and FT owns all the stock of DT, a domestic corporation. FT does not own any other property and has no liabilities. Pursuant to a reorganization described in section 368(a)(1)(F), FT transfers all the stock of DT to FA, a newly formed foreign corporation, in exchange for 100 shares of FA stock (DT acquisition) and distributes the FA stock to Individual A in liquidation pursuant to section 361(c)(1).

(ii) *Analysis.* The 100 FA shares received by FT are stock of a foreign acquiring corporation described in section 7874(a)(2)(B)(ii) and, under §1.7874–5(a), the shares retain their status as such even though FT subsequently distributes the shares to Individual A pursuant to section 361(c)(1). Thus, the 100 FA shares are included in the ownership fraction, unless the shares are treated as held by members of the EAG of purposes of applying section 7874(a)(2)(A) and §1.7874–1 and are excluded from the ownership fraction under those rules. For purposes of applying section 7874(c)(2)(A) and §1.7874–1, the 100 FA shares, which constitute transferred stock under paragraph (f)(2) of this section, are treated as

held by members of the EAG only if an exception in paragraph (c) of this section applies. See paragraph (b) of this section. The foreign-parented group exception described in paragraph (c)(2) of this section applies. The requirement set forth in paragraph (c)(2)(i) of this section is satisfied because before the DT acquisition, FT (the transferring corporation) and DT are members of the foreign-parented group of which FT is the common parent. The requirement set forth in paragraph (c)(2)(ii) of this section is satisfied because after the acquisition, and taking into account all transactions related to the acquisition, FT would be a member of the EAG absent the distribution of the FA shares pursuant to section 361(c)(1). Moreover, the DT acquisition qualifies as an internal group restructuring under §1.7874–1(c)(2). The requirement set forth in §1.7874–1(c)(2)(i) is satisfied because before the acquisition, 80 percent or more of the stock (by vote and value) of DT was held directly or indirectly by FT, the corporation that, without regard to the distribution of the FA shares pursuant to section 361(c)(1), would be common parent of the EAG after the acquisition. See §1.7874–1(c)(2)(iii). The requirement set forth in §1.7874–1(c)(2)(ii) is satisfied because after the acquisition, but without regard to the distribution of the FA shares pursuant to the section 361(c)(1) distribution, FT would directly or indirectly hold 80 percent or more of the stock (by vote and value) of FA (the foreign acquiring corporation). See §1.7874–1(c)(2)(iii). Therefore, the 100 FA shares are excluded from the numerator, but included in the denominator, of the ownership fraction. Accordingly, the ownership fraction is 0/100.

(iii) *Alternative facts.* The facts are the same as in paragraph (i) of this *Example 4*, except that in a transaction after and related to the DT acquisition, FA issues 200 shares of FA stock to Individual B in exchange for qualified property (within the meaning of §1.7874–4(h)(2)). The foreign-parented group exception does not apply because after the acquisition, and taking into account FA's issuance of the 200 FA shares to Individual B, FT would not be a member of the EAG absent FT's distribution of the 100 FA shares pursuant to section 361(c)(1). Accordingly, the 100 FA shares received by FT are not treated as held by a member of the EAG for purposes of applying section 7874(c)(2)(A) and §1.7874–1. As a result, the ownership fraction is 100/300.

(h) *Applicability dates.* Except as otherwise provided in this paragraph (h), this section applies to domestic entity acquisitions completed on or after September 22, 2014. Paragraphs (d)(2) and (f)(2)(ii) of this section apply to domestic entity acquisitions completed on or after April 4, 2016. Taxpayers, however, may elect either to apply paragraph (c)(2) of this section to domestic entity acquisitions completed before September 22, 2014, or to consistently apply paragraphs (c)(2), (d)(2), and (f)(2)(ii) of this section and §1.7874–1(c)(2)(iii) and (g) to domestic entity acquisitions completed before April 4, 2016.

[T.D. 9834, 83 FR 32548, July 12, 2018]

§1.7874–7 Disregard of certain stock attributable to passive assets.

(a) *Scope.* This section identifies certain stock of a foreign acquiring corporation that is attributable to passive assets and that is disregarded in determining the ownership fraction by value. Paragraph (b) of this section sets forth the general rule regarding when stock of a foreign acquiring corporation is excluded from the denominator of the ownership fraction under this section. Paragraph (c) of this section provides a de minimis exception to the application of the general rule of paragraph (b) of this section. Paragraph (d) of this section provides rules for the treatment of partnerships, and paragraph (e) of this section provides definitions. Paragraph (f) of this section provides examples illustrating the application of the rules of this section. Paragraph (g) of this section provides dates of applicability. The rules provided in this section are also subject to section 7874(c)(4). See §1.7874–1(d)(1) for rules addressing the interaction of this section with the expanded affiliated group rules of section 7874(c)(2)(A) and §1.7874–1.

(b) *General rule.* If, on the completion date, more than fifty percent of the gross value of all foreign group property constitutes foreign group nonqualified property, then, for purposes of determining the ownership percentage by value (but not vote) described in section 7874(a)(2)(B)(ii), stock of the foreign acquiring corporation is excluded from the denominator of the ownership fraction in an amount equal to the product of—

(1) The value of the stock of the foreign acquiring corporation, other than stock that is described in section 7874(a)(2)(B)(ii) and stock that is excluded from the denominator of the

ownership fraction under § 1.7874–1(b), § 1.7874–4(b), § 1.7874–8(b), § 1.7874–9(b), or section § 7874(c)(4); and

(2) The foreign group nonqualified property fraction.

(c) *De minimis ownership.* Paragraph (b) of this section does not apply if—

(1) The ownership percentage described in section 7874(a)(2)(B)(ii), determined without regard to the application of paragraph (b) of this section and §§ 1.7874–4(b) and 1.7874–10(b), is less than five (by vote and value); and

(2) On the completion date, each five percent former domestic entity shareholder or five percent former domestic entity partner, as applicable, owns (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) less than five percent (by vote and value) of the stock of (or a partnership interest in) each member of the expanded affiliated group. For this purpose, a five percent former domestic entity shareholder (or five percent former domestic entity partner) is a former domestic entity shareholder (or former domestic entity partner) that, before the domestic entity acquisition, owned (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) at least five percent (by vote and value) of the stock of (or a partnership interest in) the domestic entity.

(d) *Treatment of partnerships.* For purposes of this section, if one or more members of the modified expanded affiliated group own, in the aggregate, more than 50 percent (by value) of the interests in a partnership, the partnership is treated as a corporation that is a member of the modified expanded affiliated group.

(e) *Definitions.* In addition to the definitions provided in § 1.7874–12, the following definitions apply for purposes of this section.

(1) *Foreign group nonqualified property*—(i) *General rule.* Foreign group nonqualified property means foreign group property described in § 1.7874–4(h)(2), other than the following:

(A) Property that gives rise to income described in section 954(h), determined—

(*1*) In the case of property held by a foreign corporation, by substituting the term ''foreign corporation'' for the term ''controlled foreign corporation;'' and

(*2*) In the case of property held by a domestic corporation, by substituting the term ''domestic corporation'' for the term ''controlled foreign corporation,'' without regard to the phrase ''other than the United States'' in section 954(h)(3)(A)(ii)(I), and without regard to any inference that the tests in section 954(h) should be calculated or determined without taking transactions with customers located in the United States into account.

(B) Property that gives rise to income described in section 954(i), determined by substituting the term ''foreign corporation'' for the term ''controlled foreign corporation.''

(C) Property that gives rise to income described in section 1297(b)(2)(A) or (B) (determined without regard to other passive foreign investment company rules).

(D) Property held by a domestic corporation that is subject to tax as an insurance company under subchapter L of chapter 1 of subtitle A of the Internal Revenue Code, provided that the property is required to support, or is substantially related to, the active conduct of an insurance business.

(ii) *Special rule.* Foreign group nonqualified property also means any foreign group property that, in a transaction related to the domestic entity acquisition, is acquired in exchange for other property, including cash, if such other property would be described in paragraph (e)(1)(i) of this section had the transaction not occurred.

(2) *Foreign group property* means any property (including excluded property, as described in paragraph (e)(3)(ii) of this section)) held on the completion date by the modified expanded affiliated group, other than—

(i) Property that is directly or indirectly acquired in the domestic entity acquisition;

(ii) Stock or a partnership interest in a member of the modified expanded affiliated group; and

(iii) An obligation of a member of the modified expanded affiliated group.

(3) *Foreign group nonqualified property fraction*—(i) *In general.* Foreign group nonqualified property fraction means a

fraction calculated with the following numerator and denominator:

(A) The numerator of the fraction is the gross value of all foreign group nonqualified property, other than excluded property (as described in paragraph (e)(3)(ii) of this section).

(B) The denominator of the fraction is the gross value of all foreign group property, other than excluded property (as described in paragraph (e)(3)(ii) of this section)

(ii) *Excluded property*. For purposes of paragraph (e)(3) of this section, excluded property means property that gives rise to stock that is excluded from the ownership fraction with respect to the domestic entity acquisition under § 1.7874–4(b), § 1.7874–8(b), § 1.7874–9(b), or section 7874(c)(4). For this purpose, only property that was directly or indirectly acquired in a prior domestic entity acquisition (as described in § 1.7874–8(g)(4)) or covered foreign acquisition (as described in § 1.7874–9(d)(4)) with respect to the domestic entity acquisition may be considered to give rise to stock that is excluded from the ownership fraction with respect to the domestic entity acquisition under § 1.7874–8(b) or § 1.7874–9(b). If only a portion of the consideration provided in a prior domestic entity acquisition or covered foreign acquisition consisted of stock of the foreign acquiring corporation, then only a pro rata portion of a property directly or indirectly acquired in the prior domestic entity acquisition or covered foreign acquisition may be considered excluded property, based on a fraction the numerator of which is the amount of the consideration that consisted of stock of the foreign acquiring corporation and the denominator of which is the total amount of consideration.

(4) *Modified expanded affiliated group* means, with respect to a domestic entity acquisition, the group described in either paragraph (e)(4)(i) of this section or paragraph (e)(4)(ii) of this section. A *member of the modified expanded affiliated group* is an entity included in the modified expanded affiliated group.

(i) When the foreign acquiring corporation is not the common parent corporation of the expanded affiliated group, the expanded affiliated group determined as if the foreign acquiring corporation was the common parent corporation.

(ii) When the foreign acquiring corporation is the common parent corporation of the expanded affiliated group, the expanded affiliated group.

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

Example 1. Application of general rule—(i) *Facts*. Individual A owns all 20 shares of the sole class of stock of FA, a foreign corporation. FA acquires all the stock of DT, a domestic corporation, solely in exchange for 76 shares of newly issued FA stock (DT acquisition). In a transaction related to the DT acquisition, FA issues 4 shares of stock to Individual A in exchange for Asset A, which has a gross value of $50x. On the completion date, in addition to the DT stock and Asset A, FA holds Asset B, which has a gross value of $150x, and Asset C, which has a gross value of $100x. Assets A and B, but not Asset C, are nonqualified property (within the meaning of § 1.7874–4(h)(2)). Further, Asset C was not acquired in a transaction related to the DT acquisition.

(ii) *Analysis*. The 4 shares of FA stock issued to Individual A in exchange for Asset A are disqualified stock under § 1.7874–4(c) and are excluded from the denominator of the ownership fraction pursuant to § 1.7874–4(b). Furthermore, additional shares of FA stock are excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section. This is because on the completion date, the gross value of all foreign group property is $300x (the sum of the gross values of Assets A, B, and C), the gross value of all foreign group nonqualified property is $200x (the sum of the gross values of Assets A and B), and thus 66.67% of the gross value of all foreign group property constitutes foreign group nonqualified property ($200x/$300x). Because FA has only one class of stock outstanding, the shares of FA stock that are excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section are calculated by multiplying 20 shares of FA stock (100 shares less the 76 shares described in section 7874(a)(2)(B)(ii) and the 4 shares of disqualified stock) by the foreign group nonqualified property fraction. The numerator of the foreign group nonqualified property fraction is $150x (the gross value of Asset B) and the denominator is $250x (the sum of the gross values of Assets B and C). Asset A is not taken into account for purposes of the foreign group nonqualified property fraction because it gives rise to FA stock that is excluded under § 1.7874–4(b) (4 shares) and, as a result, is excluded property. Accordingly, 12 shares of FA stock are excluded from the denominator of the ownership fraction pursuant to

paragraph (b) of this section (20 shares multiplied by $150x/$250x). Thus, a total of 16 shares are excluded from the denominator of the ownership fraction (4 + 12). As a result, the ownership fraction by value is 76/84.

Example 2. Application of de minimis exception—(i) *Facts.* Individual A owns all 96 shares of the sole class of stock of FA, a foreign corporation. Individual B wholly owns DT, a domestic corporation. Individuals A and B are not related. FA acquires all the stock of DT solely in exchange for 4 shares of newly issued FA stock (DT acquisition). On the completion date, in addition to all of the stock of DT, FA holds Asset A, which is nonqualified property (within the meaning of §1.7874–4(h)(2)).

(ii) *Analysis.* Without regard to the application of §§1.7874–4(b) and 1.7874–10(b) as well as paragraph (b) of this section, the ownership percentage described in section 7874(a)(2)(B)(ii) would be less than 5 (by vote and value), or 4 (4/100, or 4 shares of FA stock held by Individual B by reason of owning the DT stock, determined under §1.7874–2(f)(2), over 100 shares of FA stock outstanding after the DT acquisition). Furthermore, on the completion date, Individual B owns less than 5% (by vote and value) of the stock of FA and DT (the members of the expanded affiliated group). Accordingly, the de minimis exception in paragraph (c) of this section applies. Therefore, paragraph (b) of this section does not apply and the ownership fraction is 4/100.

Example 3. Foreign acquiring corporation not common parent of EAG—(i) *Facts.* FP, a foreign corporation, owns all 85 shares of the sole class of stock of FA, a foreign corporation. FA acquires all the stock of DT, a domestic corporation, solely in exchange for 65 shares of newly issued FA stock (DT acquisition). On the completion date, FA, in addition to all of the stock of DT, owns Asset A, which has a gross value of $40x, and Asset B, which has a gross value of $45x. Moreover, on the completion date, in addition to the 85 shares of FA stock, FP owns Asset C, which has a gross value of $10x. Assets A and C, but not Asset B, are nonqualified property (within the meaning of §1.7874–4(h)(2)). Further, Asset B was not acquired in a transaction related to the DT acquisition in exchange for nonqualified property.

(ii) *Analysis.* Under paragraph (e)(2) of this section, Assets A and B, but not Asset C, are foreign group property. Although Asset C is held on the completion date by FP, a member of the expanded affiliated group, Asset C is not foreign group property because FP is not a member of the modified expanded affiliated group. This is the case because if the expanded affiliated group were determined based on FA as the common parent corporation, FP would not be a member of such expanded affiliated group (see paragraph (e)(4)(i) of this section). Under paragraph (e)(1) of this section, Asset A, but not Asset B, is foreign group nonqualified property. Therefore, on the completion date, the gross value of all foreign group property is $85x (the sum of the gross values of Assets A and B), and the gross value of all foreign group nonqualified property is $40x (the gross value of Asset A). Accordingly, on the completion date, only 47.06% of the gross value of all foreign group property constitutes foreign group nonqualified property ($40x/$85x). Consequently, paragraph (b) of this section does not apply to exclude any FA stock from the denominator of the ownership fraction.

Example 4. Coordination with serial acquisition rule—(i) *Facts.* Individual A owns all 30 shares of the sole class of stock of FA, a foreign corporation. In Year 1, FA acquires all the stock of DT1, a domestic corporation, solely in exchange for 40 shares of newly issued FA stock (DT1 acquisition). In Year 2, FA acquires all the stock of DT2, a domestic corporation, solely in exchange for 50 shares of newly issued FA stock (DT2 acquisition). On the completion date for the DT2 acquisition, in addition to the DT2 stock, FA holds Asset A, which has a gross value of $15x, Asset B, which has a gross value of $15x, and all the stock of DT1, which has a gross value of $40x. At all times, DT1 holds only Asset C, which has a gross value of $30x, and Asset D, which has a gross value of $10x. Assets A and C, but not Assets B and D, are nonqualified property (within the meaning of §1.7874–4(h)(2)). In addition, at all times, the fair market value of each share of FA stock is $1x. Further, there have been no redemptions of FA stock subsequent to the DT1 acquisition. Lastly, under §1.7874–8, the DT1 acquisition is a prior domestic entity acquisition with respect to the DT2 acquisition and $40x of FA stock is excluded from the denominator of the ownership fraction with respect to the DT2 acquisition.

(ii) *Analysis.* Shares of FA stock are excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section. This is because on the completion date, the gross value of all foreign group property is $70x (the sum of the gross values of Assets A, B, C, and D), the gross value of all foreign group nonqualified property is $45x (the sum of the gross values of Assets A and C), and thus 64.29% of the gross value of all foreign group property constitutes foreign group nonqualified property ($45x/$70x). The shares of FA stock that are excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section are calculated by multiplying $30x ($120x, the value of all the shares of FA stock, less $50x, the value of the stock described in section 7874(a)(2)(B)(ii), less $40x, the value of the stock excluded under §1.7874–8(b)) by the foreign group nonqualified property fraction.

The property taken into account for purposes of determining the foreign group nonqualified property fraction is Asset A and Asset B. Asset C and Asset D are not taken into account for purposes of the foreign group nonqualified property fraction because they are excluded property. This is because FA indirectly acquired the Assets in the DT1 acquisition (a prior domestic entity acquisition with respect to the DT2 acquisition) and, as a result of that acquisition, $40x of FA stock is excluded from the denominator of the ownership fraction with respect to the DT2 acquisition under §1.7874–8(b). Thus, the numerator of the foreign group nonqualified property fraction is $15x (the gross value of Asset A) and the denominator is $30x (the sum of the gross values of Asset A, $15x, and Asset B, $15x). Accordingly, $15x of FA stock is excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section ($30x multiplied by $15x/$30x). Thus, a total of $55x of FA stock is excluded from the denominator of the ownership fraction ($40x + $15x), making the denominator $65x ($120x − $55x). As a result, the ownership percentage with respect to the DT2 acquisition by value is 76.92 ($50x/$65x).

(ii) *Alternative facts.* The facts are the same as in paragraph (i) of this *Example 4*, except as follows. Initially, there are 40 shares of FA stock outstanding, all of which are owned by Individual A. At all times, the gross value of asset D is $20x. In the DT1 acquisition, FA acquires all the stock of DT1 ($50x fair market value) solely in exchange for 40 shares of newly issued FA stock and $10x of other property. As in paragraph (i) of this Example 4, shares of FA stock are excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section. This is because on the completion date, the gross value of all foreign group property is $80x (the sum of the gross values of Assets A, B, C, and D), the gross value of all foreign group nonqualified property is $45x (the sum of the gross values of Assets A and C), and thus 56.25% of the gross value of all foreign group property constitutes foreign group nonqualified property ($45x/$80x). The shares of FA stock that are excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section are calculated by multiplying $40x ($130x, the value of all the shares of FA stock, less $50x, the value of the stock described in section 7874(a)(2)(B)(ii), less $40x, the value of the stock excluded under §1.7874–8(b)) by the foreign group nonqualified property fraction. The property taken into account for purposes of determining the foreign group nonqualified property fraction is Asset A, Asset B, and the portion of Asset C and Asset D that is not excluded property. Eighty percent of each of Asset C and Asset D are considered excluded property because FA indirectly acquired Asset C and Asset D in the DT1 acquisition (a prior domestic entity acquisition with respect to the DT2 acquisition); as a result of that acquisition, $40x of FA stock is excluded from the denominator of the ownership fraction with respect to the DT2 acquisition under §1.7874–8(b); and 80% of the consideration provided in the DT1 acquisition consisted of stock of FA ($40x/$50x). Thus, the numerator of the foreign group nonqualified property fraction is $21x (the sum of the gross values of Asset A, $15x, and the portion of Asset C that is not excluded property, $6x) and the denominator is $40x (the sum of the gross values of Asset A, $15x, Asset B, $15x, and the portion of Asset C and Asset D that is not excluded property, $6x and $4x, respectively). Accordingly, $21x of FA stock is excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section ($40x multiplied by $21x/$40x). Thus, a total of $61x of FA stock is excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section ($40x + $21x), making the denominator $69x ($130x − $61x). As a result, the ownership percentage with respect to D2 acquisition by value is 72.46 ($50x/$69x).

(g) *Applicability dates.* This section applies to domestic entity acquisitions completed on or after July 12, 2018. For domestic entity acquisitions completed before July 12, 2018, see §1.7874–7T, as contained in 26 CFR part 1 revised as of April 1, 2017. However, to the extent this section differs from §1.7874–7T, as contained in 26 CFR part 1 revised as of April 1, 2017, taxpayers may elect to consistently apply the differences to domestic entity acquisitions completed before July 12, 2018.

[T.D. 9834, 83 FR 32551, July 12, 2018]

§1.7874–8 Disregard of certain stock attributable to serial acquisitions.

(a) *Scope.* This section identifies stock of a foreign acquiring corporation that is disregarded in determining an ownership fraction by value because it is attributable to certain prior domestic entity acquisitions. Paragraph (b) of this section sets forth the general rule regarding the amount of stock of a foreign acquiring corporation that is excluded from the denominator of the ownership fraction by value under this section, and paragraphs (c) through (f) of this section provide rules for determining this amount. Paragraph (g) provides definitions. Paragraph (h) of this section provides examples illustrating

the application of the rules of this section. Paragraph (i) of this section provides dates of applicability. This section applies after taking into account §1.7874–2(e). See §1.7874–1(d)(1) for rules addressing the interaction of this section with the expanded affiliated group rules of section 7874(c)(2)(A) and §1.7874–1.

(b) *General rule.* This paragraph (b) applies to a domestic entity acquisition (relevant domestic entity acquisition) when the foreign acquiring corporation (including a predecessor, as defined in §1.7874–10(f)(1)) has completed one or more prior domestic entity acquisitions. When this paragraph (b) applies, then, for purposes of determining the ownership percentage by value (but not vote) described in section 7874(a)(2)(B)(ii), stock of the foreign acquiring corporation is excluded from the denominator of the ownership fraction in an amount equal to the sum of the excluded amounts computed separately with respect to each prior domestic entity acquisition and each relevant share class.

(c) *Computation of excluded amounts.* With respect to each prior domestic entity acquisition and each relevant share class, the excluded amount is the product of—

(1) The total number of prior acquisition shares, reduced by the sum of the number of allocable redeemed shares for all redemption testing periods; and

(2) The fair market value of a single share of stock of the relevant share class on the completion date of the relevant domestic entity acquisition.

(d) *Computation of allocable redeemed shares*—(1) *In general.* With respect to each prior domestic entity acquisition and each relevant share class, the allocable redeemed shares, determined separately for each redemption testing period, is the product of the number of redeemed shares during the redemption testing period and the redemption fraction.

(2) *Redemption fraction.* The redemption fraction is determined separately with respect to each prior domestic entity acquisition, each relevant share class, and each redemption testing period, as follows:

(i) The numerator is the total number of prior acquisition shares, reduced by the sum of the number of allocable redeemed shares for all prior redemption testing periods.

(ii) The denominator is the sum of—

(A) The number of outstanding shares of the foreign acquiring corporation stock as of the end of the last day of the redemption testing period; and

(B) The number of redeemed shares during the redemption testing period.

(e) *Rules for determining redemption testing periods*—(1) *In general.* Except as provided in paragraph (e)(2) of this section, a redemption testing period with respect to a prior domestic entity acquisition is the period beginning on the day after the completion date of the prior domestic entity acquisition and ending on the day prior to the completion date of the relevant domestic entity acquisition.

(2) *Election to use multiple redemption testing periods.* A foreign acquiring corporation may establish a reasonable method for dividing the period described in paragraph (e)(1) of this section into shorter periods (each such shorter period, a redemption testing period). A reasonable method would include a method based on a calendar convention (for example, daily, monthly, quarterly, or yearly), or on a convention that triggers the start of a new redemption testing period whenever a share issuance occurs that exceeds a certain threshold. In order to be reasonable, the method must be consistently applied with respect to all prior domestic entity acquisitions and all relevant share classes.

(f) *Appropriate adjustments required to take into account share splits and similar transactions.* For purposes of this section, appropriate adjustments must be made to take into account changes in a foreign acquiring corporation's capital structure, including, for example, stock splits, reverse stock splits, stock distributions, recapitalizations, and similar transactions. Thus, for example, in determining the total number of prior acquisition shares with respect to a relevant share class, appropriate adjustments must be made to take into account a stock split with respect to that relevant share class that occurs after the completion date with respect to a prior domestic entity acquisition.

(g) *Definitions*. In addition to the definitions provided in §1.7874–12, the following definitions apply for purposes of this section.

(1) A *binding contract* means an instrument enforceable under applicable law against the parties to the instrument. The presence of a condition outside the control of the parties (including, for example, regulatory agency approval) does not prevent an instrument from being a binding contract. Further, the fact that insubstantial terms remain to be negotiated by the parties to the contract, or that customary conditions remain to be satisfied, does not prevent an instrument from being a binding contract. A tender offer that is subject to section 14(d) of the Securities and Exchange Act of 1934, (15 U.S.C. 78n(d)(1)), and Regulation 14D (17 CFR 240.14d–1 through 240.14d–103) and that is not pursuant to a binding contract, is treated as a binding contract made on the date of its announcement, notwithstanding that it may be modified by the offeror or that it is not enforceable against the offerees.

(2) A *relevant share class* means, with respect to a prior domestic entity acquisition, each separate legal class of shares in the foreign acquiring corporation from which prior acquisition shares were issued. See also paragraph (f) of this section (requiring appropriate adjustments in certain cases).

(3) *Total number of prior acquisition shares* means, with respect to a prior domestic entity acquisition and each relevant share class, the total number of shares of stock of the foreign acquiring corporation that were described in section 7874(a)(2)(B)(ii) as a result of that acquisition (without regard to whether the 60 percent test of section 7874(a)(2)(B)(ii) was satisfied), other than stock treated as received by former domestic entity shareholders or former domestic entity partners under §1.7874–10(b) or section 7874(c)(4), adjusted as appropriate under paragraph (f) of this section.

(4) A *prior domestic entity acquisition*—(i) *General rule*. Except as provided in this paragraph (g)(4), a prior domestic entity acquisition means, with respect to a relevant domestic entity acquisition, a domestic entity acquisition that occurred within the 36-month period ending on the signing date of the relevant domestic entity acquisition.

(ii) *Exception*. A domestic entity acquisition is not a prior domestic entity acquisition if it is described in paragraph (g)(4)(ii)(A) or (B) of this section.

(A) *De minimis*. A domestic entity acquisition is described in this paragraph (g)(4)(ii)(A) if—

(*1*) The ownership percentage described in section 7874(a)(2)(B)(ii) with respect to the domestic entity acquisition was less than five (by vote and value); and

(*2*) The fair market value of the stock of the foreign acquiring corporation described in section 7874(a)(2)(B)(ii) as a result of the domestic entity acquisition (without regard to whether the 60 percent test of section 7874(a)(2)(B)(ii) was satisfied) did not exceed $50 million, as determined on the completion date with respect to the domestic entity acquisition.

(B) *Foreign-parented group*. A domestic entity acquisition is described in this paragraph (g)(4)(ii)(B) if—

(*1*) Before the domestic entity acquisition and any related transaction, the domestic entity was a member of a foreign-parented group (as described in §1.7874–6(f)(1)); and

(*2*) The domestic entity acquisition qualified for the internal group restructuring exception under §1.7874–1(c)(2).

(5) A *redeemed share* means a share of stock in a relevant share class that was redeemed (within the meaning of section 317(b)).

(6) A *signing date* means the first date on which the contract to effect the relevant domestic entity acquisition is a binding contract, or if another binding contract to effect a substantially similar acquisition was terminated with a principal purpose of avoiding section 7874, the first date on which such other contract was a binding contract.

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

Example 1. Application of general rule—(i) *Facts*. Individual A wholly owns DT1, a domestic corporation. Individual B owns all 100 shares of the sole class of stock of FA, a foreign corporation. In Year 1, FA acquires all the stock of DT1 solely in exchange for 100 shares of newly issued FA stock (DT1 acquisition). On the completion date with respect to the DT1 acquisition, the fair market value

of each share of FA stock is $1x. In Year 3, FA enters into a binding contract to acquire all the stock of DT2, a domestic corporation wholly owned by Individual C. Thereafter, FA acquires all the stock of DT2 solely in exchange for 150 shares of newly issued FA stock (DT2 acquisition). On the completion date with respect to the DT2 acquisition, the fair market value of each share of FA stock is $1.50x. FA did not complete the DT1 acquisition and DT2 acquisition pursuant to a plan (or series of related transactions) for purposes of applying §1.7874–2(e). In addition, there have been no redemptions of FA stock subsequent to the DT1 acquisition.

(ii) *Analysis*. The DT1 acquisition is a prior domestic entity acquisition with respect to the DT2 acquisition (the relevant domestic entity acquisition) because the DT1 acquisition occurred within the 36-month period ending on the signing date with respect to the DT2 acquisition. Accordingly, paragraph (b) of this section applies to the DT2 acquisition. As a result, and because there were no redemptions of FA stock, the excluded amount is $150x, calculated as 100 (the total number of prior acquisition shares) multiplied by $1.50x (the fair market value of a single share of FA stock on the completion date with respect to the DT2 acquisition). Accordingly, the numerator of the ownership fraction by value is $225x (the fair market value of the stock of FA that, with respect to the DT2 acquisition, is described in section 7874(a)(2)(B)(ii)) (150 shares x $1.50x per share). In addition, the denominator of the ownership fraction is $375x (calculated as $525x, the fair market value of all 350 shares of FA stock as of the completion date with respect to the DT2 acquisition, less $150x, the excluded amount). Therefore, the ownership percentage by value is 60 ($225x divided by $375x).

Example 2. Effect of certain redemptions—(i) *Facts*. The facts are the same as in paragraph (i) of *Example 1* of this paragraph (h), except that in Year 2 FA redeems 50 shares of its stock (the Year 2 redemption).

(ii) *Analysis*. As is the case in paragraph (ii) of *Example 1* of this paragraph (h), the DT1 acquisition is a prior domestic entity acquisition with respect to the DT2 acquisition (the relevant domestic entity acquisition), and paragraph (b) of this section thus applies to the DT2 acquisition. Because of the Year 2 redemption, the allocable redeemed shares, and thus the redemption fraction, must be calculated. For this purpose, the redemption testing period is the period beginning on the day after the completion date with respect to the DT1 acquisition and ending on the day prior to the completion date with respect to the DT2 acquisition. The redemption fraction for the redemption testing period is thus 100/200, calculated as 100 (the total number of prior acquisition shares) divided by 200 (150, the number of outstanding shares of FA stock on the last day of the redemption testing period, plus 50, the number of redeemed shares during the redemption testing period), and the allocable redeemed shares for the redemption testing period is 25, calculated as 50 (the number of redeemed shares during the redemption testing period) multiplied by 100/200 (the redemption fraction for the redemption testing period). As a result, the excluded amount is $112.50x, calculated as 75 (100, the total number of prior acquisition shares, less 25, the allocable redeemed shares) multiplied by $1.50x (the fair market value of a single share of FA stock on the completion date with respect to the DT2 acquisition). Accordingly, the numerator of the ownership fraction by value is $225x (the fair market value of the stock of FA that, with respect to the DT2 acquisition, is described in section 7874(a)(2)(B)(ii)) (150 shares × $1.50x per share), and the denominator of the ownership fraction is $337.50x (calculated as $450x, the fair market value of all 300 shares of FA stock as of the completion date with respect to the DT2 acquisition, less $112.50x, the excluded amount). Therefore, the ownership percentage by value is 66.67 ($225x divided by $337.50x).

Example 3. Stock split—(i) *Facts*. The facts are the same as in paragraph (i) of *Example 2* of this paragraph (h), except as follows. After the Year 2 redemption, but before the DT2 acquisition, FA undergoes a stock split and, as a result, each of the 150 shares of FA stock outstanding are converted into two shares (Year 2 stock split). Further, pursuant to the DT2 acquisition, FA acquires all the stock of DT2 solely in exchange for 300 shares of newly issued FA stock. Moreover, on the completion date with respect to the DT2 acquisition, the fair market value of each share of FA stock is $0.75x.

(ii) *Analysis*. As is the case in paragraph (ii) of *Example 1* of this paragraph (h), the DT1 acquisition is a prior domestic entity acquisition with respect to the DT2 acquisition (the relevant domestic entity acquisition), and paragraph (b) of this section thus applies to the DT2 acquisition. In addition, as is the case in paragraph (ii) of *Example 2* of this paragraph (h), the redemption testing period is the period beginning on the day after the completion date with respect to the DT1 acquisition and ending on the day prior to the completion date with respect to the DT2 acquisition. To calculate the redemption fraction, the total number of prior acquisition shares and the number of redeemed shares during the redemption testing period must be appropriately adjusted to take into account the Year 2 stock split. See paragraph (f) of this section. In this case, the appropriate adjustment is to increase the total number of prior acquisition shares from 100 to 200 and to increase the number of redeemed shares during the redemption testing period from 50 to 100. Thus, the redemption

fraction for the redemption testing period is 200/400, calculated as 200 (the total number of prior acquisition shares) divided by 400 (300, the number of outstanding shares of FA stock on the last day of the redemption testing period, plus 100, the number of redeemed shares during the redemption testing period), and the allocable redeemed shares for the redemption testing period is 50, calculated as 100 (the number of redeemed shares during the redemption testing period) multiplied by 200/400 (the redemption fraction for the redemption testing period). In addition, for purposes of calculating the excluded amount, the total number of prior acquisition shares must be adjusted from 100 to 200. See paragraph (f) of this section. Accordingly, the excluded amount is $112.50x, calculated as 150 (200, the total number of prior acquisition shares, less 50, the allocable redeemed shares) multiplied by $0.75x (the fair market value of a single share of FA stock on the completion date with respect to the DT2 acquisition). Consequently, the numerator of the ownership fraction by value is $225x (the fair market value of the stock of FA that, with respect to the DT2 acquisition, is described in section 7874(a)(2)(B)(ii)) (300 shares × $0.75x per share), and the denominator of the ownership fraction is $337.50x (calculated as $450x, the fair market value of all 600 shares of FA stock as of the completion date with respect to the DT2 acquisition, less $112.50x, the excluded amount). Therefore, the ownership percentage by value is 66.67 ($225 divided by $337.50x).

(i) *Applicability dates*. Except as provided in this paragraph (i), this section applies to domestic entity acquisitions completed on or after April 4, 2016, regardless of when a prior domestic entity acquisition was completed. Paragraphs (g)(3) and (g)(4)(ii) of this section apply to domestic entity acquisitions completed on or after July 12, 2018. However, taxpayers may elect to consistently apply paragraphs (g)(3) and (g)(4)(ii) of this section to domestic entity acquisitions completed on or after April 4, 2016, and before July 12, 2018. For domestic entity acquisitions completed on or after April 4, 2016, and before July 12, 2018, see §1.7874–8T(g)(3) and (g)(4)(ii) as contained in 26 CFR part 1 revised as of April 1, 2017.

[T.D. 9834, 83 FR 32553, July 12, 2018]

§ 1.7874–9 Disregard of certain stock in third-country transactions.

(a) *Scope*. This section identifies certain stock of a foreign acquiring corporation that is disregarded in determining the ownership fraction. Paragraph (b) of this section provides a rule that, in a third-country transaction, excludes from the denominator of the ownership fraction stock in the foreign acquiring corporation held by former shareholders of an acquired foreign corporation by reason of holding certain stock in that foreign corporation. Paragraph (c) of this section defines a third-country transaction, and paragraph (d) of this section provides other definitions. Paragraph (e) of this section provides operating rules. Paragraph (f) of this section provides an example illustrating the application of the rules of this section. Paragraph (g) of this section provides the dates of applicability. See §1.7874–1(d)(1) for rules addressing the interaction of this section with the expanded affiliated group rules of section 7874(c)(2)(A) and §1.7874–1.

(b) *Exclusion of certain stock of a foreign acquiring corporation from the ownership fraction*. When a domestic entity acquisition is a third-country transaction, stock of the foreign acquiring corporation held by reason of holding stock in the acquired foreign corporation (within the meaning of paragraph (e)(4) of this section) is, to the extent the stock otherwise would be included in the denominator of the ownership fraction, excluded from the denominator of the ownership fraction pursuant to this paragraph.

(c) *Third-country transaction*. A domestic entity acquisition is a third-country transaction if the following requirements are satisfied:

(1) The foreign acquiring corporation completes a covered foreign acquisition pursuant to a plan (or series of related transactions) that includes the domestic entity acquisition.

(2) After the covered foreign acquisition and all related transactions are complete, the foreign acquiring corporation is not a tax resident of the foreign country in which the acquired foreign corporation was a tax resident before the covered foreign acquisition and all related transactions.

(3) The ownership percentage described in section 7874(a)(2)(B)(ii), determined without regard to the application of paragraph (b) of this section, is at least 60.

(d) *Definitions.* In addition to the definitions provided in §1.7874–12, the following definitions apply for purposes of this section.

(1) A *foreign acquisition* means a transaction in which a foreign acquiring corporation directly or indirectly acquires substantially all of the properties held directly or indirectly by an acquired foreign corporation (within the meaning of paragraph (e)(2) of this section).

(2) An *acquired foreign corporation* means a foreign corporation whose properties are acquired in a foreign acquisition.

(3) *Foreign ownership percentage* means, with respect to a foreign acquisition, the percentage of stock (by vote or value) of the foreign acquiring corporation held by reason of holding stock in the acquired foreign corporation (within the meaning of paragraph (e)(3) of this section).

(4) *Covered foreign acquisition*—(i) *In general.* Except as provided in paragraphs (d)(4)(ii) and (iii) of this section, a covered foreign acquisition means a foreign acquisition in which, after the acquisition and all related transactions are complete, the foreign ownership percentage is at least 60.

(ii) *Substantial business activities exception.* A foreign acquisition is not a covered foreign acquisition if, on the completion date, the following requirements are satisfied:

(A) The foreign acquiring corporation is a tax resident of a foreign country.

(B) The expanded affiliated group has substantial business activities in the country in which the foreign acquiring corporation is a tax resident when compared to the total business activities of the expanded affiliated group. For this purpose, the principles of §1.7874–3 apply and the determination of whether there are substantial business activities is made without regard to the domestic entity acquisition.

(iii) *No income tax exception.* A foreign acquisition is not a covered foreign acquisition if—

(A) Before the acquisition and all related transactions, the acquired foreign corporation was created or organized in, or under the law of, a foreign country that does not impose corporate income tax and was not a tax resident of any other foreign country; and

(B) After the acquisition and all related transactions are complete, the foreign acquiring corporation is created or organized in, or under the law of, a foreign country that does not impose corporate income tax and is not a tax resident of any other foreign country.

(5) A *tax resident* of a foreign country has the meaning set forth in §1.7874–3(d)(11).

(e) *Operating rules.* The following rules apply for purposes of this section.

(1) *Acquisition of multiple foreign corporations that are tax residents of the same foreign country.* When multiple foreign acquisitions occur pursuant to the same plan (or a series of related transactions) and two or more of the acquired foreign corporations were tax residents of the same foreign country before the foreign acquisitions and all related transactions, then those foreign acquisitions are treated as a single foreign acquisition and those acquired foreign corporations are treated as a single acquired foreign corporation for purposes of this section.

(2) *Acquisition of properties of an acquired foreign corporation.* For purposes of determining whether a foreign acquisition occurs, the principles of section 7874(a)(2)(B)(i) and §1.7874–2(c) and (d) (regarding acquisitions of properties of a domestic entity and acquisitions by multiple foreign corporations) apply with the following modifications:

(i) The principles of §1.7874–2(c)(1) (providing rules for determining whether there is an indirect acquisition of properties of a domestic entity), including §1.7874–2(b)(5) (providing rules for determining the proportionate amount of properties indirectly acquired), apply by substituting the term "foreign" for "domestic" wherever it appears.

(ii) The principles of §1.7874–2(c)(2) (regarding acquisitions of stock of a foreign corporation that owns a domestic entity) apply by substituting the term "domestic" for "foreign" wherever it appears.

(3) *Computation of foreign ownership percentage.* For purposes of determining a foreign ownership percentage, the

principles of all rules applicable to calculating an ownership percentage apply (including §§ 1.7874–2, 1.7874–4, 1.7874–5, 1.7874–7, and section 7874(c)(4)) with the following modifications:

(i) Stock of a foreign acquiring corporation described in section 7874(a)(2)(B)(ii) is not taken into account.

(ii) The principles of this section, section 7874(c)(2)(A), and §§ 1.7874–1, 1.7874–6, 1.7874–8, and 1.7874–10 do not apply.

(iii) The principles of § 1.7874–7 apply by, in addition to the exclusions listed in § 1.7874–7(e)(2)(i) through (iii), also excluding from the definition of foreign group property any property held directly or indirectly by the acquired foreign corporation immediately before the foreign acquisition and directly or indirectly acquired in the foreign acquisition.

(4) *Stock held by reason of holding stock in an acquired foreign corporation.* For purposes of determining stock of a foreign acquiring corporation held by reason of holding stock in an acquired foreign corporation, the principles of section 7874(a)(2)(B)(ii) and §§ 1.7874–2(f) and 1.7874–5 apply.

(5) *Change in the tax residency of a foreign corporation.* For purposes of this section, a change in a country in which a foreign corporation is a tax resident is treated as a transaction. Further, for purposes of this section, if a foreign acquiring corporation changes the country in which it is a tax resident in a manner that would not otherwise be considered to result in a foreign acquisition (for example, by changing where it is managed and controlled), then the foreign acquiring corporation is treated as—

(i) Both an acquired foreign corporation and a foreign acquiring corporation; and

(ii) Directly or indirectly acquiring all of the properties held directly or indirectly by the acquired foreign corporation solely in exchange for stock of the foreign acquiring corporation.

(f) *Example.* The following example illustrates the rules of this section.

Example. Third-country transaction—(i) *Facts.* FA, a newly formed foreign corporation that is a tax resident of Country Y, acquires all the stock of DT, a domestic corporation that is wholly owned by Individual A, solely in exchange for 65 shares of newly issued FA stock (DT acquisition). Pursuant to a plan that includes the DT acquisition, FA acquires all the stock of FT, a foreign corporation that is a tax resident of Country X and wholly owned by Individual B, solely in exchange for the remaining 35 shares of newly issued FA stock (FT acquisition). After the FT acquisition and all related transactions, the expanded affiliated group does not have substantial business activities in Country Y when compared to the total business activities of the expanded affiliated group, as determined under the principles of § 1.7874–3 and without regard to the DT acquisition.

(ii) *Analysis.* As described in paragraphs (A) through (C) of this *Example*, the requirements set forth in paragraphs (c)(1) through (3) of this section are satisfied and, as result, the DT acquisition is a third-country transaction.

(A) The FT acquisition is a foreign acquisition because, pursuant to the FT acquisition, FA (a foreign acquiring corporation) acquires 100 percent of the stock of FT and is thus treated as indirectly acquiring 100 percent of the properties held by FT (an acquired foreign corporation). See § 1.7874–2(c)(1) and paragraph (e)(2) of this section. Moreover, Individual B is treated as receiving 35 shares of FA stock by reason of holding stock in FT. See § 1.7874–2(f)(1)(i) and paragraph (e)(4) of this section. As a result, not taking into account the 65 shares of FA stock held by Individual A (a former domestic entity shareholder), 100 percent (35/35) of the stock of FA is held by reason of holding stock in FT and, thus, the foreign ownership percentage is 100. See paragraph (e)(3) of this section. Accordingly, the FT acquisition is a covered foreign acquisition. Therefore, because the FT acquisition occurs pursuant to a plan that includes the DT acquisition, the requirement set forth in paragraph (c)(1) of this section is satisfied.

(B) The requirement set forth in paragraph (c)(2) of this section is satisfied because, after the FT acquisition and all related transactions, the foreign country in which FA is a tax resident (Country Y) is different than the foreign country in which FT was a resident (Country X) before the FT acquisition and all related transactions.

(C) The requirement set forth in paragraph (c)(3) of this section is satisfied because, not taking into account paragraph (b) of this section, the ownership fraction is 65/100 and the ownership percentage is 65.

(D) Because the DT acquisition is a third-country transaction, the 35 shares of FA stock held by reason of holding stock in FT are excluded from the denominator of the ownership fraction. See paragraph (b) of this section. As a result, the ownership fraction is 65/65 and the ownership percentage is 100.

The result would be the same if instead FA had directly acquired all of the properties held by FT in exchange for FA stock, for example, in a transaction that would qualify for U.S. federal income tax purposes as an asset reorganization under section 368.

(iii) *Alternative facts.* The facts are the same as in paragraph (i) of this example, except that before the FT acquisition, but in a transaction related to the FT acquisition, FT becomes a tax resident of Country Y by reincorporating in Country Y. As is the case in paragraph (ii) of this *Example*, the requirements set forth in paragraphs (c)(1) and (3) of this section are satisfied. The requirement set forth in paragraph (c)(2) of this section is satisfied because, after the FT acquisition and any related transactions, the foreign country of which FA is a tax resident (Country Y) is different than the foreign country of which FT was a tax resident (Country X) before the FT acquisition and the reincorporation. See paragraph (e)(5) of this section. Accordingly, the DT acquisition is a third-country transaction and the consequences are the same as in paragraph (ii)(D) of this *Example*.

(iv) *Alternative facts.* The facts are the same as in paragraph (i) of this *Example*, except that, instead of FA acquiring all of the stock of FT, FS, a newly formed foreign corporation that is wholly owned by FA and that is a tax resident of Country X, acquires all the stock of FT solely in exchange for 35 shares of newly issued FA stock (FT acquisition). As a result of the FT acquisition, FS and FA are each treated as indirectly acquiring 100 percent of the properties held by FT. See §1.7874–2(c)(1)(i) and (iii) and paragraph (e)(2) of this section. Accordingly, each of FS's and FA's indirect acquisition of properties of FT (an acquired foreign corporation) is a foreign acquisition. However, FS's indirect acquisition of FT's properties is not a covered foreign acquisition because no shares of FS stock are held by reason of holding stock in FT; thus, with respect to this foreign acquisition, the foreign ownership percentage is zero. See §1.7874–2(f) and paragraphs (e)(3) and (4) of this section. FA's indirect acquisition of FT's properties is a covered foreign acquisition because 35 shares of FA stock (the shares received by Individual B) are held by reason of holding stock in FT; thus, the foreign ownership percentage is 100 percent (35/35). See §1.7874–2(f)(1)(i) and paragraphs (e)(3) and (4) of this section. Accordingly, because the FT acquisition occurs pursuant to a plan that includes the DT acquisition, the requirement set forth in paragraph (c)(1) of this section is satisfied. Further, as is the case in paragraphs (ii)(B) through (C) of this *Example*, the requirements set forth in paragraphs (c)(2) and (3) of this section are satisfied. Therefore, the DT acquisition is a third-country transaction and the consequences are the same as in paragraph (ii)(D) of this *Example*.

(g) *Applicability dates.* This section applies to domestic entity acquisitions completed on or after July 12, 2018. For domestic entity acquisitions completed before July 12, 2018, see §1.7874–9T, as contained in 26 CFR part 1 revised as of April 1, 2017. However, to the extent this section differs from §1.7874–9T, as contained in 26 CFR part 1 revised as of April 1, 2017, taxpayers may elect to consistently apply the differences to domestic entity acquisitions completed before July 12, 2018.

[T.D. 9834, 83 FR 32555, July 12, 2018]

§ 1.7874–10 Disregard of certain distributions.

(a) *Scope.* This section identifies distributions made by a domestic entity that are disregarded in determining an ownership fraction. Paragraph (b) of this section provides the general rule that former domestic entity shareholders or former domestic entity partners are treated as receiving additional stock of the foreign acquiring corporation when the domestic entity has made non-ordinary course distributions (NOCDs). Paragraph (c) of this section identifies distributions that, in whole or in part, are outside the scope of this section. Paragraph (d) of this section provides a de minimis exception to the application of the general rule in paragraph (b) of this section. Paragraph (e) of this section provides rules concerning the treatment of distributions made by a predecessor, and paragraph (f) of this section provides rules for identifying a predecessor. Paragraph (g) of this section provides a special rule for certain distributions described in section 355. Paragraph (h) of this section provides rules regarding the allocation of NOCD stock. Paragraph (i) of this section addresses cases in which there are multiple foreign acquiring corporations, and paragraph (j) of this section addresses cases in which multiple domestic entities are treated as a single domestic entity. Paragraph (k) of this section provides definitions. Paragraph (l) of this section provides dates of applicability. See §1.7874–

1(d)(2) for rules addressing the interaction of this section with the expanded affiliated group rules of section 7874(c)(2)(A) and § 1.7874–1.

(b) *General rule regarding NOCDs.* Except as provided in paragraph (d) of this section, for purposes of determining the ownership percentage by value (but not vote) described in section 7874(a)(2)(B)(ii), former domestic entity shareholders or former domestic entity partners, as applicable, are treated as receiving, by reason of holding stock or partnership interests in a domestic entity, stock of the foreign acquiring corporation with a fair market value equal to the amount of the non-ordinary course distributions (NOCDs), determined as of the date of the distributions, made by the domestic entity during the look-back period. The stock of the foreign acquiring corporation treated as received under this paragraph (b) (NOCD stock) is in addition to stock of the foreign acquiring corporation otherwise treated as received by the former domestic entity shareholders or former domestic entity partners by reason of holding stock or partnership interests in the domestic entity.

(c) *Distributions that are not NOCDs.* If only a portion of a distribution is an NOCD, section 7874(c)(4) may apply to the remainder of the distribution. This section does not, however, create a presumption that section 7874(c)(4) applies to the remainder of the distribution.

(d) *De minimis exception to the general rule.* Paragraph (b) of this section does not apply if—

(1) The ownership percentage described in section 7874(a)(2)(B)(ii), determined without regard to the application of paragraph (b) of this section and §§ 1.7874–4(b) and 1.7874–7(b), is less than five (by vote and value); and

(2) On the completion date, each five percent former domestic entity shareholder or five percent former domestic entity partner, as applicable, owns (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) less than five percent (by vote and value) of the stock of (or a partnership interest in) each member of the expanded affiliated group. For this purpose, a five percent former domestic entity shareholder (or five percent former domestic entity partner) is a former domestic entity shareholder (or former domestic entity partner) that, before the domestic entity acquisition, owned (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) at least five percent (by vote and value) of the stock of (or a partnership interest in) the domestic entity.

(e) *Treatment of distributions made by a predecessor.* For purposes of this section, a corporation or a partnership (relevant entity), including a domestic entity, is treated as making the following distributions made by a predecessor with respect to the relevant entity:

(1) A distribution made before the predecessor acquisition with respect to the predecessor; and

(2) A distribution made in connection with the predecessor acquisition to the extent the property distributed is directly or indirectly provided by the predecessor. See paragraph (k)(1)(iv) of this section.

(f) *Rules for identifying a predecessor*—(1) *Definition of predecessor.* A corporation or a partnership (tentative predecessor) is a predecessor with respect to a relevant entity if—

(i) The relevant entity completes a predecessor acquisition; and

(ii) After the predecessor acquisition and all related transactions are complete, the tentative predecessor ownership percentage is at least 10.

(2) *Definition of predecessor acquisition*—(i) *In general.* Predecessor acquisition means a transaction in which a relevant entity directly or indirectly acquires substantially all of the properties held directly or indirectly by a tentative predecessor.

(ii) *Acquisition of properties of a tentative predecessor.* For purposes of determining whether a predecessor acquisition occurs, the principles of section 7874(a)(2)(B)(i) apply, including § 1.7874–2(c) other than § 1.7874–2(c)(2) and (4) (regarding acquisitions of properties of a domestic entity), without regard to whether the tentative predecessor is domestic or foreign.

(iii) *Lower-tier entities of a predecessor.* If, before a predecessor acquisition and

all related transactions, the predecessor held directly or indirectly stock in a corporation or an interest in a partnership, then, for purposes of this section, the relevant entity is not considered to directly or indirectly acquire the properties held directly or indirectly by the corporation or partnership.

(3) *Definition of tentative predecessor ownership percentage.* Tentative predecessor ownership percentage means, with respect to a predecessor acquisition, the percentage of stock or partnership interests (by value) in a relevant entity held by reason of holding stock or partnership interests in the tentative predecessor. For purposes of computing the tentative predecessor ownership percentage, the following rules apply:

(i) For purposes of determining the stock or partnership interests in a relevant entity held by reason of holding stock or partnership interests in the tentative predecessor, the principles of section 7874(a)(2)(B)(ii) and §§1.7874–2(f)(1)(i) through (iii) and 1.7874–5 apply.

(ii) For purposes of determining the stock or partnership interests in a relevant entity included in the numerator of the fraction used to compute the tentative predecessor ownership percentage, the rules of paragraph (f)(3)(i) of this section apply, and all the rules applicable to calculating the numerator of an ownership fraction with respect to a domestic entity acquisition apply, except that—

(A) The principles of section 7874(c)(2)(A) and §§1.7874–1 and 1.7874–6 do not apply; and

(B) The principles of paragraph (b) of this section do not apply.

(iii) For purposes of determining stock or partnership interests in a relevant entity included in the denominator of the fraction used to compute the tentative predecessor ownership percentage, the principles of section 7874(a)(2)(B)(ii) and all rules applicable to calculating the denominator of an ownership fraction with respect to a domestic entity acquisition apply, except that—

(A) The principles of section 7874(c)(2)(A) and §§1.7874–1 and 1.7874–6 do not apply; and

(B) The principles of §§1.7874–4 and 1.7874–7 through 1.7874–9 do not apply.

(g) *Rule regarding direction of a section 355 distribution.* For purposes of this section, if a domestic corporation (distributing corporation) distributes the stock of another domestic corporation (controlled corporation) pursuant to a transaction described in section 355, and, immediately before the distribution, the fair market value of the stock of the controlled corporation owned by the distributing corporation and any related person (determined under section 7874(d)(3), without regard to whether the person is foreign) represents more than 50 percent of the fair market value of the stock of the distributing corporation, then, the controlled corporation is deemed, on the date of the distribution, to have distributed the stock of the distributing corporation. The deemed distribution is equal to the fair market value of the stock of the distributing corporation (but not taking into account the fair market value of the stock of the controlled corporation) on the date of the distribution.

(h) *Allocation of NOCD stock.* NOCD stock is allocated among the former domestic entity shareholders or former domestic entity partners, as applicable, based on the amount of NOCDs that the former domestic entity shareholders or former domestic entity partners, as applicable, are treated as having received under this paragraph (h). Under this paragraph (h), a pro rata portion of each distribution during a look-back year is treated as comprising an NOCD with respect to the look-back year, based on a fraction the numerator of which is the amount of NOCDs during the look-back year and the denominator of which is the amount of distributions during the look-back year. Thus, each former domestic entity shareholder or former domestic entity partner, as applicable, is treated as receiving an amount of NOCD stock equal to the amount of NOCDs treated as received by the former domestic entity shareholder or former domestic entity partner, as applicable.

(i) *Multiple foreign acquiring corporations.* If there are multiple foreign acquiring corporations with respect to a domestic entity acquisition, then the

foreign acquiring corporation or corporations as to which NOCD stock is considered comprised is based on the proportion of consideration directly or indirectly provided by a foreign acquiring corporation in the domestic entity acquisition relative to the total amount of consideration directly or indirectly provided by the foreign acquiring corporations in the domestic entity acquisition. For purposes of this paragraph (i), consideration is not considered directly provided by a foreign acquiring corporation if it was indirectly provided by another foreign acquiring corporation. In addition, for purposes of this paragraph (i), consideration provided in the domestic entity acquisition does not include money or other property described in paragraph (k)(1)(iii) of this section.

(j) *Multiple domestic entities.* If pursuant to §1.7874–2(e) two or more domestic entities are treated as a single domestic entity, then the determination of the amount of NOCDs made by the single domestic entity is made by—

(1) Applying the rules of this section to each domestic entity on a separate basis, with the result that the amount of NOCDs made by each domestic entity is separately computed; and

(2) Treating the amount of NOCDs made by the single domestic entity as the sum of the separately computed NOCDs made by each domestic entity.

(k) *Definitions.* In addition to the definitions provided in §1.7874–12, the following definitions apply for purposes of this section.

(1) A *distribution* means the following:

(i) Any distribution made by a corporation with respect to its stock other than—

(A) A distribution to which section 305 applies;

(B) A distribution to which section 304(a)(1) applies; and

(C) Except as provided in paragraphs (k)(1)(iii) and (iv) of this section, a distribution pursuant to section 361(c)(1) (other than a distribution to which section 355 applies).

(ii) Any distribution by a partnership (other than a distribution pursuant to section 752(b) to the extent that the transaction giving rise to such distribution does not reduce the partnership's value).

(iii) In the case of a domestic entity, a transfer of money or other property to the former domestic entity shareholders or former domestic entity partners that is made in connection with the domestic entity acquisition to the extent the money or other property is directly or indirectly provided by the domestic entity.

(iv) In the case of a predecessor, a transfer of money or other property to the former owners of the predecessor that is made in connection with the predecessor acquisition to the extent the money or other property is directly or indirectly provided by the predecessor.

(2) *Distribution history period*—(i) *In general.* Except as provided in paragraph (k)(2)(ii) or (iii) of this section, a distribution history period means, with respect to a look-back year, the 36-month period preceding the start of the look-back year.

(ii) *Formation date less than 36 months but at least 12 months before look-back year.* If the formation date is less than 36 months, but at least 12 months, before the start of a look-back year, then the distribution history period with respect to that look-back year means the entire period, starting with the formation date, that precedes the start of the look-back year.

(iii) *Formation date less than 12 months before look-back year.* If the formation date is less than 12 months before the start of a look-back year, then there is no distribution history period with respect to that look-back year.

(3) *Formation date* means, with respect to a domestic entity, the date that the domestic entity was created or organized, or, if earlier, the earliest date that any predecessor of the domestic entity was created or organized.

(4) *Look-back period* means, with respect to a domestic acquisition, the 36-month period ending on the completion date or, if shorter, the entire period, starting with the formation date, that ends on the completion date.

(5) *Look-back year* means, with respect to a look-back period, the following:

(i) If the look-back period is 36 months, the three consecutive 12-month periods that comprise the look-back period.

(ii) If the look-back period is less than 36 months, but at least 24 months—

(A) The 12-month period that ends on the completion date;

(B) The 12-month period that immediately precedes the period described in paragraph (k)(5)(ii)(A) of this section; and

(C) The period, if any, that immediately precedes the period described in paragraph (k)(5)(ii)(B) of this section.

(iii) If the look-back period is less than 24 months, but at least 12 months—

(A) The 12-month period that ends on the completion date; and

(B) The period, if any, that immediately precedes the period described in paragraph (k)(5)(iii)(A) of this section.

(iv) If the look-back period is less than 12 months, the entire period, starting with the formation date, that ends on the completion date.

(6) *NOCDs* mean, with respect to a look-back year, the excess of all distributions made during the look-back year over the NOCD threshold for the look-back year.

(7) *NOCD threshold* means, with respect to a look-back year, the following:

(i) If the look-back year has at least a 12-month distribution history period, 110 percent of the sum of all distributions made during the distribution history period multiplied by a fraction. The numerator of the fraction is the number of days in the look-back year and the denominator is the number of days in the distribution history period with respect to the look-back year.

(ii) If the look-back year has no distribution history period, zero.

(l) *Applicability date.* This section applies to domestic entity acquisitions completed on or after July 12, 2018. For domestic entity acquisitions completed before July 12, 2018, see § 1.7874–10T, as contained in 26 CFR part 1 revised as of April 1, 2017. However, to the extent this section differs from § 1.7874–10T, as contained in 26 CFR part 1 revised as of April 1, 2017, taxpayers may elect to consistently apply the differences to domestic entity acquisitions completed before July 12, 2018.

[T.D. 9834, 83 FR 32557, July 12, 2018]

§ 1.7874–11 Rules regarding inversion gain.

(a) *Scope.* This section provides rules for determining the inversion gain of an expatriated entity for purposes of section 7874. Paragraph (b) of this section provides rules for determining the inversion gain of an expatriated entity. Paragraph (c) of this section provides special rules with respect to certain foreign partnerships in which an expatriated entity owns an interest. Paragraph (d) of this section provides additional definitions. Paragraph (e) of this section provides an example that illustrates the rules of this section. Paragraph (f) of this section provides the applicability dates.

(b) *Inversion gain*—(1) *General rule.* Except as provided in paragraphs (b)(2) and (3) of this section, inversion gain includes income (including an amount treated as a dividend under section 78) or gain recognized by an expatriated entity for any taxable year that includes any portion of the applicable period by reason of a direct or indirect transfer of stock or other properties or license of any property either as part of the domestic entity acquisition, or after such acquisition if the transfer or license is to a specified related person.

(2) *Exception for property described in section 1221(a)(1).* Inversion gain does not include income or gain recognized by reason of the transfer or license, after the domestic entity acquisition, of property that is described in section 1221(a)(1) in the hands of the transferor or licensor.

(3) *Treatment of partnerships.* Except to the extent provided in paragraph (c) of this section and section 7874(e)(2), inversion gain does not include income or gain recognized by reason of the transfer or license of property by a partnership.

(c) *Transfers and licenses by partnerships.* If a partnership that is a foreign related person transfers or licenses property, a partner of the partnership shall be treated as having transferred or licensed its proportionate share of that property, as determined under the rules and principles of sections 701 through 777, for purposes of determining the inversion gain of an expatriated entity. See section 7874(e)(2) for

rules regarding the treatment of transfers and licenses by domestic partnerships and transfers of interests in certain domestic partnerships.

(d) *Definitions*. The definitions provided in § 1.7874–12 apply for purposes of this section.

(e) *Example*. The following example illustrates the rules of this section.

Example. —(i) *Facts*. On July 1, 2016, FA, a foreign corporation, acquires all the stock of DT, a domestic corporation, in an inversion transaction. When the inversion transaction occurred, DT wholly owned FS, a foreign corporation that is a controlled foreign corporation (within the meaning of section 957(a)). During the applicable period, FS sells to FA property that is not described in section 1221(a)(1) in the hands of FS. Under section 951(a)(1)(A), DT has a $80x gross income inclusion that is attributable to FS's gain from the sale of the property. Under section 960(a)(1), DT is deemed to have paid $20x of the post-1986 foreign income taxes of FS by reason of this income inclusion and includes $20x in gross income as a deemed dividend under section 78. Accordingly, DT recognizes $100x ($80x + $20x) of gross income because of FS's sale of property to FA.

(ii) *Analysis*. Pursuant to section 7874(a)(2)(A), DT is an expatriated entity. Under paragraph (b)(1) of this section, DT's $100x gross income recognized under sections 951(a)(1)(A) and 78 is inversion gain, because it is income recognized by an expatriated entity during the applicable period by reason of an indirect transfer of property by DT (through its wholly-owned CFC, FS) after the inversion transaction to a specified related person (FA). Sections 7874(a)(1) and (e) therefore prevent the use of certain tax attributes (such as net operating losses) to reduce the U.S. tax owed with respect to DT's $100x gross income recognized under sections 951(a)(1)(A) and 78.

(f) *Applicability dates*. Except as otherwise provided in this paragraph (f), this section applies to transfers and licenses of property completed on or after November 19, 2015, but only if the inversion transaction was completed on or after September 22, 2014. For inversion transactions completed on or after September 22, 2014, however, taxpayers may elect to apply paragraph (b) of this section by excluding the phrase ''(including an amount treated as a dividend under section 78)'' for transfers and licenses of property completed on or after November 19, 2015, and before April 4, 2016.

[T.D. 9834, 83 FR 32559, July 12, 2018]

§ 1.7874–12 Definitions.

(a) *Definitions*. Except as otherwise provided, the following definitions apply for purposes of this section and §§ 1.367(b)–4, 1.956–2, 1.7701(l)–4, and 1.7874–1 through 1.7874–11.

(1) An *affiliated group* has the meaning set forth in section 1504(a) but without regard to section 1504(b)(3), except that section 1504(a) is applied by substituting ''more than 50 percent'' for ''at least 80 percent'' each place it appears. A *member of the affiliated group* is an entity included in the affiliated group.

(2) The *applicable period* means, with respect to an inversion transaction, the period described in section 7874(d)(1). However, see also § 1.7874–2(b)(13) in the case of a subsequent acquisition (or a similar acquisition under the principles of § 1.7874–2(c)(4)(i)) that is an inversion transaction.

(3) The *completion date* means, with respect to a domestic entity acquisition, the date that the domestic entity acquisition and all transactions related to the domestic entity acquisition are complete.

(4) A *controlled foreign corporation* (or *CFC*) has the meaning provided in section 957.

(5) A *domestic entity acquisition* means an acquisition described in section 7874(a)(2)(B)(i).

(6) A *domestic entity* means, with respect to a domestic entity acquisition, a domestic corporation or domestic partnership described in section 7874(a)(2)(B)(i). A reference to a domestic entity includes a successor to such domestic corporation or domestic partnership, including a corporation that succeeds to and takes into account amounts with respect to the domestic entity pursuant to section 381.

(7) An *expanded affiliated group* (or *EAG*) means, with respect to a domestic entity acquisition, an affiliated group that includes the foreign acquiring corporation, determined as of the completion date. A *member of the EAG* is an entity included in the EAG, and a reference to a member of the EAG includes a predecessor with respect to such member.

(8) An *expatriated entity* means, with respect to an inversion transaction—

(i) The domestic entity; and

(ii) A United States person that, on any date on or after the completion date, is or was related (within the meaning of section 267(b) or 707(b)(1)) to the domestic entity.

(9) *Expatriated foreign subsidiary*—(i) *General rule.* Except as provided in paragraph (a)(9)(ii) of this section, an expatriated foreign subsidiary means a foreign corporation that is a CFC (determined without applying subparagraphs (A), (B), and (C) of section 318(a)(3) so as to consider a United States person as owning stock which is owned by a person who is not a United States person) and in which an expatriated entity is a United States shareholder (determined without applying subparagraphs (A), (B), and (C) of section 318(a)(3) so as to consider a United States person as owning stock which is owned by a person who is not a United States person).

(ii) *Exception to the general rule.* A foreign corporation is not an expatriated foreign subsidiary if, with respect to the inversion transaction as a result of which the foreign corporation otherwise would be an expatriated foreign subsidiary—

(A) On the completion date, the foreign corporation was both a CFC (determined without applying subparagraphs (A), (B), and (C) of section 318(a)(3) so as to consider a United States person as owning stock which is owned by a person who is not a United States person) and a member of the EAG; and

(B) On or before the completion date, the domestic entity was not a United States shareholder (determined without applying subparagraphs (A), (B), and (C) of section 318(a)(3) so as to consider a United States person as owning stock which is owned by a person who is not a United States person) with respect to the foreign corporation.

(10) A *foreign acquiring corporation* means, with respect to a domestic entity acquisition, the foreign corporation described in section 7874(a)(2)(B). A reference to a foreign acquiring corporation includes a successor to the foreign acquiring corporation, including a corporation that succeeds to and takes into account amounts with respect to the foreign acquiring corporation pursuant to section 381.

(11) A *foreign related person* means, with respect to an inversion transaction, a foreign person that is related (within the meaning of section 267(b) or 707(b)(1)) to, or under the same common control as (within the meaning of section 482), a person that is an expatriated entity with respect to the inversion transaction.

(12) A *former domestic entity partner* of a domestic entity that is a domestic partnership is any person that held an interest in the partnership before the domestic entity acquisition, including any person that holds an interest in the partnership both before and after the domestic entity acquisition.

(13) A *former domestic entity shareholder* of a domestic entity that is a domestic corporation is any person that held stock in the domestic corporation before the domestic entity acquisition, including any person that holds stock in the domestic corporation both before and after the domestic entity acquisition.

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

(15) An *inversion transaction* means a domestic entity acquisition in which the foreign acquiring corporation is treated as a surrogate foreign corporation under section 7874(a)(2)(B), taking into account section 7874(a)(3).

(16) A *non-EFS foreign related person* means, with respect to an inversion transaction, a foreign related person that is not an expatriated foreign subsidiary.

(17) The *ownership fraction* means, with respect to a domestic entity acquisition, the ownership percentage described in section 7874(a)(2)(B)(ii), expressed as a fraction.

(18) A *specified related person* means, with respect to an inversion transaction—

(i) A non-EFS foreign related person;

(ii) A domestic partnership in which a non-EFS foreign related person is a partner; and

(iii) A domestic trust of which a non-EFS foreign related person is a beneficiary.

(19) A *United States person* means a person described in section 7701(a)(30).

(20) A *United States shareholder* has the meaning provided in section 951(b).

(b) *Applicability dates*. Except as otherwise provided in this paragraph (b), this section applies to domestic entity acquisitions completed on or after September 22, 2014. The following apply to domestic entity acquisitions completed on or after April 4, 2016: paragraph (a)(8) of this section; in paragraph (a)(6) of this section, the phrase '', including a corporation that succeeds to and takes into account amounts with respect to the domestic entity pursuant to section 381''; and the second sentence of paragraph (a)(10) of this section. For domestic entity acquisitions completed on or after September 22, 2014, and before April 4, 2016, however, taxpayers, may elect to apply the provisions in the immediately prior sentence.

[T.D. 9834, 83 FR 32560, July 12, 2018]

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SOURCE: Sections 1.9000–1 through 1.9000–8 contained in T.D. 6500, 25 FR 12155, Nov. 26, 1960, unless otherwise noted.

§ 1.9000–1 Statutory provisions.

The Act of June 15, 1955 (Pub. L. 74, 84th Cong., 69 Stat. 134), provides as follows:

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. *Repeal of sections 452 and 462*—(a) *Prepaid income*. Section 452 of the Internal Revenue Code of 1954 is hereby repealed.

(b) Reserves for estimated expenses, etc. Section 462 of the Internal Revenue Code of 1954 is hereby repealed.

SEC. 2. *Technical amendments*. The following provisions of the Internal Revenue Code of 1954 are hereby amended as follows:

(1) Subsection (c) of section 381 is amended by striking out paragraph (7) (relating to carryover of prepaid income in certain corporate acquisitions).

(2) The table of sections for subpart B of part II of subchapter E of chapter 1 (relating to taxable year for which items of gross income included) is amended by striking out

''Sec. 452. Prepaid income.''

(3) The table of sections for subpart C of such part II (relating to taxable year for which deductions are taken) is amended by striking out:

''Sec. 462. Reserves for estimated expenses, etc.''

SEC. 3. *Effective date*. The amendments made by this act shall apply with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

SEC. 4. *Saving provisions*—(a) *Filing of statement*. If:

(1) the amount of any tax required to be paid for any taxable year ending on or before the date of the enactment of this act is increased by reason of the enactment of this act, and

(2) the last date prescribed for payment of such tax (or any installment thereof) is before December 15, 1955,

then the taxpayer shall, on or before December 15, 1955, file a statement which shows the increase in the amount of such tax required to be paid by reason of the enactment of this act.

(b) *Form and effect of statement*—(1) *Form of statement, etc*. The statement required by subsection (a) shall be filed at the place fixed for filing the return. Such statement shall be in such form, and shall include such information necessary or appropriate to show the increase in the amount of the tax required to be paid for the taxable year by reason of the enactment of this act, as the Secretary of the Treasury or his delegate shall by regulations prescribe.

(2) *Treatment as amount shown on return*. The amount shown on a statement filed under subsection (a) as the increase in the amount of the tax required to be paid for the taxable year by reason of the enactment of this act shall, for all purposes of the internal revenue laws, be treated as tax shown on the return. Notwithstanding the preceding sentence, that portion of the amount of increase in tax for any taxable year which is attributable to a decrease (by reason of the enactment of this act) in the net operating loss for a succeeding taxable year shall not be treated as tax shown on the return.

(3) *Waiver of interest in case of payment on or before December 15, 1955*. If the taxpayer, on or before December 15, 1955, files the statement referred to in subsection (a) and pays in full that portion of the amount shown thereon for which the last date prescribed for payment is before December 15, 1955, then for purposes of computing interest (other than interest on overpayments) such portion shall be treated as having been paid on the last date prescribed for payment. This paragraph shall not apply if the amount shown on the statement as the increase in the amount of the tax required to be paid for the taxable year by reason of the enactment of this act is greater than the actual increase unless the taxpayer establishes, to the satisfaction of the Secretary of the Treasury or his delegate, that his computation of the greater amount was based upon a reasonable interpretation and application of sections 452 and 462 of the Internal Revenue Code of 1954, as those sections existed before the enactment of this act.

(c) *Special rules*—(1) *Interest for period before enactment*. Interest shall not be imposed on the amount of any increase in tax resulting from the enactment of this act for any period before the day after the date of the enactment of this act.

(2) *Estimated tax*. Any addition to the tax under section 294(d) of the Internal Revenue Code of 1939 shall be computed as if this act had not been enacted. In the case of any installment for which the last date prescribed for payment is before December 15, 1955, any addition to the tax under section 6654 of the Internal Revenue Code of 1954 shall be computed as if this act had not been enacted.

(3) *Treatment of certain payments which taxpayer is required to make*. If:

(A) The taxpayer is required to make a payment (or an additional payment) to another person by reason of the enactment of this act, and

(B) The Internal Revenue Code of 1954 prescribes a period, which expires after the close of the taxable year, within which the taxpayer must make such payment (or additional payment) if the amount thereof is to be taken into account (as a deduction or otherwise) in computing taxable income for such taxable year,

then, subject to such regulations as the Secretary of the Treasury or his delegate may prescribe, if such payment (or additional payment) is made on or before December 15, 1955, it shall be treated as having been made within the period prescribed by such Code.

(4) *Treatment of certain dividends*. Subject to such regulations as the Secretary of the Treasury or his delegate may prescribe, for purposes of section 561(a)(1) of the Internal Revenue Code of 1954, dividends paid after the 15th day of the third month following the close of the taxable year and on or before December 15, 1955, may be treated as having been paid on the last day of the taxable year, but only to the extent (A) that such dividends are attributable to an increase in taxable income for the taxable year resulting from the enactment of this act, and (B) elected by the taxpayer.

(5) *Determination of date prescribed*. For purposes of this section, the determination of the last date prescribed for payment or for filing a return shall be made without regard to any extension of time therefor and without regard to any provision of this section.

(6) *Regulations*. For requirement that the Secretary of the Treasury or his delegate shall prescribe all rules and regulations as may be necessary by reason of the enactment of this act, see section 7805(a) of the Internal Revenue Code of 1954.

§ 1.9000–2 Effect of repeal in general.

(a) Section 452 (relating to prepaid income) and section 462 (relating to reserves for estimated expenses) of the Internal Revenue Code of 1954 were repealed by the Act of June 15, 1955 (Pub. L. 74, 84th Cong., 69 Stat. 134), with respect to all years subject to such Code. The effect of the repeal will generally be to increase the tax liability of taxpayers who elected to adopt the methods of accounting provided by sections 452 and 462. References to sections of law in §§ 1.9000–2 to 1.9000–8, inclusive, are references to the Internal Revenue Code of 1954 unless otherwise specified.

(b) The Act of June 15, 1955, provides that if the amount of any tax is increased by the repeal of sections 452 and 462 and if the last date prescribed for the payment of such tax (or any installment thereof) is before December 15, 1955, then the taxpayer shall on or before such date file a statement as prescribed in § 1.9000–3. The last date prescribed for payment for this purpose shall be determined without regard to any extensions of time and without regard to the provisions of the Act of June 15, 1955.

§ 1.9000–3 Requirement of statement showing increase in tax liability.

(a) *Returns filed before June 15, 1955*. Where a return reflecting an election under section 452 or 462 was filed before June 15, 1955, the taxpayer must file on or before December 15, 1955, a statement on Form 2175 showing the increase in tax liability resulting from the repeal of sections 452 and 462. The provisions of this paragraph may be illustrated by the following example:

Example. Corporation X filed its income tax return for the calendar year 1954 on March 15, 1955, and elected under section 6152 to pay the unpaid amount of the tax shown thereon in two equal installments. Such installment payments are due on March 15, 1955, and June 15, 1955, respectively. The corporation elected to compute its tax for such taxable year under the methods of accounting provided by sections 452 and 462. Corporation X's tax liability is increased by reason of the enactment of Public Law 74, and since the last date prescribed for paying its tax expires before December 15, 1955, it is required to submit the prescribed statement on or before December 15, 1955, showing its increase in tax liability.

(b) *Returns filed on or after June 15, 1955*. A taxpayer filing a return on or after June 15, 1955, for a taxable year ending on or before such date, may

elect to apply the accounting methods provided in sections 452 and 462. The election may be exercised by either of the following methods:

(1) By computing the tax liability shown on such return as though the provisions of sections 452 and 462 had not been repealed. In such a case, the taxpayer must file on or before December 15, 1955, a statement on Form 2175 showing the increase in tax liability resulting from the repeal of sections 452 and 462.

(2) By computing his tax liability without regard to sections 452 and 462. In this case, Form 2175 must be filed with the return. However, taxable income and the tax liability computed with the application of sections 452 and 462 shall be shown on lines 8 and 14, respectively, of the form in lieu of the amounts otherwise called for on those lines.

If a taxpayer does not make an election to have the provisions of sections 452 and 462 apply, the savings provisions of section 4 of the Act of June 15, 1955, are not applicable.

(c) *Taxable years ending after June 15, 1955*. A taxpayer having a taxable year ending after June 15, 1955, may not elect to apply the methods of accounting prescribed in sections 452 and 462 in computing taxable income for such taxable year. Such a taxpayer must file his return and pay the tax as if such sections had not been enacted.

(d) *Other situations requiring statements*. (1) A person who made an election under section 452 or 462 but whose tax liability was not increased by reason of the enactment of the Act of June 15, 1955, is nevertheless required to file a statement on Form 2175 if his gross income is increased or his deductions are decreased as the result of the repeal of sections 452 and 462. A partnership which makes an election under such sections must file such a statement. In addition, a partner, stockholder, distributee, etc. (whether or not such person made an election under section 452 or 462), shall file a statement showing any increase in his tax liability resulting from the effects of the repeal on the gross income or deductions of any person mentioned in the previous sentences of this subparagraph.

(2) A statement shall also be filed for a taxable year, other than a year to which an election under section 452 or 462 is applicable, if the repeal of such sections increases the tax liability of such year. Thus, a statement must be filed for any taxable year to which a net operating loss is carried from a year to which an election under section 452 or 462 is applicable, provided that the repeal of such sections affects the amount of the tax liability for the year to which such loss is carried. A separate statement must also be filed for a year in which there is a net operating loss which is changed by reason of the repeal of sections 452 and 462. Where there is a short taxable year involved, a taxpayer may have two taxable years to which elections under sections 452 and 462 are applicable and, in such a case, a statement, on Form 2175, must be filed for each such year.

§ 1.9000–4 Form and content of statement.

(a) *Information to be shown*. The statement shall be filed on Form 2175 which may be obtained from district directors. It shall be filed with the district director for the internal revenue district in which the return was filed. The statement shall be prepared in accordance with the instructions contained thereon and shall show the following information:

(1) The name and address of the taxpayer,

(2) The amounts of each type of income deferred under section 452,

(3) The amount of the addition to each reserve deducted under section 462,

(4) The taxable income and the tax liability of the taxpayer computed with the application of sections 452 and 462,

(5) The taxable income and the tax liability of the taxpayer computed without the application of sections 452 and 462,

(6) The details of the recomputation of taxable income and tax liability, including any changes in other items of income, deductions, and credits resulting from the repeal of sections 452 and 462, and

(7) If self-employment tax is increased, the computations and information required on page 3 of Schedule C, Form 1040.

(b) *Procedure for recomputing tax liability.* In determining the taxable income and the tax liability computed without the application of sections 452 and 462, such items as vacation pay and prepaid subscription income shall be reported under the law and regulations applicable to the taxable year as if such sections had not been enacted. The tax liability for the year shall be recomputed by restoring to taxable income the amount of income deferred under section 452 and the amount of the deduction taken under section 462. Other deductions or credits affected by such changes in taxable income shall be adjusted. For example, if the deduction for contributions allowed for the taxable year was limited under section 170(b), the amount of such deduction shall be recomputed, giving effect to the increase in adjusted gross income or taxable income, as the case may be, by reason of the adjustments required by the repeal of sections 452 and 462.

§ 1.9000–5 Effect of filing statement.

(a) *Years other than years affected by a net operating loss carryback.* If the taxpayer files a timely statement in accordance with the provisions of § 1.9000–3, the amount of the increase in tax shown on such statement for a taxable year shall, except as provided in paragraph (b) of this section, be considered for all purposes of the Code, as tax shown on the return for such year. In general, such increase shall be assessed and collected in the same manner as if it had been tax shown on the return as originally filed. The provisions of this paragraph may be illustrated by the following example:

Example. A taxpayer filed his return showing a tax liability computed under the methods of accounting provided by sections 452 and 462 as $1,000 and filed the statement in accordance with § 1.9000–3 showing an increase in tax liability of $200. The tax computed as though sections 452 and 462 had not been enacted is $1,200, and the difference of $200 is the increase in the tax attributable to the repeal of sections 452 and 462. This increase is considered to be tax shown on the return for such taxable year. Additions to the tax for fraud or negligence under section 6653 will be determined by reference to $1,200 (that is, $1,000 plus $200) as the tax shown on the return.

(b) *Years affected by a net operating loss carryback.* In the case of a year which is affected by a net operating loss carryback from a year to which an election under section 452 or 462 applies, that portion of the amount of increase in tax shown on the statement for the year to which the loss is carried back which is attributable to a decrease in such net operating loss shall not be treated as tax shown on the return.

§ 1.9000–6 Provisions for the waiver of interest.

(a) *In general.* If the statement is filed in accordance with § 1.9000–3 and if that portion of the increase in tax which is due before December 15, 1955 (without regard to any extension of time for payment and without regard to the provisions of §§ 1.9000–2 to 1.9000–8, inclusive), is paid in full on or before such date, then no interest shall be due with respect to that amount. The provisions of this paragraph may be illustrated by the following example:

Example. Corporation M's return for the calendar year 1954 was filed on March 15, 1955, and the tax liability shown thereon was paid in equal installments on March 15, 1955, and June 15, 1955. M filed a statement on December 15, 1955, showing the increase in its tax liability resulting from the repeal of sections 452 and 462 and paid at that time the increase in tax shown thereon. No interest will be imposed with respect to the amount of such payment.

Interest shall be computed under the applicable provisions of the internal revenue laws on any portion of the increase in tax shown on the statement which is due after December 15, 1955, and which is not paid when due.

(b) *Limitation on application of waiver.* The provisions of paragraph (a) of this section shall not apply to any portion of the increase in tax shown on the statement if such increase reflects an amount in excess of that attributable solely to the repeal of sections 452 and 462, i. e., is attributable in whole or in part to excessive or unwarranted deferrals or accruals under section 452 or 462, as the case may be, in computing the tax liability with the application of

such sections. Notwithstanding the preceding sentence, paragraph (a) of this section shall be applicable if the taxpayer can show that the tax liability as computed with the application of sections 452 and 462 is based upon a reasonable interpretation and application of such sections as they existed prior to repeal. If the taxpayer complied with the provisions of the regulations under sections 452 and 462 in computing the tax liability with the application of such sections, he will be regarded as having reasonably interpreted and applied sections 452 and 462. In this regard, it is not essential that the taxpayer submit with his return the detailed information required by such regulations in support of the deduction claimed under section 462, but such information shall be supplied at the request of the Commissioner.

(c) *Interest for periods prior to June 16, 1955.* No interest shall be imposed with respect to any increase in tax resulting solely from the repeal of sections 452 and 462 for any period prior to June 16, 1955 (the day after the date of the enactment of the Act of June 15, 1955). The preceding sentence does not apply to that part of any increase in tax which is due to the improper application of sections 452 and 462. The provisions of this paragraph shall not apply to interest imposed under section 3779 of the Internal Revenue Code of 1939. (See paragraph (d) of this section.)

(d) *Amounts deferred by corporations expecting carrybacks.* Interest shall be imposed at the rate of 6 percent on so much of the amount of tax deferred under section 3779 of the Internal Revenue Code of 1939 as is not satisfied within the meaning of section 3779(i)(1), notwithstanding the fact that a greater amount would have been satisfied, had sections 452 and 462 not been repealed. Interest will be imposed at such rate until the amount not so satisfied is paid.

§ 1.9000–7 Provisions for estimated tax.

(a) *Additions to tax under section 294(d) of the Internal Revenue Code of 1939.* Any addition to the tax under section 294(d) (relating to estimated tax) of the Internal Revenue Code of 1939 shall be computed as if the tax for the year for which the estimate was made were computed with sections 452 and 462 still applicable to such taxable year. For the purpose of the preceding sentence, it is not necessary for the taxpayer actually to have made an election under section 452 or 462; it is only necessary for the taxpayer to have taken such sections into account in estimating its tax liability for the year. Thus, if in determining the amount of estimated tax, the taxpayer computed his estimated tax liability by applying those sections, that portion of any additions to tax under section 294(d) resulting from the repeal of sections 452 and 462 shall be disregarded.

(b) *Additions to tax under section 6654.* In the case of an underpayment of estimated tax, any additions to the tax under section 6654, with respect to installments due before December 15, 1955, shall be computed without regard to any increase in tax resulting from the repeal of sections 452 and 462. Any additions to the tax with respect to installments due on or after December 15, 1955, shall be imposed in accordance with the applicable provisions of the Code, and as though sections 452 and 462 had not been enacted. Thus, a taxpayer whose declaration of estimated tax was based upon an estimate of his taxable income for the year of the estimate which was determined by taking sections 452 and 462 into account, must file an amended declaration on or before the due date of the next installment of estimated tax due on or after December 15, 1955. Such amended declaration shall reflect an estimate of the tax without the application of such sections. If the taxpayer bases his estimate on the tax for the preceding taxable year under section 6654(d)(1)(A), an amended declaration must be filed on or before the due date of the next installment due on or after December 15, 1955, if the tax for the preceding taxable year is increased as the result of the repeal of sections 452 and 462. Similarly, if the taxpayer bases his estimate on the tax computed under section 6654(d)(1)(B), he must file an amended declaration on or before the due date of the next installment due on or after December 15, 1955, taking into account the repeal of sections 452 and 462 with respect to the preceding taxable year. Any increase in estimated

tax shown on an amended declaration filed in accordance with this paragraph must be paid in accordance with section 6153(c).

(c) *Estimated tax of corporations.* Corporations required to file a declaration of estimated tax under section 6016 for taxable years ending on and after December 31, 1955, shall estimate their tax liability for such year as if sections 452 and 462 had not been enacted. Thus, if the corporation bases its estimated tax liability under section 6655(d) (1) or (2) on its operations for the preceding taxable year, the effect of the repeal of sections 452 and 462 with respect to such year must be taken into account.

§ 1.9000–8 Extension of time for making certain payments.

(a) *Time for payment specified in Code.* (1) If the treatment of any payment (including its allowance as a deduction or otherwise) is dependent upon the making of a payment within a period of time specified in the Code the period within which the payment is to be made is extended where the amount to be paid is increased by reason of the repeal of sections 452 and 462: *Provided,* That:

(i) The taxpayer, because of a pre-existing obligation, is required to make a payment or an additional payment to another person by reason of such repeal;

(ii) The deductibility of the payment or additional payment is contingent upon its being made within a period prescribed by the Code, which period expires after the close of the taxable year; and

(iii) The payment or additional payment is made on or before December 15, 1955.

If the foregoing conditions are met, the payment or additional payment will be treated as having been made within the time specified in the Code, and, subject to any other conditions in the Code, it shall be deductible for the year to which it relates. The provision of this paragraph may be illustrated by the following examples:

Example 1. Section 267 (relating to losses, expenses and interest between related taxpayers) applies to amounts accrued by taxpayer A for salary payable to B. For the calendar year 1954, A is obligated to pay B a salary equal to 5 percent of A's taxable income for the taxable year. The amount accrued as salary payable to B for 1954 is $5,000 with the taxable income reflecting the application of section 462. As a result of the repeal of section 462 the salary payable to B for 1954 is increased to $6,000. The additional $1,000 is paid to B on December 15, 1955. In recomputing A's tax liability for 1954 the additional deduction of $1,000 for salary payable to B will be treated as having been made within two and one-half months after the close of the taxable year and will be deductible in that year.

Example 2. On March 1, 1955, Corporation X, a calendar year taxpayer using the accrual method of accounting, makes a payment described in section 404(a)(6) (relating to contributions to an employees' trust) of $10,000 which is accrued for 1954 and is determined on the basis of the amount of taxable income for that year. The taxpayer filed its return on March 15, 1955. By reason of the repeal of section 462, X's taxable income is increased so that it is required to make an additional contribution of $2,000 to the employees' trust. The additional payment is made on December 15, 1955. For purposes of recomputing X's tax liability for 1954, this additional payment is deemed to have been made on the last day of 1954.

(2) The time for inclusion in the taxable income of the payee of any additional payment of the type described in subparagraph (1) of this paragraph, shall be determined without regard to section 4(c)(3) of the Act of June 15, 1955, and §§ 1.9000–2 to 1.9000–8, inclusive.

(b) *Dividends paid under section 561.* under section 4(c)(4) of the Act of June 15, 1955, the period during which distributions may be recognized as dividends paid under section 561 for a taxable year to which section 452 or 462 apply may be extended under the conditions set forth below.

(1) *Accumulated earnings tax or personal holding company tax.* In the case of the accumulated earnings tax or the personal holding company tax, if:

(i) The income of a corporation is increased for a taxable year by reason of the repeal of sections 452 and 462 so that it would become liable for the tax (or an increase in the tax) imposed on accumulated earnings or personal holding companies unless additional dividends are distributed;

(ii) The corporation distributes dividends to its stockholders after the 15th day of the 3d month following the close

of its taxable year and on or before December 15, 1955, which dividends are attributable to an increase in its accumulated taxable income or undistributed personal holding company income, as the case may be, resulting from the repeal of sections 452 and 462, and

(iii) The corporation elects in its statement, submitted under §1.9000–3, to have the provisions of section 4(c)(4) of the Act of June 15, 1955, apply:

Then such dividends shall be treated as having been paid on the last day of the taxable year to which the statement applies.

(2) *Regulated investment companies.* In the case of a regulated investment company taxable under section 852, if:

(i) The taxable income of the regulated investment company is increased by reason of the repeal of sections 452 and 462 (without regard to any deduction for dividends paid as provided for in this subparagraph);

(ii) The company distributes dividends to its stockholders after the 15th day of the 3d month following the close of its taxable year and on or before December 15, 1955, which dividends are attributable to an increase in its investment company income resulting from the repeal of sections 452 and 462; and

(iii) The company elects in its statement, submitted under §1.9000–3, to have the provisions of section 4(c)(4) of the Act of June 15, 1955, apply:

then such dividends are to be treated as having been paid on the last day of the taxable year to which the statement applies. The dividends paid are to be determined under this subparagraph without regard to the provisions of section 855.

(3) *Related provisions.* An election made under subparagraph (1) or (2) of this paragraph is irrevocable. The time for inclusion in the taxable income of the distributees of any distributions of the type described in subparagraph (1) or (2) of this paragraph shall be determined without regard to section 4(c)(4) of the Act of June 15, 1955, and §§1.9000–2 to 1.9000–8, inclusive.

RETIREMENT-STRAIGHT LINE ADJUSTMENT ACT OF 1958

SOURCE: Sections 1.9001 through 1.9001–4 contained in T.D. 6500, 25 FR 12158, Nov. 26, 1960, unless otherwise noted.

§ 1.9001 Statutory provisions; Retirement-Straight Line Adjustment Act of 1958.

Section 94 of the Technical Amendments Act of 1958 (72 Stat. 1669) provides as follows:

SEC. 94. *Change from retirement to straight line method of computing depreciation in certain cases*—(a) *Short title.* This section may be cited as the ''Retirement-Straight Line Adjustment Act of 1958''.

(b) *Making of election.* Any taxpayer who held retirement-straight line property on his 1956 adjustment date may elect to have this section apply. Such an election shall be made at such time and in such manner as the Secretary shall prescribe. Any election under this section shall be irrevocable and shall apply to all retirement-straight line property as hereinafter provided in this section (including such property for periods when held by predecessors of the taxpayer).

(c) *Retirement-straight line property defined.* For purposes of this section, the term ''retirement-straight line property'' means any property of a kind or class with respect to which the taxpayer or a predecessor (under the terms and conditions prescribed for him by the Commissioner) for any taxable year beginning after December 31, 1940, and before January 1, 1956, changed from the retirement to the straight line method of computing the allowance of deductions for depreciation.

(d) *Basis adjustments as of 1956 adjustment date.* If the taxpayer has made an election under this section, then in determining the adjusted basis on his 1956 adjustment date of all retirement-straight line property held by the taxpayer, in lieu of the adjustments for depreciation provided in section 1016(a) (2) and (3) of the Internal Revenue Code of 1954, the following adjustments shall be made (effective as of his 1956 adjustment date) in respect of all periods before the 1956 adjustment date:

(1) *Depreciation sustained before March 1, 1913.* For depreciation sustained before March 1, 1913, on retirement-straight line property held by the taxpayer or a predecessor on such date for which cost was or is claimed as basis and which either:

(A) *Retired before changeover.* Was retired by the taxpayer or a predecessor before the changeover date, but only if (i) a deduction was allowed in computing net income by reason of such retirement, and (ii) such deduction was computed on the basis of cost without adjustment for depreciation sustained

before March 1, 1913. In the case of any such property retired during any taxable year beginning after December 31, 1929, the adjustment under this subparagraph shall not exceed that portion of the amount attributable to depreciation sustained before March 1, 1913, which resulted (by reason of the deduction so allowed) in a reduction in taxes under the Internal Revenue Code of 1954 or prior income, war-profits, or excess-profits tax laws.

(B) *Held on changeover date.* Was held by the taxpayer or a predecessor on the changeover date. This subparagraph shall not apply to property to which paragraph (2) applies.

The adjustment determined under this paragraph shall be allocated (in the manner prescribed by the Secretary) among all retirement-straight line property held by the taxpayer on his 1956 adjustment date.

(2) *Property disposed of after changeover and before 1956 adjustment date.* For that portion of the reserve prescribed by the Commissioner in connection with the changeover which was applicable to property:

(A) Sold, or

(B) With respect to which a deduction was allowed for Federal income tax purposes by reason of casualty or ''abnormal'' retirement in the nature of special obsolescence, if such sale occurred in, or such deduction was allowed for, a period on or after the changeover date and before the taxpayer's 1956 adjustment date.

(3) *Depreciation allowable from changeover to 1956 adjustment date.* For depreciation allowable, under the terms and conditions prescribed by the Commissioner in connection with the changeover, for all periods on and after the changeover date and before the taxpayer's 1956 adjustment date.

This subsection shall apply only with respect to taxable years beginning after December 31, 1955.

(e) *Effect on period from changeover to 1956 adjustment date.* If the taxpayer has made an election under this section, then in determining the adjusted basis of any retirement-straight line property as of any time on or after the changeover date and before the taxpayer's 1956 adjustment date, in lieu of the adjustments for depreciation provided in section 1016(a) (2) and (3) of the Internal Revenue Code of 1954 and the corresponding provisions of prior revenue laws, the following adjustments shall be made:

(1) *For prescribed reserve.* For the amount of the reserve prescribed by the Commissioner in connection with the changeover.

(2) *For allowable depreciation.* For the depreciation allowable under the terms and conditions prescribed by the Commissioner in connection with the changeover.

This subsection shall not apply in determining adjusted basis for purposes of section 437(c) of the Internal Revenue Code of 1939. This subsection shall apply only with respect to taxable years beginning on or after the changeover date and before the taxpayer's 1956 adjustment date.

(f) *Equity invested capital, etc.* If an election is made under this section, then (notwithstanding the terms and conditions prescribed by the Commissioner in connection with the changeover):

(1) *Equity invested capital.* In determining equity invested capital under sections 458 and 718 of the Internal Revenue Code of 1939, accumulated earnings and profits as of the changeover date, and as of the beginning of each taxable year thereafter, shall be reduced by the depreciation sustained before March 1, 1913, as computed under subsection (d)(1)(B); and

(2) *Definition of equity capital.* In determining the adjusted basis of assets for the purpose of section 437(c) of the Internal Revenue Code of 1939 (and in addition to any other adjustments required by such Code), the basis shall be reduced by depreciation sustained before March 1, 1913 (as computed under subsection (d)), together with any depreciation allowable under subsection (e)(2) for any period before the year for which the excess profits credit is being computed.

(g) *Definitions.* For purposes of this section:

(1) *Depreciation.* The term ''depreciation'' means exhaustion, wear and tear, and obsolescence.

(2) *Changeover.* The term ''changeover'' means a change from the retirement to the straight line method of computing the allowance of deductions for depreciation.

(3) *Changeover date.* The term ''changeover date'' means the first day of the first taxable year for which the changeover was effective.

(4) *1956 adjustment date.* The term ''1956 adjustment date'' means, in the case of any taxpayer, the first day of his first taxable year beginning after December 31, 1955.

(5) *Predecessor.* The term ''predecessor'' means any person from whom property of a kind or class to which this section refers was acquired, if the basis of such property is determined by reference to its basis in the hands of such person. Where a series of transfers of property has occurred and where in each instance the basis of the property was determined by reference to its basis in the hands of the prior holder, the term includes each such prior holder.

(6) The term ''Secretary'' means the Secretary of the Treasury or his delegate.

(7) The term ''Commissioner'' means the Commissioner of Internal Revenue.

§ 1.9001–1 Change from retirement to straight-line method of computing depreciation.

(a) *In general.* The Retirement-Straight Line Adjustment Act of 1958 (72 Stat. 1669), which is contained in

section 94 of the Technical Amendments Act of 1958, approved September 2, 1958, provides various adjustments to be made by certain railroads which changed from the retirement to the straight-line method of computing the allowance of deductions for the depreciation of those roadway assets which are defined in this section as retirement-straight line property. The adjustments are available to all eligible taxpayers who make an irrevocable election to have the provisions of the Retirement-Straight Line Adjustment Act of 1958 apply. This election shall be made at the time and in the manner prescribed by this section. If an election is made in accordance with this section, then the provisions of the Act and of §§ 1.9001 to 1.9001–4, inclusive, shall apply. An election made in accordance with this section shall not be considered a change in accounting method for purposes of section 481 of the Code.

(b) *Making of election.* (1) Subsection (b) of the Act provides that any taxpayer who held retirement-straight line property on its 1956 adjustment date may elect to have the provisions of the Act apply. The election shall be irrevocable and shall apply to all retirement-straight line property, including such property for periods when held by predecessors of the taxpayer.

(2) An election may be made in accordance with the provisions of this section even though the taxpayer has, at the time of election, litigated some or all of the issues covered by the provisions of the Act and has received from the courts a determination which is less favorable to the taxpayer than the treatment provided by the Act. Once an election has been made in accordance with the provisions of this section, the taxpayer may not receive the benefit of more favorable treatment, as a result of litigation, than that provided by the Act on the issues involved.

(3) The election to have the provisions of the Act apply shall be made by filing a statement to that effect, on or before January 11, 1960, with the district director for the internal revenue district in which the taxpayer's income tax return for its first taxable year beginning after December 31, 1955, was filed. A copy of this statement shall be filed with any amended return, or claim for refund, made under the Act.

(c) *Definitions.* For purposes of the Act and §§ 1.9001 to 1.9001–4, inclusive:

(1) *The Act.* The term *the Act* means the Retirement-Straight Line Adjustment Act of 1958, as contained in section 94 of the Technical Amendments Act of 1958 (72 Stat. 1669).

(2) *Commissioner.* The term *Commissioner* means the Commissioner of Internal Revenue.

(3) *Retirement-straight line property.* The term *retirement-straight line property* means any property of a kind or class with respect to which the taxpayer (or a predecessor of the taxpayer) changed, pursuant to the terms and conditions prescribed for it by the Commissioner, from the retirement to the straight-line method of computing the allowance for any taxable year beginning after December 31, 1940, and before January 1, 1956, of deductions for depreciation. The term does not include any specific property which has always been properly accounted for in accordance with the straight-line method of computing the depreciation allowances or which, under the terms-letter, was permitted or required to be accounted for under the retirement method.

(4) *Depreciation.* The term *depreciation* means exhaustion, wear and tear, and obsolescence.

(5) *Predecessor.* The term *predecessor* means any person from whom property of a kind or class to which the Act refers was acquired, if the basis of such property is determined by reference to its basis in the hands of such person. Where a series of transfers of property has occurred and where in each instance the basis of the property was determined by reference to its basis in the hands of the prior holder, the term includes each such prior holder.

(6) *Changeover.* The term *changeover* means a change from the retirement to the straight-line method of computing the allowance of deductions for depreciation.

(7) *Changeover date.* The term *changeover date* means the first day of the first taxable year for which the changeover was effective.

(8) *1956 adjustment date.* The term *1956 adjustment date* means, in the case of any taxpayer, the first day of its first taxable year beginning after December 31, 1955.

(9) *Terms-letter.* The term *terms-letter* means the terms and conditions prescribed by the Commissioner in connection with the changeover.

(10) *Terms-letter reserve.* The term *terms-letter reserve* means the reserve for depreciation prescribed by the Commissioner in connection with the changeover.

(11) *Depreciation sustained before March 1, 1913.* The term *depreciation sustained before March 1, 1913* may be construed to mean, to the extent that it is impossible to determine the actual amount of such depreciation from the books and records, that amount which is obtained by (i) deducting the ''cost of reproduction new less depreciation'' from the ''cost of reproduction new'', as ascertained as of the valuation date by the Interstate Commerce Commission under the provisions of section 19a of part I of the Interstate Commerce Act (49 U.S.C. 19a), and then (ii) making such retroactive adjustments to the remainder as are required, in the opinion of the Commissioner of Internal Revenue, to properly reflect the depreciation sustained before March 1, 1913. For this purpose, any retirement-straight line property held on March 1, 1913, and retired on or before the valuation date shall be taken into account.

§ 1.9001–2 Basis adjustments for taxable years beginning on or after 1956 adjustment date.

(a) *In general.* Subsection (d) of the Act provides the basis adjustments required to be made by the taxpayer as of the 1956 adjustment date in respect of all periods before that date in order to determine the adjusted basis of all retirement-straight line property held by the taxpayer on that date. This adjusted basis on the 1956 adjustment date shall be used by the taxpayer for all purposes of the Code for any taxable year beginning after December 31, 1955. In order to arrive at the adjusted basis on the 1956 adjustment date, the taxpayer shall start with the unadjusted basis of all retirement-straight line property held on the changeover date by the taxpayer or a predecessor and shall, with respect to both the asset and reserve accounts, (1) make the adjustments prescribed by this section and subsection (d) of the Act and (2) also make those adjustments required, in accordance with the method of accounting regularly used, for those additions, retirements, and other dispositions of property which occurred on or after the changeover date and before the taxpayer's 1956 adjustment date. For an illustration of adjustments required in accordance with the method of accounting regularly used, see paragraph (e)(3) of this section. The adjustments required by subsection (d) of the Act shall be made in lieu of the adjustments for depreciation otherwise required by section 1016(a) (2) and (3) of the Code. The adjustments required by subsection (d) of the Act are set forth in paragraphs (b), (c), and (d) of this section.

(b) *Adjustment for depreciation sustained before March 1, 1913*—(1) *In general.* Subsection (d)(1) of the Act requires an adjustment to be made as of the 1956 adjustment date for depreciation sustained before March 1, 1913, on all retirement-straight line property held on March 1, 1913, by the taxpayer or a predecessor for which cost was or is claimed as basis and which was either (i) retired before the changeover date by the taxpayer or a predecessor or (ii) held on the changeover date by the taxpayer or a predecessor. This adjustment for depreciation sustained before March 1, 1913, shall be made in accordance with the conditions and limitations described in subparagraphs (2) and (3) of this paragraph and shall be allocated, in the manner prescribed in subparagraph (4) of this paragraph, among all retirement-straight line property held by the taxpayer on its 1956 adjustment date. The term ''cost'', when used in this paragraph with reference to the basis of property, shall be construed to mean the amount paid for the property or, if that amount could not be determined, then such other amount as was accepted by the Commissioner as ''cost'' for basis purposes.

(2) *Depreciation sustained on property retired before the changeover date.* Pursuant to subsection (d)(1)(A) of the Act,

an adjustment to the basis of retirement-straight line property held by the taxpayer on its 1956 adjustment date shall be made as of that date for depreciation sustained before March 1, 1913, on all retirement-straight line property held on March 1, 1913, by the taxpayer or a predecessor for which cost was claimed as the basis and which was retired before the changeover date by the taxpayer or a predecessor, except that:

(i) The adjustment shall be made only if a deduction was allowed in computing net income by reason of the retirement and the deduction so allowed was computed on the basis of the cost of the property unadjusted for depreciation sustained before March 1, 1913, and

(ii) In the case of any such property retired during any taxable year beginning after December 31, 1929, the adjustment shall not exceed that portion of the amount attributable to depreciation sustained before March 1, 1913, which resulted, by reason of the deduction so allowed, in a reduction of taxes under the Code or under prior income, war-profits or excess-profits tax laws.

(3) *Depreciation sustained on property held on the changeover date.* Pursuant to subsection (d)(1)(B) of the Act, an adjustment to the basis of retirement-straight line property held by the taxpayer on its 1956 adjustment date shall be made as of that date for depreciation sustained before March 1, 1913, on all retirement-straight line property held on March 1, 1913, by the taxpayer or a predecessor for which cost was or is claimed as basis and which was held on the changeover date by the taxpayer or a predecessor. This subparagraph shall not apply, however, to any such property which (i) was disposed of on or after the changeover date by reason of sale, casualty, or abnormal retirement in the nature of special obsolescence, and (ii) is property to which paragraph (c) of this section and subsection (d)(2) of the Act apply.

(4) *Manner of allocating adjustment.* Pursuant to subsection (d)(1) of the Act, the amount of the adjustment required under this paragraph for depreciation sustained before March 1, 1913, which is attributable to a particular kind or class of retirement-straight line property held by the taxpayer on its 1956 adjustment date shall be made with respect to that kind or class of such property. If the adjustment required under this paragraph for depreciation sustained before March 1, 1913, is attributable to retirement-straight property of a particular kind or class no longer held by the taxpayer on its 1956 adjustment date, then the part of the adjustment to be allocated to any retirement-straight line property held by the taxpayer on its 1956 adjustment date shall be that amount which bears the same ratio to the adjustment as the unadjusted basis of the property so held bears to the entire unadjusted basis of all retirement-straight line property held by the taxpayer on its 1956 adjustment date.

(c) *Adjustment for part of terms-letter reserve applicable to property disposed of on or after changeover date and before 1956 adjustment date.* Pursuant to subsection (d)(2) of the Act, an adjustment to the basis of retirement-straight line property held by the taxpayer on its 1956 adjustment date shall be made as of that date for that part of the terms-letter reserve which was applicable to any retirement-straight line property disposed of by sale, casualty, or abnormal retirement in the nature of special obsolescence, but only if the sale occurred in, or a deduction by reason of such casualty or abnormal retirement was allowed for Federal income-tax purposes for a period on or after the changeover date and before the taxpayer's 1956 adjustment date. This paragraph shall apply even though, in computing the adjusted basis of the property for purposes of determining gain or loss on the sale, casualty, or abnormal retirement, the basis of the retirement-straight line property was not reduced by the part of the terms-letter reserve applicable to the property. If necessary, the adjustment required by this paragraph shall be allocated, in the manner prescribed in paragraph (b)(4) of this section, among all retirement-straight line property held by the taxpayer on its 1956 adjustment date.

(d) *Adjustment for depreciation allowable under the terms-letter for periods on and after the changeover date and before the 1956 adjustment date.* Pursuant to

subsection (d)(3) of the Act, an adjustment to the basis of retirement-straight line property held by the taxpayer on its 1956 adjustment date shall be made as of that date for the entire amount of depreciation allowable under the terms-letter for all periods on and after the changeover date and before the taxpayer's 1956 adjustment date. This adjustment shall include all such depreciation allowable with respect to any retirement-straight line property which was disposed of on or after the changeover date and before the 1956 adjustment date.

(e) *Illustration of basis adjustments required for taxable years beginning on or after the 1956 adjustment date.* The application of this section may be illustrated by the following example, which is based upon the assumption that multiple asset accounts are used:

Example. (1) Assume that on its changeover date, January 1, 1943, the taxpayer or its predecessor held retirement-straight line property with an unadjusted cost basis of $10,000. The terms-letter reserve established as of January 1, 1943, with respect to such property was $3,000. Depreciation sustained before March 1, 1913, on retirement-straight line property held on that date by the taxpayer or its predecessor, for which cost was or is claimed as basis, amounts to $800. Of this total depreciation sustained before March 1, 1913, $200 is attributable to retirement-straight line property retired before January 1, 1943, under circumstances requiring the adjustment under paragraph (b)(2) of this section, and $600 is attributable to retirement-straight line property held on January 1, 1943, by the taxpayer or its predecessor. On December 31, 1954, retirement-straight line property costing $1,500 was permanently retired under circumstances giving rise to an abnormal retirement in the nature of special obsolescence. The terms-letter reserve applicable to this retired property was $450, of which $120 represents depreciation sustained before March 1, 1913. On December 31, 1954, retirement-straight line property costing $1,000 was also permanently retired under circumstances giving rise to a normal retirement. None of the property retired on December 31, 1954, had any market or salvage value on that date. Depreciation allowable under the terms-letter on retirement-straight line property for all periods on and after January 1, 1943, and before January 1, 1956 (the taxpayer's 1956 adjustment date), amounts to $2,155, of which $345 is applicable to the property retired as an abnormal retirement.

(2) The reserve for depreciation as of January 1, 1956, contains a credit balance of $3,360, determined as follows but without regard to the Act:

(i) Credits to reserve:		
Terms-letter reserve as of January 1, 1943		$3,000
Depreciation allowable under terms-letter from January 1, 1943, to December 31, 1955		2,155
Balance		5,155
(ii) Charges to reserve:		
Part of terms-letter reserve applicable to property abnormally retired	$450	
Depreciation applicable to property abnormally retired and allowable from January 1, 1943, to December 31, 1954	345	
Adjustment for normal retirement	1,000	
		$1,795
(iii) Balance as of January 1, 1956		3,360

(3) The adjusted basis on January 1, 1956, of the retirement-straight line property held by the taxpayer on that date is $6,010, determined as follows and in accordance with this section:

(i) Asset account:		
Unadjusted cost on January 1, 1943		$10,000
Less:		
Adjustment for abnormal retirement	$1,500	
Adjustment for normal retirement	1,000	
		2,500
Balance as of January 1, 1956		7,500
(ii) Credits to reserve for depreciation:		
Depreciation sustained before March 1, 1913, on—		
Property retired before January 1, 1943		200
Property held on January 1, 1943	$600	
Less part of such depreciation sustained on property abnormally retired on December 31, 1954	120	
		480
Part of terms-letter reserve applicable to property abnormally retired on December 31, 1954 (including $120 depreciation sustained before March 1, 1913)		450
Depreciation allowable under terms-letter from January 1, 1943, to December 31, 1955		2,155
Total Credits		3,285
(iii) Charges to reserve for depreciation:		
Part of terms-letter reserve applicable to property abnormally retired		450

Depreciation applicable to property abnormally retired and allowable from January 1, 1943, to December 31, 1954		345
Adjustment for normal retirement		1,000
Total charges		1,795
(iv) Balance in reserve for depreciation:		
Total credits		3,285
Total charges		1,795
Balance as of January 1, 1956		1,490
(v) Adjusted basis of property:		
Balance in asset account		7,500
Balance in reserve for depreciation		1,490
Adjusted basis as of January 1, 1956		6,010

(4) The following adjustments to the reserve determined under subparagraph (2) of this paragraph may be made in order to arrive at the reserve determined under subparagraph (3)(iv) of this paragraph:

(i) Credit balance in reserve, as determined under subparagraph (2) of this paragraph		$3,360
(ii) Credit adjustments:		
Depreciation sustained before March 1, 1913, on—		
Property retired before January 1, 1943	$200	
Property held on January 1, 1943	480	
Part of terms-letter reserve applicable to property abnormally retired on December 31, 1954	450	
		1,130
Balance		4,490
(iii) Debit adjustment:		
Terms-letter reserve as of January 1, 1943		3,000
(iv) Credit Balance in reserve, as determined under subparagraph (3)(iv) of this paragraph		1,490

(5) The $6,010 adjusted basis as of January 1, 1956, of the retirement-straight line property held by the taxpayer on that date is to be recovered over the estimated remaining useful life of that property. The remaining useful life of the property will be reviewed regularly, and appropriate adjustments in the rates will be made as necessary in order to spread the remaining cost less estimated salvage over the estimated remaining useful life of the property. See § 1.167(a)–1.

§ 1.9001–3 Basis adjustments for taxable years between changeover date and 1956 adjustment date.

(a) *In general.* (1) Subsection (e) of the Act provides the adjustments required to be made in determining the adjusted basis of any retirement-straight line property as of any time on or after the changeover date and before the taxpayer's 1956 adjustment date. This adjusted basis shall be used for all purposes of the Internal Revenue Code of 1939 and the Internal Revenue Code of 1954 for taxable years beginning on or after the changeover date and before the taxpayer's 1956 adjustment date, except as provided in subparagraph (4) of this paragraph. The adjustments so required, which are set forth in paragraphs (b) and (c) of this section, shall not be used in determining the adjusted basis of property for taxable years beginning before the changeover date or on or after the taxpayer's 1956 adjustment date.

(2) In order to arrive at the adjusted basis as of any specific date occurring on or after the changeover date and before the 1956 adjustment date, the taxpayer shall start with the unadjusted basis of all retirement-straight line property held on the changeover date by the taxpayer or its predecessor and shall, as of that specific date and with respect to both the asset and reserve accounts, (i) make the adjustments prescribed by this section and subsection (e) of the Act and (ii) also make those adjustments required, in accordance with the method of accounting regularly used, for additions, retirements, and other dispositions of property. For an illustration of adjustments required in accordance with the method of accounting regularly used, see the example in paragraph (d) of this section.

(3) The adjustments required by subsection (e) of the Act shall be made in lieu of the adjustments for depreciation otherwise required by section 1016(a) (2) and (3) of the Code and by the corresponding provisions of prior revenue laws.

(4) Although this section, and subsection (e) of the Act, shall apply in determining the excess-profits tax, they shall not apply in determining adjusted basis for the purpose of computing equity capital for any day under section 437(c) (relating to the Excess Profits Tax Act of 1950) (64 Stat. 1137) of the Internal Revenue Code of 1939. For the adjustments to be made in computing equity capital under such section, see paragraph (c) of § 1.9001–4.

(b) *Adjustment for terms-letter reserve.* Pursuant to subsection (e)(1) of the Act, the basis of any retirement-

straight line property shall be adjusted, as of any specific applicable date occurring on or after the changeover date and before the 1956 adjustment date, for the amount of the terms-letter reserve applicable to such property.

(c) *Adjustment for depreciation allowable under the terms-letter.* Pursuant to subsection (e)(2) of the Act, the basis of any retirement-straight line property shall be adjusted, as of any specific applicable date occurring on or after the changeover date and before the 1956 adjustment date, for depreciation applicable to such property and allowable under the terms-letter.

(d) *Illustration of basis adjustments required for taxable years beginning on or after the changeover date and before the 1956 adjustment date.* The application of this section may be illustrated by the following example, which is based upon the assumption that multiple asset accounts are used:

Example. (1) The facts are assumed to be the same as those in the example under paragraph (e) of § 1.9001–2, except that the adjusted basis of retirement-straight line property is determined as of January 1, 1955, and the depreciation allowable under the terms-letter from the changeover date to December 31, 1954, is $2,100.

(2) The adjusted basis on January 1, 1955, of the retirement-straight line property held by the taxpayer on that date is $4,195, determined as follows and in accordance with this section:

(i) Asset account:		
Unadjusted cost on January 1, 1943		$10,000
Less:		
Adjustment for abnormal retirement	$1,500	
Adjustment for normal retirement	1,000	
		2,500
Balance as of January 1, 1955		7,500
(ii) Credits to reserve for depreciation:		
Entire terms-letter reserve as of January 1, 1943		3,000
Depreciation allowable under terms-letter from January 1, 1943, to December 31, 1954		2,100
Total credits		5,100
(iii) Charges to reserve for depreciation:		
Part of terms-letter reserve applicable to property abnormally retired on December 31, 1954		450
Depreciation applicable to property abnormally retired and allowable from January 1, 1943, to December 31, 1954		345
Adjustment for normal retirement		1,000
Total charges		1,795
(iv) Balance in reserve for depreciation:		
Total credits		5,100
Total charges		1,795
Balance as of January 1, 1955		3,305
(v) Adjusted basis of property:		
Balance in asset account		7,500
Balance in reserve for depreciation		3,305
Adjusted basis as of January 1, 1955		4,195

§ 1.9001–4 Adjustments required in computing excess-profits credit.

(a) *In general.* Subsection (f) of the Act provides adjustments required to be made in computing the excess-profits credit for any taxable year under the Excess Profits Tax Act of 1940 (54 Stat. 975) or under the Excess Profits Tax Act of 1950 (64 Stat. 1137). These adjustments are set forth in paragraphs (b) and (c) of this section, and they shall apply notwithstanding the terms-letter.

(b) *Equity invested capital.* (1) Pursuant to subsection (f)(1) of the Act, in determining equity invested capital for any day of any taxable year under section 458 (relating to the Excess Profits Tax Act of 1950) or section 718 (relating to the Excess Profits Tax Act of 1940) of the Internal Revenue Code of 1939, the accumulated earnings and profits as of the changeover date, and as of the beginning of each taxable year thereafter, shall be reduced by the depreciation sustained before March 1, 1913, on all retirement-straight line property held on March 1, 1913, by the taxpayer or a predecessor for which cost was or is claimed as basis and which was held on the changeover date by the taxpayer or a predecessor.

(2) For the computation of accumulated earnings and profits in determining equity invested capital, see 26 CFR (1941 Supp.) 30.718–2, as amended by Treasury Decision 5299, approved October 1, 1943, 8 FR 13451, C.B. 1943, 747 (Regulations 109); 26 CFR (1943 Cum. Supp.) 35.718–2 (Regulations 112); and 26 CFR (1939) 41.458–4 (Regulations 130).

(c) *Equity capital.* (1) Pursuant to subsection (f)(2) of the Act, in determining the adjusted basis of assets for the purpose of computing equity capital for

any day under section 437(c) (relating to the Excess Profits Tax Act of 1950) of the Internal Revenue Code of 1939, the basis of the assets which enter into the computation shall also be reduced by:

(i) Depreciation sustained before March 1, 1913, on all retirement-straight line property held on March 1, 1913, by the taxpayer or a predecessor for which cost was or is claimed as basis and which was:

(*a*) Retired before the changeover date by the taxpayer or a predecessor, or

(*b*) Held on the changeover date by the taxpayer or a predecessor and also held as of the beginning of the day for which the equity capital is being determined; and

(ii) All depreciation applicable to the assets which enter into the computation and allowable under the terms-letter for all periods on and after the changeover date and before the taxable year for which the excess-profits credit is being computed.

(2) The adjustment required to be made by subparagraph (1)(i)(*a*) of this paragraph as of the beginning of the day for which the equity capital is being determined shall be made in accordance with the conditions and limitation described in paragraph (b)(2) of §1.9001–2.

(3) For the determination of equity capital under section 437(c) of the Internal Revenue Code of 1939, see 26 CFR (1939) 40.437–5 (Regulations 130).

DEALER RESERVE INCOME ADJUSTMENT ACT OF 1960

§ 1.9002 Statutory provisions; Dealer Reserve Income Adjustment Act of 1960 (74 Stat. 124).

SECTION 1. *Short title.* This Act may be cited as the ''Dealer Reserve Income Adjustment Act of 1960''.

SEC. 2. *Persons to whom this Act applies.* This Act shall apply to any person who, for his most recent taxable year ending on or before June 22, 1959:

(1) Computed, or was required to compute, taxable income under an accrual method of accounting.

(2) Treated any dealer reserve income, which should have been taken into account (under the accrual method of accounting) for such taxable year, as accruable for a subsequent taxable year, and

(3) Before September 1, 1960, makes an election under section 3(a) or 4(a) of this Act.

SEC. 3. *Election to have section 481 apply—(a) General rule.* If:

(1) For the year of the change (determined under subsection (b)), the treatment of dealer reserve income by any person to whom this Act applies is changed to a method proper under the accrual method of accounting (whether or not such person initiated the change),

(2) Such person makes an election under this subsection, and

(3) Such person does not make the election provided by section 4(a),

then, for purposes of section 481 of the Internal Revenue Code of 1954, the change described in paragraph (1) shall be treated as a change in method of accounting not initiated by the taxpayer.

(b) *Year of change, etc.* In applying section 481 of the Internal Revenue Code of 1954 for purposes of this section, the ''year of the change'' in the case of any person is:

(1) Except as provided in paragraph (2), the first taxable year ending after June 22, 1959, or

(2) The earliest taxable year (whether the Internal Revenue Code of 1954 or the Internal Revenue Code of 1939 applies to such year) for which:

(A) On or before June 22, 1959:

(i) The Secretary of the Treasury or his delegate issued a notice of deficiency, or a written notice of a proposed deficiency, with respect to dealer reserve income, or

(ii) Such person filed with the Secretary or his delegate a claim for refund or credit with respect to dealer reserve income, and

(B) The assessment of any deficiency, or the refund or credit of any overpayment, whichever is applicable, was not, on June 21, 1959, prevented by the operation of any law or rule of law.

For purposes of this section, section 481 of such Code shall be treated as applying to any year of the change to which the Internal Revenue Code of 1939 applies.

SEC. 4. *Election to have section 481 not apply; payment in installments*—(a) *General rule.* If a person to whom this Act applies makes an election under this subsection, then for purposes of Chapter 1 of the Internal Revenue Code of 1954 (and the corresponding provisions of prior law) a change in the treatment of dealer reserve income to a method proper under the accrual method of accounting shall be treated as not a change in method of accounting in respect of which section 481 of the Internal Revenue Code of 1954 applies. Any election under this subsection shall apply to all taxable years ending on or before June 22, 1959 (whether the provisions of the Internal Revenue Code of 1954 or the corresponding provisions of prior law apply), for which the assessment of any deficiency, or

for which refund or credit of any overpayment, whichever is applicable, was not, on June 21, 1959, prevented by the operation of any law or rule of law.

(b) *Election to pay tax in installments*—(1) *Eligibility.* If the net increase in tax (as defined in paragraph (2)) which results solely from the effect of the election provided by subsection (a) exceeds $2,500, then the taxpayer may elect (at the time the election is made under subsection (a)) to pay in two or more (but not to exceed 10) equal annual installments any portion of such net increase which (on the date of such election) is unpaid.

(2) *Net increase in tax defined.* For purposes of this section, the term ''net increase in tax'' means the amount (if any) by which:

(A) The sum of the increases in tax (including interest) for all taxable years to which the election applies and which is attributable to the election, exceeds

(B) The sum of the decreases in tax (including interest) for all taxable years to which the election applies and which is attributable to the election.

For purposes of this paragraph, interest for the period before the date of the election shall be computed as provided in Chapter 67 of the Internal Revenue Code of 1954 (or the corresponding provisions of prior revenue laws).

(c) *Due date for installments.* If an election is made under subsection (b), the first installment shall be paid on or before the date prescribed by section 6151(a) of the Internal Revenue Code of 1954 for payment of the tax for the taxable year in which the election was made, and each succeeding installment shall be paid on or before the date which is one year after the date prescribed by this subsection for payment of the preceding installment.

(d) *Effect of subsequent redetermination of tax*—(1) *Redetermination.* If:

(A) The taxpayer makes an election under subsection (b), and

(B) There is a redetermination of the taxpayer's tax for any taxable year to which the election provided by subsection (a) applies,

then the net increase in tax (as defined in subsection (b)(2) shall be redetermined.

(2) *Effect of increase.* If the redetermination described in paragraph (1)(B) results in an increase in the net increase in tax (as defined in subsection (b)(2)), the resulting increase shall be prorated to all the installments. The part of such resulting increase so prorated to any installment the date for payment of which has not arrived shall be collected at the same time as, and as a part of, such installment. The part of such resulting increase so prorated to any installment the date for payment of which has arrived shall be paid upon notice and demand from the Secretary of the Treasury or his delegate.

(3) *Effect of decrease.* For treatment of a decrease in the net increase in tax as the result of a redetermination described in paragraph (1)(B), see section 6403 of the Internal Revenue Code of 1954 (relating to overpayment of installment).

(e) *Suspension of interest*—(1) *In general.* If an election under subsection (a) applies and there is a net increase in tax (as defined in subsection (b)(2)), no interest shall be imposed on any underpayment (and no interest shall be paid on any overpayment) attributable to such election for the period beginning on the date of such election and ending on the date prescribed by section 6151(a) of the Internal Revenue Code of 1954 for payment of the tax for the taxable year in which the election was made.

(2) *No interest during installment period.* If an election under subsection (b) applies, no interest shall be imposed for the period on or after the date fixed for payment of the first installment unless payment of unpaid installments is accelerated under subsection (f) or (g).

(3) *Interest where payment is accelerated.* If payment is accelerated under subsection (f) or (g), interest determined in accordance with the provisions of section 6601 of the Internal Revenue Code of 1954 on the entire unpaid tax shall be payable:

(A) If payment is accelerated under subsection (f), from the date of notice and demand provided by such subsection to the date such tax is paid, or

(B) If payment is accelerated under subsection (g), from the date fixed for paying the unpaid installment to the date such tax is paid.

(f) *Termination of installment payment privilege.* The extension of time provided by this section for payment of tax shall cease to apply, and any unpaid installments shall be paid upon notice and demand from the Secretary of the Treasury or his delegate, if:

(1) In the case of a taxpayer who is an individual, he dies or ceases to engage in a trade or business,

(2) In the case of a taxpayer who is a partner, the entire interest of such partner is transferred or liquidated or the partnership terminates, or

(3) In the case of a taxpayer which is a corporation, the taxpayer ceases to engage in a trade or business, unless the unpaid portion of the tax payable in installments is required to be taken into account by the acquiring corporation under section 5(d).

(g) *Failure to pay installment.* If any installment under this section is not paid on or before the date fixed for its payment by this section (including any extension of time for payment of such installment), the unpaid installments shall be paid upon notice and demand from the Secretary of the Treasury or his delegate.

(h) *Suspension of running of periods of limitation.* The running of the periods of limitation provided by section 6502 of the Internal Revenue Code of 1954 (or corresponding provision of prior law) for the collection of any amount of tax payable in installments under this section shall be suspended for the period of any extension of time for payment granted under this section.

SEC. 5. *Definitions; special rules*—(a) *Dealer reserve income.* For purposes of this Act, the term ''dealer reserve income'' means:

(1) That part of the consideration derived by any person from the sale or other disposition of customers' sales contracts, notes, and other evidences of indebtedness (or derived from customers' finance charges connected with such sales or other dispositions) which is:

(A) Attributable to the sale by such person to such customers, in the ordinary course of his trade or business, of real property or tangible personal property, and

(B) Held in a reserve account, by the financial institution to which such person disposed of such evidences of indebtedness, for the purpose of securing obligations of such person or of such customers, or both; and

(2) That part of the consideration:

(A) Derived by any person from a sale described in paragraph (1)(A) in respect of which part or all of the purchase price of the property sold is provided by a financial institution to or for the customer to whom such property is sold, or

(B) Derived by such person from finance charges connected with the financing of such sale,

which is held in a reserve account by such financial institution for the purpose of securing obligations of such person or of such customer, or both.

(b) *Financial institution.* For purposes of this Act, the term ''financial institution'' means any person regularly engaged in the business of acquiring evidences of indebtedness of the kind described in subsection (a)(1), or of financing sales of the kind described in subsection (a)(2), or both.

(c) *Other terms; application of other laws.* Except where otherwise distinctly expressed or manifestly intended, terms used in this Act shall have the same meaning as when used in the Internal Revenue Code of 1954 and all provisions of law shall apply with respect to this Act as if this Act were a part of such Code.

(d) *Acquiring corporation.* In the case of the acquisition of assets of a corporation by another corporation in a distribution or transfer described in section 381(a) of the Internal Revenue Code of 1954, the acquiring corporation shall, for purposes of this Act, be treated as if it were the distributor or transferor corporation.

(e) *Statutes of limitations*—(1) *Extension of period for assessment and refund or credit.* For purposes of applying sections 3 and 4 of this Act, if the assessment of any deficiency, or the refund or credit of any overpayment, for any taxable year was not prevented on June 21, 1959, by the operation of any law or rule of law, but would be so prevented prior to September 1, 1961, the period within which such assessment, or such refund or credit, may be made shall not expire prior to September 1, 1961. An election by a taxpayer under section 3 or 4 of this Act shall be considered as a consent to the application of the provisions of this subsection.

(2) *Years closed by closing agreement or compromise.* For purposes of this Act, if the assessment of any deficiency, or the refund or credit of any overpayment, for any taxable year is prevented on the date of an election under section 3 or 4 of this Act by the operation of the provisions of Chapter 74 of the Internal Revenue Code of 1954 (relating to closing agreements and compromises) or by the corresponding provisions of the Internal Revenue Code of 1939, such assessment, or such refund or credit, shall be considered as having been prevented on June 21, 1959.

(f) *Regulations.* The Secretary of the Treasury or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this Act, including regulations relating to:

(1) The application of the provisions of this Act in the case of partnerships, and

(2) The manner in which the elections provided by this Act are to be made.

[T.D. 6490, 25 FR 8369, Sept. 1, 1960]

§ 1.9002–1 Purpose, applicability, and definitions.

(a) *In general.* The Dealer Reserve Income Adjustment Act of 1960 (74 Stat. 124) contains transitional provisions relating to adjustments to income resulting from a change in the income tax treatment of dealer reserve income. The purpose of the Act is to provide eligible taxpayers who elect to have its provisions apply with two alternatives for accounting for the adjustments to income resulting from a change to a proper method of reporting dealer reserve income. The Act also provides certain taxpayers with an election to pay in installments any net increase in tax. Eligible taxpayers must make any election under the provisions of the Act prior to September 1, 1960. If any election is made, then the applicable provisions of the Act and §§ 1.9002–1 to 1.9002–8, inclusive, shall apply.

(b) *Eligibility to elect.* In order to be eligible to make any of the elections provided by the Act, a taxpayer must

have, for his most recent taxable year ending on or before June 22, 1959, (1) computed, or been required to compute, taxable income under an accrual method of accounting, and (2) treated dealer reserve income (or portions thereof) which should have been taken into account (under the accrual method of accounting) for such most recent taxable year as accruable for a subsequent taxable year. Thus, the elections provided by the Act are not available to a person who, for his most recent taxable year ending on or before June 22, 1959, reported dealer reserve income under a method proper under the accrual method of accounting or who was not required to compute taxable income under the accrual method of accounting. An election may be made even though the taxpayer is litigating his liability for income tax based upon his treatment of dealer reserve income, whether in The Tax Court of the United States or any other court, and an election filed by a taxpayer who is litigating his liability for income tax based upon his treatment of dealer reserve income does not constitute a waiver of his right to continue pending litigation until final judicial determination. He must, however, comply with the provisions of the Act and the regulations thereunder.

(c) *Definitions*. For purposes of the Act and §§1.9002–1 to 1.9002–8, inclusive:

(1) *The Act*. The term *the Act* means the Dealer Reserve Income Adjustment Act of 1960 (74 Stat. 124).

(2) *Dealer reserve income*. The term *dealer reserve income* means:

(i) That part of the consideration derived by any person from the sale or other disposition of customers' sales contracts, notes, and other evidences of indebtedness (or derived from customers' finance charges connected with such sales or other dispositions) which is:

(*a*) Attributable to the sale by such person to such customers, in the ordinary course of his trade or business, of real property or tangible personal property, and

(*b*) Held in a reserve account, by the financial institution to which such person disposed of such evidences of indebtedness, for the purpose of securing obligations of such person or of such customers, or both; and

(ii) That part of the consideration:

(*a*) Derived by any person from a sale described in subdivision (i)(*a*) of this subparagraph in respect of which part or all of the purchase price of the property sold is provided by a financial institution to or for the customer to whom such property is sold, or

(*b*) Derived by such person from finance charges connected with the financing of such sale, which is held in a reserve account by such financial institution for the purpose of securing obligations of such person or of such customer, or both. Thus, the term includes amounts held in a reserve account by a financial institution in transactions in which the customer becomes obligated to the institution as well as such amounts so held by a financial institution in transactions in which the taxpayer is the obligee on the contract, note, or other evidence of indebtedness. For purposes of the definition of the term ''dealer reserve income'' it is immaterial whether or not the taxpayer guarantees the customer's obligation in excess of the reserve retained by the financial institution. The term does not include the consideration derived from transactions relating to the sale of intangible property such as stocks, bonds, copyrights, patents, etc. Further, the term does not include consideration derived by the taxpayer from transactions relating to the sale of property by a person not the taxpayer or to casual sales of property not in the ordinary course of the taxpayer's trade or business.

(3) *Financial institution*. The term *financial institution* means any person regularly engaged in the business of acquiring evidences of indebtedness of the kind described in section 5(a)(1) of the Act, or of financing sales of the kind described in section 5(a)(2) of the Act, or both. It thus includes banking institutions, finance companies, building and loan associations, and other similar type organizations, as well as an individual or partnership regularly engaged in the described business.

(4) *Taxpayer*. The term *taxpayer* means any person to whom the Act applies.

(5) *Other terms.* All other terms which are not specifically defined shall have the same meaning as when used in the Code except where otherwise distinctly expressed or manifestly intended.

[T.D. 6490, 25 FR 8371, Sept. 1, 1960]

§ 1.9002–2 Election to have the provisions of section 481 of the Internal Revenue Code of 1954 apply.

(a) *In general.* Section 3(a) of the Act provides that if the income tax treatment of dealer reserve income by the taxpayer is changed (whether or not such change is initiated by the taxpayer) to a proper method under the accrual method of accounting, then the taxpayer may elect to have such change treated as a change in method of accounting not initiated by the taxpayer to which the provisions of section 481 of the Code apply. This election may be made only when the alternative election under section 4(a) of the Act has not been exercised.

(b) *Year of change.* Where an election has been made under section 3(a) of the Act to have section 481 of the Code apply, then for purposes of applying section 481 of the Code the year of change shall be determined in accordance with the provisions of section 3(b) of the Act. Section 3(b) provides that the year of change is the earlier of (1) the first taxable year ending after June 22, 1959, or (2) the earliest taxable year for which, on or before June 22, 1959,

(i) There was issued a notice of deficiency or written notice of a proposed deficiency attributable to the erroneous treatment of dealer reserve income, or

(ii) The taxpayer filed a claim for refund or credit with respect to the treatment of such income,

and in respect of which the assessment of any deficiency, or the refund or credit of any overpayment, was not prevented on June 21, 1959, by the operation of any law or rule of law. The written notice of proposed deficiency includes a 15- or 30-day letter issued under established procedure or other similar written notification.

(c) *Application to pre-1954 Code years.* If the earliest year described in paragraph (b) of this section is a year subject to the Internal Revenue Code of 1939 in respect of which assessment of any deficiency or refund or credit of any overpayment was not prevented on June 21, 1959, by the operation of any law or rule of law, section 481 of the Internal Revenue Code of 1954 shall be treated as applying in the same manner it would have applied had it been enacted as part of the Internal Revenue Code of 1939.

(d) *Examples.* The operation of this section in determining the year of change may be illustrated by the following examples:

Example 1. D, a taxpayer on the calendar year basis who employs the accrual method of accounting, voluntarily changed to the proper method of accounting for dealer reserve income for the taxable year 1959. A statutory notice of deficiency, however, was issued prior to June 23, 1959, relating to the erroneous treatment of such income for the taxable year 1956, which was the earliest taxable year in respect of which assessment of a deficiency or credit or refund of an overpayment was not prevented on June 21, 1959. Prior to September 1, 1960, D properly exercises his election under section 3 of the Act to have the change in the treatment of dealer reserve income treated as a change in method of accounting not initiated by the taxpayer to which section 481 of the Code applies. Under these facts, 1956 is the year of the change for purposes of applying section 481. Accordingly, the net amount of any adjustment found necessary as a result of the change in the treatment of dealer reserve income which is attributable to taxable years subject to the 1954 Code shall be taken into account for the year of change in accordance with section 481. The net amount of the adjustments attributable to pre-1954 Code years is to be disregarded. The income of each taxable year succeeding the year of change in respect of which the assessment of any deficiency or refund or credit of any overpayment is not prevented will be recomputed under the proper method of accounting initiated by the change.

Example 2. Assume the same facts as set forth in example (1), except that no notice of a proposed deficiency of any type has been issued, and assume further that no claim for refund has been filed. Since there was no earlier year open on June 21, 1959, for which the taxpayer either was notified of a proposed deficiency attributable to the erroneous treatment of dealer reserve income or for which he had filed a claim for refund or credit with respect to the treatment of such income, the year of change is 1959, the first taxable year ending after June 22, 1959. Accordingly, the net amount of any adjustment found necessary as a result of the change in

the treatment of dealer reserve income which is attributable to taxable years subject to the 1954 Code shall be taken into account for the year of the change in accordance with section 481. The net amount of the adjustments attributable to pre-1954 Code years is to be disregarded.

Example 3. Assume the same facts as set forth in example (1), except that a refund claim specifying adjustments relative to dealer reserve income was timely filed for the taxable year 1951, which was the earliest taxable year for which a refund or credit of an overpayment or assessment of a deficiency was not prevented on June 21, 1959. Under this factual situation, the year of change for purposes of applying section 481 would be 1951. Section 481 would be applied to 1951 and be given effect for that year in the same manner as it would have applied had it been enacted as a part of the 1939 Code and as if the change to the proper method of accounting had not been initiated by the taxpayer. Any adjustment with regard to dealer reserve income attributable to pre-1951 years is disregarded. The income of each taxable year succeeding the year of change in respect of which the assessment of any deficiency or refund or credit of any overpayment is not prevented will be recomputed under the proper method of accounting initiated by the change.

[T.D. 6490, 25 FR 8371, Sept. 1, 1960]

§ 1.9002–3 Election to have the provisions of section 481 of the Internal Revenue Code of 1954 not apply.

Section 4(a) of the Act provides that in the treatment of dealer reserve income by the taxpayer is changed to a method proper under the accrual method of accounting, then the taxpayer may elect to have such change treated as not a change in method of accounting to which the provisions of section 481 of the Internal Revenue Code of 1954 apply. This election shall apply to all taxable years ending on or before June 22, 1959, for which the assessment of any deficiency, or for which refund or credit of any overpayment, was not prevented on June 21, 1959, by the operation of any law or rule of law. This election may be made only if the alternative election under section 3(a) of the Act has not been exercised. If an election is made under section 4(a) of the Act, taxable income (or net income in the case of a taxable year to which the Internal Revenue Code of 1939 applies) shall be recomputed under a proper method of accounting for dealer reserve income for each taxable year to which the election applies, without regard to section 481.

[T.D. 6490, 25 FR 8372, Sept. 1, 1960]

§ 1.9002–4 Election to pay net increase in tax in installments.

(a) *Election.* If an election is made under section 4(a) of the Act and if the net increase in tax determined in accordance with paragraph (b) of this section exceeds $2,500, the taxpayer may also make an election under section 4(b) of the Act prior to September 1, 1960, to pay any portion of such net increase in tax, unpaid on the date of the election, in 2 or more, but not to exceed 10, equal annual installments. If the taxpayer making the election under section 4(a) of the Act is a partnership or a small business corporation electing under Subchapter S, Chapter 1 of the Code, the determination as to whether the net increase in tax exceeds $2,500 shall be made separately as to each partner or shareholder, respectively, with regard to his individual liability. Thus, if a partnership makes an election under section 4(a) of the Act, and partners A and B had a net increase in tax of $3,000 and $2,000, respectively, as a result of dealer reserve income adjustments to partnership income, partner A may elect under section 4(b) of the Act to pay the net increase in 2 or more, but not exceeding 10, equal annual installments to the extent that such tax was unpaid on the date of the election. Partner B may not make the election since his net increase in tax does not exceed $2,500.

(b) *Net increase in tax.* (1) The term ''net increase in tax'' means the amount by which the sum of the increases in tax (including interest) for all taxable years to which the election under section 4(a) of the Act applies and which is attributable to the election exceeds the sum of the decreases in tax (including interest) for all taxable years to which the election under such section applies and which is attributable to the election.

(2) In determining the net increase in tax, the tax and interest for each taxable year to which the election applies is computed by taking into account all adjustments necessary to reflect the change to the proper treatment of dealer reserve income. If the computation

results in additional tax for a taxable year, then interest is computed under section 6601 of the Code (or corresponding provisions of prior law) on such additional tax for the taxable year involved from the last date prescribed for payment of the tax for such taxable year to the date the election is made. The interest so computed is then added to the additional tax determined for such taxable year. The sum of these two items (tax plus interest) represents the increase in tax for such taxable year. If the computation of the tax after taking into account the appropriate dealer reserve income adjustments results in a reduction in tax for any taxable year to which the election applies, interest under section 6611 of the Code (or corresponding provisions of prior law) is computed from the date of the overpayment of the tax for such year to the date of the election. The amount of the interest so computed is then added to the reduction in tax to determine the total decrease in tax for such year. The net increase in tax is then determined by adding together the total increases in tax for each year to which the election applies and from the resulting total subtracting the sum of the total decreases in tax for each year. If the total increases in tax for all such years do not exceed the total decreases in tax, there is no net increase in tax for purposes of section 4(b) of the Act. For purposes of determining the net increase in tax, net operating losses affecting the computation of tax for any prior taxable year not otherwise affected shall be taken into account.

(c) *Time for paying installments.* If the election under this section is made to pay the unpaid portion of the net increase in tax in installments, the first installment shall be paid on or before the date prescribed by section 6151(a) of the Code for payment of the tax for the taxable year in which such election is made. Each succeeding installment shall be paid on or before the date which is one year after the date prescribed for the payment of the preceding installment.

(d) *Termination of installment privilege*—(1) *For nonpayment of installment.* The extension of time provided by section 4(b) of the Act for payment of the net increase in tax in installments shall terminate, and any unpaid installments shall be paid upon notice and demand from the district director if any installment under such section is not paid by the taxpayer on or before the date fixed for its payment, including any extension of time for payment of any such installment.

(2) *For other reasons.* The extension of time provided by section 4(b) of the Act for payment of the net increase in tax in installments shall terminate, and any unpaid installments shall be paid upon notice and demand from the district director if:

(i) In the case of an individual, he dies or ceases to engage in any trade or business,

(ii) In the case of a partner, his entire interest in the partnership is transferred or liquidated or the partnership terminates, or

(iii) In the case of a corporation, it ceases to engage in a trade or business, unless the unpaid portion of the tax payable in installments is required to be taken into account by an acquiring corporation under section 5(d) of the Act.

The installment privilege is not terminated under this subparagraph even though the taxpayer terminates the trade or business in respect of which the dealer reserve income is attributable provided the taxpayer continues in a trade or business. Further, the privilege is not terminated by a transfer of a part of a partnership interest so long as the partner retains any interest in the partnership. Also, the privilege is not terminated by a transaction falling within the provisions of section 381(a) of the Code if, under section 5(d) of the Act, the acquiring corporation is required to take into account the unpaid portion of the net increase in tax. In such a case the privilege may be continued by the acquiring corporation in the same manner and under the same conditions as though it were the distributor or transferor corporation.

(e) *Redetermination of tax subsequent to exercise of installment election.* Section 4(d) of the Act provides that where a taxpayer has elected to pay the net increase in tax in installments and

thereafter it becomes necessary to redetermine the taxpayer's tax for any taxable year to which the election provided by section 4(a) of the Act applies, then the net increase in tax shall be redetermined. Where the redetermination does not involve adjustments affecting the treatment of dealer reserve income, then the net increase in tax previously computed will not be disturbed. The net increase in tax is limited to the amount of tax computed under section 4(b)(2) of the Act as a result of the change in treatment accorded dealer reserve income. If the redetermination of tax for any taxable year to which the election applies results in an addition to the net increase in tax previously computed, then such addition shall be prorated to all of the installments whether paid or unpaid. The part of the addition, prorated to installments which are not yet due, shall be collected at the same time as, and as a part of, such installments. The part of the addition prorated to installments, the time for payment of which has arrived, shall be paid upon notice and demand from the district director. Under section 4(g) of the Act, failure to make such payment within 10 days after issuance of notice and demand will terminate the installment privilege. The imposition of interest on the addition to the net increase in tax as a result of the redetermination will be determined in the same manner as interest on the previously computed net increase in tax. Thus, no interest will be imposed on the amount of the addition to the net increase in tax prorated to installments not yet due unless the installment privilege is terminated under subsection (f) or (g) of section 4 of the Act. If a reduction in the net increase in tax results from a redetermination of tax for any taxable year to which the election applies, the entire amount of such reduction shall, in accordance with the provisions of section 6403 of the Code (relating to overpayment of installments), be prorated to the installments which are not yet due, resulting in a pro rata reduction in each of such installments. Where the redetermination does not involve adjustments pertaining to dealer reserve income, then any resulting deficiency pertaining to the year to which the election applies will be assessed and collected, in accordance with the applicable provisions of the Code (or corresponding provisions of prior law) without regard to any election made under the Act.

(f) *Periods of limitation*. Section 4(h) of the Act provides that where there is an extension of time for payment of tax under the provisions of section 4(b) of the Act, the running of the periods of limitation provided by section 6502 of the Code (or corresponding provisions of prior law) for collection of such tax is suspended for the period of time for which the extension is granted.

[T.D. 6490, 25 FR 8372, Sept. 1, 1960]

§ 1.9002–5 Special rules relating to interest.

(a) *In general*. Where an election is made under section 4(a) of the Act interest is computed under section 6601 of the Code (or corresponding provisions of prior law) on any increase in tax attributable to such election for each taxable year involved for the period from the last date prescribed for payment of the tax for such year (determined without regard to any extensions of time for filing the return) through the date preceding the date on which the election is made. Where the election under section 4(a) of the Act results in a decrease in tax for any year to which the election applies, interest is computed in accordance with section 6611 of the Code (or corresponding provisions of prior law) from the date of overpayment through the date preceding the date on which the election is made. Where there is a net increase in tax as a result of the election under section 4(a) of the Act, no interest shall be imposed on any underpayment (and no interest shall be paid on any overpayment) attributable to the dealer reserve income adjustment for any year to which the election applies for the period commencing with the date such election is made and ending on the date prescribed for filing the return (determined without regard to extensions of time) for the taxable year in which the election is made. This rule applies regardless of whether the election under section 4(b) of the Act is made. If there is no net increase in tax, interest on any underpayment

or overpayment attributable to the dealer reserve income adjustment for any taxable year to which the election applies for the period commencing with the date of the election shall be determined in accordance with §§ 301.6601–1 and 301.6611–1 of this chapter (Regulations on Procedure and Administration).

(b) *Installment period*—(1) *Where payment is not accelerated.* If the election under section 4(b) of the Act is made to pay the net increase in tax in installments, no interest will be imposed on such net increase in tax for the period beginning with the due date fixed under section 4(c) of the Act for the first installment payment and ending with the date fixed under such section for the last installment payment unless payment of the unpaid installments is accelerated under other provisions of the Act. See subsections (f) and (g) of section 4 of the Act.

(2) *Where payment is accelerated.* Where payment of the unpaid installments is accelerated because of the termination of the installment privilege, interest will be computed under section 6601 of the Code on the entire unpaid net increase in tax for the applicable period set forth below:

(i) In the case of acceleration under section 4(f) of the Act for reasons other than nonpayment of an installment, from the date of the notice and demand for payment of the unpaid tax to the date of payment; or

(ii) In the case of acceleration under section 4(g) of the Act for nonpayment of an installment, from the date fixed for payment of the installment to the date of payment.

When payment is accelerated under section 4(f) of the Act, however, no interest will be charged where payment of the unpaid installments is made within 10 days of issuance of the notice and demand for such payment.

[T.D. 6490, 25 FR 8373, Sept. 1, 1960]

§ 1.9002–6 Acquiring corporation.

Section 5(d) of the Act provides that for purposes of such Act in the case of the acquisition of the assets of a corporation by another corporation in a distribution or transfer described in section 381(a) of the Code the acquiring corporation shall be treated as if it were the distributor or transferor corporation.

[T.D. 6490, 25 FR 8373, Sept. 1, 1960]

§ 1.9002–7 Statute of limitations.

(a) *Extension of period for assessment and refund or credit.* Under section 5(e) of the Act, if an election is made to have the Act apply, and if the assessment of any deficiency, or the refund or credit of any overpayment attributable to the election, for any taxable year to which the Act applies was not prevented on June 21, 1959, by the operation of any law or rule of law (except as provided in paragraph (b) of this section, relating to closing agreements and compromises), but would be so prevented prior to September 1, 1961, the period within which such assessment, or such refund or credit, may be made with respect to such taxable year shall not expire prior to September 1, 1961. An election under either section 3 or 4 of the Act will be considered to be a consent to the extension of the period of limitation for purposes of assessment for any year to which the Act applies. Thus, for example, if, as the result of an election under section 4(a) of the Act, assessment of a deficiency for the taxable year 1955 was not prevented by the statute of limitations, a judicial decision that had become final, or otherwise, on June 21, 1959, but would (except for section 5(e) of the Act) be prevented on a later date, as for instance September 1, 1959, then for purposes of applying section 4 of the Act, assessment may be made at any time prior to September 1, 1961, with respect to such year if the taxpayer made an election under the Act prior to September 1, 1960. Section 5(e) of the Act will, in no event, operate to shorten the period of limitation otherwise applicable with respect to any taxable year.

(b) *Years closed by closing agreement or compromise.* For purposes of the Act, if the assessment of any deficiency or a refund or credit of any overpayment for any taxable year was not prevented on June 21, 1959, but is prevented on the date of an election under section 3 or 4 of the Act by the operation of the provisions of chapter 74 of the Code (relating to closing agreements and compromises), assessment, refund, or credit

will, nevertheless, be considered as being prevented on June 21, 1959.

[T.D. 6490, 25 FR 8373, Sept. 1, 1960]

§ 1.9002–8 Manner of exercising elections.

(a) *By whom election is to be made*—(1) *In general.* Generally, the taxpayer to whom the Act applies will exercise the elections provided therein. In the case of a partnership or a corporation electing under the provisions of subchapter S, chapter 1 of the Code, the election shall be exercised by the persons specified in subparagraphs (2) and (3) of this paragraph, respectively.

(2) *Partnerships.* In the case of a partnership, the election under section 3 or 4(a) of the Act shall be exercised by the partnership. If an election is made by the partnership under section 4(a) of the Act, any election under section 4(b) of the Act to pay the net increase in tax in installments shall be made by each partner separately. The determination as to whether the net increase in tax resulting from the election under section 4(a) of the Act exceeds $2,500 shall be made with reference to the increase or decrease in the tax of each partner attributable to the adjustment to his distributive share of the partnership income resulting from the election.

(3) *Subchapter S corporations.* In the case of an electing small business corporation under subchapter S, chapter 1 of the Code, the election under section 3 or 4(a) of the Act shall be made by such corporation. An election under section 4(b) of the Act to pay the net increase in tax in installments shall, to the extent the net increase in tax resulting from the election is attributable to adjustments to income for taxable years for which the corporation was not an electing small business corporation, be made by the corporation. The determination as to whether the net increase in tax for such taxable years exceeds $2,500 shall be made with reference to the increase or decrease in tax of the corporation. Any election under section 4(b) of the Act to pay the net increase in tax in installments shall, to the extent the increase in tax is attributable to years for which the corporation was an electing small business corporation, be made by the shareholders separately. The determination in such a case as to whether the net increase in tax for such taxable years exceeds $2,500 shall be made with reference to the increases or decreases in the tax of each shareholder attributable to the adjustments to taxable income of the electing small business corporation resulting from the election.

(b) *Time and manner of making elections*—(1) *In general.* Any election made under the Act shall be made by the taxpayers described in paragraph (a) of this section before September 1, 1960, by filing a statement with the district director with whom such taxpayer's income tax return for the taxable year in which the election is made is required to be filed. A copy of the statement of election shall be attached to and filed with such taxpayer's income tax return for such taxable year.

(2) *Election to have section 481 apply.* An election under section 3 of the Act shall be made in the form of a statement which shall include the following:

(i) A clear indication that an election is being made under section 3 of the Act;

(ii) Information sufficient to establish eligibility to make the election; and

(iii) The year of change as defined in section 3(b) of the Act.

An amended income tax return reflecting the increase or decrease in tax attributable to the election shall be filed for the year of change together with schedules showing how the tax was recomputed under section 481 of the Code. If income tax returns have been filed for any taxable years subsequent to the year of change, amended returns reflecting the proper treatment of dealer reserve income for such years shall also be filed. In the case of partnerships and electing small business corporations under subchapter S, chapter 1 of the Code, amended returns shall be filed by the partnership or electing small business corporation, as well as by the partners or shareholders, as the case may be. Any amended return shall be filed with the office of the district director with whom the taxpayer files his income tax return for the taxable year in which the election is made and, if practicable, on the same date the

statement of election is filed, but amended returns shall be filed in no event later than November 30, 1960, unless an extension of time is granted under section 6081 of the Code. Whenever the amended returns do not accompany the statement of election, a copy of the statement shall be submitted with the amended returns.

(3) *Election not to have section 481 apply.* An election under section 4(a) of the Act shall be made in the form of a statement which shall include the following:

(i) A clear indication that an election is being made under section 4(a) of the Act;

(ii) Information sufficient to establish eligibility to make the election; and

(iii) The taxable years to which the election applies.

Amended income tax returns reflecting the increase or decrease in tax attributable to the election shall be filed for the taxable years to which the election applies. If income tax returns have been filed for any subsequent taxable years, amended returns reflecting the proper treatment of dealer reserve income for such years shall also be filed. In the case of partnerships and electing small business corporations under subchapter S, chapter 1 of the Code, amended returns shall be filed by the partnership or electing small business corporation, as well as by the partners or shareholders, as the case may be. Any amended return shall be filed with the office of the district director with whom the taxpayer files his income tax return for the taxable year in which the election is made and, if practicable, on the same date the statement of election is filed, but amended returns shall be filed in no event later than November 30, 1960, unless an extension of time is granted under section 6081 of the Code. Whenever the amended returns do not accompany the statement of election, a copy of the statement shall be submitted with the amended return.

(4) *Election to pay tax in installments.* (i) Except as otherwise provided in subdivision (ii) of this subparagraph, if the taxpayer making the election under section 4(a) of the Act also desires to make the election under section 4(b) of the Act to pay the increase in tax in installments, then the statement of election shall include the following additional information:

(*a*) A clear indication that an election is also being made under section 4(b) of the Act;

(*b*) A summary of the total increases and decreases in tax, together with interest thereon, in sufficient detail to establish eligibility to make the election; and

(*c*) The number of annual installments in which the taxpayer elects to pay the net increase in tax.

(ii) Where a partnership or electing small business corporation under subchapter S, chapter 1 of the Code, has made an election under section 4(a) of the Act, and any partner or shareholder, as the case may be, desires to make an election under section 4(b) of the Act, a statement of election shall be filed by such partner or shareholder containing the following information:

(*a*) A clear indication that an election is being made under section 4(b) of the Act;

(*b*) A summary of the total increases and decreases in tax, together with interest thereon, of such partner or shareholder in sufficient detail to establish eligibility to make the election;

(*c*) The number of annual installments in which the partner or shareholder elects to pay the net increase in tax; and

(*d*) The office of the district director and the date on which the election under section 4(a) of the Act was filed by such partnership or corporation.

The statement of election under section 4(b) of the Act shall be accompanied by a copy of the statement of election under section 4(a) of the Act made by the partnership or electing small business corporation under subchapter S, chapter 1 of the Code, as the case may be.

(c) *Effect of election.* An election made under section 3 or 4 of the Act shall become irrevocable on September 1, 1960, and shall be binding on the taxpayer for all taxable years to which it applies.

[T.D. 6490, 25 FR 8373, Sept. 1, 1960]

PUBLIC DEBT AND TAX RATE EXTENSION ACT OF 1960

AUTHORITY: Sections 1.9003 to 1.9003–5 issued under sec. 302(c), 74 Stat. 292, as amended; 26 U.S.C. 613 note.

§ 1.9003 Statutory provisions; section 4 of the Act of September 14, 1960 (Pub. L. 86–781, 74 Stat. 1017).

SEC. 4. Subsection (c) of section 302 of the Public Debt and Tax Rate Extension Act of 1960 (Pub. L. 86–564; 74 Stat. 293) is amended to read as follows:

(c) *Effective date*—(1) *In general.* Except as provided in paragraph (2), the amendments made by subsections (a) and (b) shall be applicable only with respect to taxable years beginning after December 31, 1960.

(2) *Calcium carbonates, etc.*—(A) *Election for past years.* In the case of calcium carbonates or other minerals when used in making cement, if an election is made by the taxpayer under subparagraph (C):

(i) The amendments made by subsection (b) shall apply to taxable years with respect to which such election is effective, and

(ii) Provisions having the same effect as the amendments made by subsection (b) shall be deemed to be included in the Internal Revenue Code of 1939 and shall apply to taxable years with respect to which such election is effective in lieu of the corresponding provisions of such Code.

(B) *Years to which applicable.* An election made under subparagraph (C) to have the provisions of this paragraph apply shall be effective for all taxable years beginning before January 1, 1961, in respect of which:

(i) The assessment of a deficiency,

(ii) The refund or credit of an overpayment, or

(iii) The commencement of a suit for recovery of a refund under section 7405 of the Internal Revenue Code of 1954,

is not prevented on the date of the enactment of this paragraph by the operation of any law or rule of law. Such election shall also be effective for any taxable year beginning before January 1, 1961, in respect of which an assessment of a deficiency has been made but not collected on or before the date of the enactment of this paragraph.

(C) *Time and manner of election.* An election to have the provisions of this paragraph apply shall be made by the taxpayer on or before the 60th day after the date of publication in the FEDERAL REGISTER of final regulations issued under authority of subparagraph (F), and shall be made in such form and manner as the Secretary of the Treasury or his delegate shall prescribe by regulations. Such election, if made, may not be revoked.

(D) *Statutes of limitation.* Notwithstanding any other law, the period within which an assessment of a deficiency attributable to the application of the amendments made by subsection (b) may be made with respect to any taxable year to which such amendments apply under an election made under subparagraph (C), and the period within which a claim for refund or credit of an overpayment attributable to the application of such amendments may be made with respect to any such taxable year, shall not expire prior to one year after the last day for making an election under subparagraph (C). An election by a taxpayer under subparagraph (C) shall be considered as a consent to the application of the provisions of this subparagraph.

(E) *Terms; applicability of other laws.* Except where otherwise distinctly expressed or manifestly intended, terms used in this paragraph shall have the same meaning as when used in the Internal Revenue Code of 1954 (or corresponding provisions of the Internal Revenue Code of 1939) and all provisions of law shall apply with respect to this paragraph as if this paragraph were a part of such Code (or corresponding provisions of the Internal Revenue Code of 1939).

(F) *Regulations.* The Secretary of the Treasury or his delegate shall prescribe such regulations as may be necessary to carry out the provisions of this paragraph.

[T.D. 6492, 25 FR 8904, Sept. 16, 1960]

§ 1.9003–1 Election to have the provisions of section 613(c) (2) and (4) of the 1954 Code, as amended, apply for past years.

(a) *In general.* Section 4 of the Act of September 14, 1960 (Pub. L. 86–781, 74 Stat. 1017), amended section 302(c) of the Public Debt and Tax Rate Extension Act of 1960 to permit certain taxpayers for taxable years beginning before January 1, 1961, to apply the provisions of section 302(b) of that Act. Section 302(b) of the Act amended section 613(c) (2) and (4) of the Internal Revenue Code of 1954 to read in part as follows:

SEC. 613. *Percentage Depletion.* * * *

(c) *Definition of gross income from property.* For purposes of this section:

* * * * *

(2) *Mining.* The term ''mining'' includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto), and so much of the transportation of ores or minerals (whether or not by common carrier) from the

point of extraction from the ground to the plants or mills in which such treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary or his delegate finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

* * * * *

(4) *Treatment processes considered as mining*. The following treatment processes where applied by the mine owner or operator shall be considered as mining to the extent they are applied to the ore or mineral in respect of which he is entitled to a deduction for depletion under section 611:

* * * * *

(F) In the case of calcium carbonates and other minerals when used in making cement—all processes (other than preheating of the kiln feed) applied prior to the introduction of the kiln feed into the kiln, but not including any subsequent process;

(b) *Election*. Under section 302(c)(2) of the Act, the taxpayer, in the case of calcium carbonates or other minerals when used by him in making cement, may elect to apply the provisions of section 613(c) (2) and (4) of the 1954 Code as amended in lieu of the corresponding provisions of prior law. The taxpayer must make the election in accordance with §1.9003–4 on or before November 15, 1960, and the election shall become irrevocable on November 15, 1960.

(c) *Years to which the election is applicable*. If the election described in paragraph (b) of this section is made by the taxpayer, the provisions of section 613(c) (2) and (4) as amended by section 302(b) of the Act apply to all taxable years beginning before January 1, 1961, in respect of which:

(1) The assessment of any deficiency,

(2) Refund or credit of any overpayment,

(3) Commencement of a suit for recovery of a refund under section 7405 of the Internal Revenue Code of 1954,

is not prevented on September 14, 1960, by the operation of any law or rule of law. The election also applies to taxable years beginning before January 1, 1961, in respect of which an assessment of a deficiency has been made but not collected on or before September 14, 1960.

[T.D. 6492, 25 FR 8905, Sept. 16, 1960]

§ 1.9003–2 Effect of election.

(a) *In general*. If a taxpayer makes the election described in paragraph (b) of §1.9003–1, he shall be deemed to have consented to the application of section 302(b) of the Act with respect to all taxable years to which the election applies. Thus, subparagraph (F) of section 613(c)(4) of the Internal Revenue Code of 1954 as amended must be applied in determining gross income from mining for the taxable years to which the election applies (including years subject to the Internal Revenue Code of 1939) whether or not the taxpayer is litigating the issue. Further, the election shall apply to all calcium carbonates or other minerals mined and used by the taxpayer in making cement.

(b) *Effect on gross income from mining*. The election is only determinative of what constitutes ''mining'' for purposes of computing percentage depletion and has no effect on the method employed in determining the amount of gross income from mining. In applying the election to the years affected there shall be taken into account the effect that any adjustments resulting from the election shall have on other items affected thereby, such as charitable contributions, foreign tax credit, net operating loss, and the effect that adjustments to any such items shall have on other taxable years. The provisions of section 302(b) of the Act are applicable with respect to taxable years subject to the Internal Revenue Code of 1939 for purposes of applying sections 450 and 453 of that Code.

[T.D. 6492, 25 FR 8905, Sept. 16, 1960]

§ 1.9003–3 Statutes of limitation.

Under section 302(c)(2) of the Act, the period within which the assessment of any deficiency or the credit or refund of any overpayment attributable to the election may be made shall not expire sooner than 1 year after November 15, 1960. Thus, if assessment of a deficiency or credit or refund of an overpayment, whichever is applicable, is not prevented on September 14, 1960, the time for making assessment or credit or refund shall not expire for at least 1 year after November 15, 1960, notwithstanding any other provision of law to the contrary. Even though assessment of a deficiency is prevented on September 14, 1960, if commencement of a suit for recovery of a refund under section 7405 of the Code may be made on such date, then any deficiency resulting from the election may be assessed

at any time within 1 year after November 15, 1960. If the taxpayer makes the election he shall be deemed to have consented to the application of the provisions of section 302(c)(2) of the Act extending the time for assessing a deficiency attributable to the election. Section 302(c)(2) of the Act does not shorten the period of limitations otherwise applicable. An agreement may be entered into under section 6501(c)(4) of the Code and corresponding provisions of prior law to extend the period for assessment.

[T.D. 6492, 25 FR 8905, Sept. 16, 1960]

§ 1.9003–4 Manner of exercising election.

(a) *By whom election is to be made.* Generally, the taxpayer whose tax liability is affected by the election shall make the election. In the case of a partnership, or a corporation electing under the provisions of subchapter S, chapter 1 of the Code, the election shall be exercised by the partnership or such corporation, as the case may be.

(b) *Time and manner of making election.* The election shall be made on or before November 15, 1960, by filing a statement with the district director with whom the taxpayer's income tax return for the taxable year in which the election is made is required to be filed. The statement shall include the following:

(1) A clear indication that an election is being made under section 302(c)(2) of the Act, and

(2) The taxable years to which the election applies.

Amended income tax returns reflecting any increase or decrease in tax attributable to the election shall be filed for the taxable years to which the election applies. In the case of partnerships and electing small business corporations under subchapter S, chapter 1 of the Code, amended returns shall be filed by the partnership or electing small business corporations, as well as by the partners or shareholders, as the case may be. Any amended return shall be filed with the office of the district director with whom the taxpayer files his income tax return for the taxable year in which the election is made and, if practicable, on the same date the statement of election is filed, but amended returns shall be filed in no event later than February 28, 1961, unless an extension of time is granted under section 6081 of the Code. Whenever the amended returns do not accompany the statement of election, a copy of the statement shall be submitted with the amended returns. The amended returns shall be accompanied by payment of the additional tax (together with interest thereon) resulting from the election.

[T.D. 6492, 25 FR 8905, Sept. 16, 1960]

§ 1.9003–5 Terms; applicability of other laws.

All other terms which are not otherwise specifically defined shall have the same meaning as when used in the Code (or the corresponding provisions of prior law) except where otherwise distinctly expressed or manifestly intended to the contrary. Further, all provisions of law contained in the Code (or the corresponding provisions of prior law) shall apply to the extent that they can apply. Thus, all of the provisions of subtitle F of the Code and the corresponding provisions of prior law shall apply to the extent they can apply, including the provisions of law relating to assessment, collection, credit or refund, and limitations. For purposes of this section and §§ 1.9003–1 to 1.9003–4, inclusive, the term ''Act'' means the Public Debt and Tax Rate Extension Act of 1960 as amended (74 Stat. 293, 1018).

[T.D. 6492, 25 FR 8905, Sept. 16, 1960]

CERTAIN BRICK AND TILE CLAY, FIRE CLAY, AND SHALE; REGULATIONS UNDER THE ACT OF SEPTEMBER 26, 1961

§ 1.9004 Statutory provisions; the Act of September 26, 1961 (Pub. L. 87–312, 75 Stat. 674).

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) *Election for past years.* In the case of brick and tile clay, fire clay, or shale used by the mineowner or operator in the manufacture of building or paving brick, drainage and roofing tile, sewer pipe, flower pots, and kindred products (without regard to the applicable rate of percentage depletion), if an election is made

under subsection (c), for the purpose of applying section 613(c) of the Internal Revenue Code of 1954 (and corresponding provision of the Internal Revenue Code of 1939) for each of the taxable years with respect to which the election is effective:

(1) Gross income from the property shall be 50 per centum of the amount for which the manufactured products are sold during the taxable year except that with respect to such manufactured products, gross income from the property shall not exceed an amount equal to $12.50 multiplied by the number of short tons used in the manufactured products sold during the taxable year, and

(2) For purposes of computing the 50 per centum limitation under section 613(a) of the Internal Revenue Code of 1954 (or the corresponding provision of the Internal Revenue Code of 1939), the taxable income from the property (computed without allowance for depletion) shall be 50 per centum of the taxable income from the manufactured products sold during the taxable year (computed without allowance for depletion).

(b) *Years to which applicable.* An election made under subsection (c) to have the provisions of this section apply shall be effective for all taxable years beginning before January 1, 1961, in respect of which:

(1) The assessment of a deficiency,

(2) The refund or credit of an overpayment, or

(3) The commencement of a suit for recovery of a refund under section 7405 of the Internal Revenue Code of 1954, is not prevented on the date of the enactment of this Act by the operation of any law or rule of law. Such election shall also be effective for any taxable year beginning before January 1, 1961, in respect of which an assessment of a deficiency has been made but not collected on or before the date of the enactment of this Act.

(c) *Time and manner of election.* An election to have the provisions of this section apply shall be made by the taxpayer on or before the sixtieth day after the date of publication in the FEDERAL REGISTER of final regulations issued under authority of subsection (f), and shall be made in such form and manner as the Secretary of the Treasury or his delegate shall prescribe by regulations. Such election, if made, may not be revoked.

(d) *Statutes of limitation.* Notwithstanding any other law, the period within which an assessment of a deficiency attributable to the election under subsection (c) may be made with respect to any taxable year for which such election is effective, and the period within which a claim for refund or credit of an overpayment attributable to the election under such subsection may be made with respect to any such taxable year, shall not expire prior to one year after the last day for making an election under subsection (c). An election by a taxpayer under subsection (c) shall be considered as a consent to the application of the provisions of this subsection.

(e) *Terms; applicability of other laws.* Except where otherwise distinctly expressed or manifestly intended, terms used in this section shall have the same meaning as when used in the Internal Revenue Code of 1954 (or corresponding provisions of the Internal Revenue Code of 1939) and all provisions of law shall apply with respect to this section as if this section were a part of such Code (or corresponding provisions of the Internal Revenue Code of 1939).

(f) *Regulations.* The Secretary of the Treasury or his delegate shall prescribe such regulations as may be necessary to carry out the provisions of this section.

(75 Stat. 674; 26 U.S.C. 613 note)

[T.D. 6575, 26 FR 9632, Oct. 12, 1961]

§ 1.9004–1 Election relating to the determination of gross income from the property for taxable years beginning prior to 1961 in the case of certain clays and shale.

(a) *In general.* The Act of September 26, 1961 (Pub. L. 87–312, 75 Stat. 674), provides that certain taxpayers may elect to apply the provisions thereof to all taxable years beginning before January 1, 1961, with respect to which the election is effective. The Act prescribes special rules for the application of section 613 (a) and (c) of the Internal Revenue Code of 1954 (and corresponding provisions of the Internal Revenue Code of 1939) in the case of shale and certain clays used by the mine owner or operator in the manufacture of certain clay and shale products.

(b) *Election.* The election to apply the provisions of the Act may be made only by a mine owner or operator with respect to brick and tile clay, fire clay, or shale which he mined and used in the manufacture of building or paving brick, drainage and roofing tile, sewer pipe, flower pots, and kindred products. The election must be made in accordance with § 1.9004–4 on or before December 11, 1961, and the election shall become irrevocable on December 11, 1961.

(c) *Years to which the election is applicable.* If the election described in paragraph (b) of this section is made by the taxpayer, the provisions of the Act shall be effective for all taxable years beginning before January 1, 1961, in respect of which the:

(1) Assessment of a deficiency,

(2) Refund or credit of an overpayment, or

(3) Commencement of a suit for recovery of a refund under section 7405 of the Internal Revenue Code of 1954,

is not prevented on September 26, 1961, by the operation of any law or rule of law. The election is also effective for any taxable year beginning before January 1, 1961, in respect of which an assessment of a deficiency has been made but not collected on or before September 26, 1961.

(75 Stat. 674; 26 U.S.C. 613 note)

[T.D. 6575, 26 FR 9632, Oct. 12, 1961]

§ 1.9004–2 Effect of election.

(a) *In general.* If a taxpayer makes the election described in paragraph (b) of § 1.9004–1, he shall be deemed to have consented to the application of the Act with respect to all the clay and shale described in that paragraph for all taxable years for which the election is effective whether or not the taxpayer is litigating the issue for any of such years. Thus, in applying section 613 of the Internal Revenue Code of 1954 (and corresponding provisions of the Internal Revenue Code of 1939) to those years:

(1) The ''gross income from the property'' for purposes of section 613(c) of the Internal Revenue Code of 1954 (and corresponding provisions of the Internal Revenue Code of 1939) shall be 50 percent of the amount for which the mineowner or operator sold, during the taxable year, the building or paving brick, drainage and roofing tile, sewer pipe, flower pots, and kindred products manufactured from the clay and shale described in paragraph (b) of § 1.9004–1, but shall not exceed an amount equal to $12.50 multiplied by the number of short tons of all such clay or shale mined and used by the mineowner or operator in the manufacture of the products sold during the taxable year; and

(2) The ''taxable income from the property'' (computed without allowance for depletion) for purposes of section 613(a) of the Internal Revenue Code of 1954 (and corresponding provisions of the Internal Revenue Code of 1939) shall be 50 percent of the taxable income from the manufactured products sold during the taxable year (computed without allowance for depletion).

(b) *Effect on depletion rates and other items.* The election shall have no effect on the applicable rate of percentage depletion for the taxable years to which the election is effective. In applying the election to the years affected there shall be taken into account the effect that any adjustments resulting from the election shall have on other items affected thereby, such as charitable contributions, foreign tax credit, net operating loss, and the effect that adjustments to any such items shall have on other taxable years. The provisions of the Act are applicable with respect to taxable years subject to the Internal Revenue Code of 1939 for purposes of applying sections 450 and 453 of that Code.

(75 Stat. 674; 26 U.S.C. 613 note)

[T.D. 6575, 26 FR 9632, Oct. 12, 1961]

§ 1.9004–3 Statutes of limitation.

The period within which the assessment of any deficiency or the credit or refund of any overpayment attributable to the election may be made shall not expire sooner than one year after December 11, 1961. Thus, if assessment of a deficiency or credit or refund of an overpayment, whichever is applicable, is not prevented on September 26, 1961, the time for making assessment or credit or refund shall not expire for at least one year after December 11, 1961, notwithstanding any other provision of law to the contrary. Even though assessment of a deficiency is prevented on September 26, 1961, if commencement of a suit for recovery of a refund under section 7405 of the Internal Revenue Code of 1954 may be made on such date, then any deficiency resulting from the election may be assessed at any time within 1 year after December 11, 1961. If a taxpayer makes the election, he shall be deemed to have consented to the application of the provisions of the Act extending the time for assessing a deficiency attributable to the election. The Act does not shorten the periods of limitation otherwise applicable. An agreement may be entered into under section 6501(c)(4) of the Internal Revenue Code of 1954 and corresponding provisions of

prior law to extend the period for assessment.

(75 Stat. 674; 26 U.S.C. 613 note)

[T.D. 6575, 26 FR 9632, Oct. 12, 1961]

§ 1.9004–4 Manner of exercising election.

(a) *By whom election is to be made.* Generally, the taxpayer whose tax liability is affected by the election shall make the election. In the case of a partnership, or a corporation electing under the provisions of subchapter S, chapter 1 of the Internal Revenue Code of 1954, the election shall be exercised by the partnership or such corporation, as the case may be.

(b) *Time and manner of making election.* The election shall be made on or before December 11, 1961, by filing a statement with the district director with whom the taxpayer's income tax return for the taxable year in which the election is made is required to be filed. The statement shall include the following:

(1) A clear indication that an election is being made under the Act, and

(2) The taxable years to which the election applies.

Amended income tax returns reflecting any increase or decrease in tax attributable to the election shall be filed for the taxable years to which the election applies. In the case of partnerships and electing small business corporations under subchapter S, chapter 1 of the Internal Revenue Code of 1954, amended returns shall be filed by the partnership or electing small business corporation, as well as by the partners or shareholders, as the case may be. Any amended return shall be filed with the office of the district director with whom the taxpayer files his income tax return for the taxable year in which the election is made and, if practicable, on the same date the statement of election is filed, but amended returns shall be filed in no event later than March 31, 1962, unless an extension of time is granted under section 6081 of the Internal Revenue Code of 1954. Whenever the amended returns do not accompany the statement of election, a copy of the statement shall be submitted with the amended returns. The amended returns shall be accompanied by payment of the additional tax (together with interest thereon) resulting from the election.

(75 Stat. 674, 26 U.S.C. 613 note)

[T.D. 6575, 26 FR 9633, Oct. 12, 1961]

§ 1.9004–5 Terms; applicability of other laws.

All other terms which are not otherwise specifically defined shall have the same meaning as when used in the Internal Revenue Code of 1954 (or the corresponding provisions of prior law) except where otherwise distinctly expressed or manifestly intended to the contrary. Further, all provisions of law contained in the Code (or the corresponding provisions of prior law) shall apply to the extent that they can apply. Thus, all the provisions of subtitle F of the Code (and the corresponding provisions of prior law) shall apply to the extent they can apply, including the provisions of law relating to assessment, collection, credit or refund, and limitations. For purposes of this section and §§ 1.9004–1 to 1.9004–4, inclusive, the term ''Act'' means the Act of September 26, 1961 (Pub. L. 87–312, 75 Stat. 674).

(75 Stat. 674, 26 U.S.C. 613 note)

[T.D. 6575, 26 FR 9633, Oct. 12, 1961]

QUARTZITE AND CLAY USED IN PRODUCTION OF REFRACTORY PRODUCTS; ELECTION FOR PRIOR TAXABLE YEARS

§ 1.9005 Statutory provisions; section 2 of the Act of September 26, 1961 (Pub. L. 87–321, 75 Stat. 683).

SEC. 2. *Election for quartzite and clay used in the production of refractory products*—(a) *Election for past years.* If an election is made under subsection (c), in the case of quartzite and clay used by the mine owner or operator in the production of refractory products, for the purpose of applying section 613(c) of the Internal Revenue Code of 1954 (and corresponding provisions of the Internal Revenue Code of 1939) for each of the taxable years with respect to which the election is effective:

(1) The term ''ordinary treatment processes'' shall include crushing, grinding, and separating the mineral from waste, but shall not include any subsequent process; and

(2) The gross income from mining for each short ton of such quartzite or clay used in the production of all refractory products sold

during the taxable year shall be equal to 87½ percent of the lesser of:

(A) The average lowest published or advertised price, or

(B) The average lowest actual selling price, at which, during the taxable year, the mine owner or operator offered to sell, or sold, such quartzite or clay (in the form and condition of such products after the application of only the processes described in paragraph (1) and before transportation from the plant in which such processes were applied). For purposes of this paragraph, exceptional, unusual, or nominal sales or selling prices shall be disregraded. If the mine owner or operator makes no sales of, or makes only exceptional, unusual, or nominal sales of, such quartzite or clay after application of only the processes described in paragraph (1), then in lieu of the price provided for in subparagraph (A) or (B) there shall be used the average lowest recognized selling price for the taxable year for such quartzite or clay in the marketing area of the mine owner or operator published in a trade journal or other industry publication.

(b) *Years to which applicable.* An election made under subsection (c) to have the provisions of this section apply shall be effective on and after January 1, 1951, for all taxable years beginning before January 1, 1961, in respect of which:

(1) The assessment of a deficiency,

(2) The refund or credit of an overpayment, or

(3) The commencement of a suit for recovery of a refund under section 7405 of the Internal Revenue Code of 1954,

is not prevented on the date of the enactment of this Act by the operation of any law or rule of law. Such election shall also be effective on and after January 1, 1951, for any taxable year beginning before January 1, 1961, in respect of which an assessment of a deficiency has been made but not collected on or before the date of the enactment of this Act.

(c) *Time and manner of election.* An election to have the provisions of this section apply shall be made by the taxpayer on or before the 60th day after the date of publication in the FEDERAL REGISTER of final regulations issued under authority of subsection (f), and shall be made in such form and manner as the Secretary of the Treasury or his delegate shall prescribe by regulations. Such election, if made, may not be revoked.

(d) *Statutes of limitations.* Notwithstanding any other law, the period within which an assessment of a deficiency attributable to the election under subsection (c) may be made with respect to any taxable year for which such election is effective, and the period within which a claim for refund or credit of an overpayment attributable to the election under such subsection may be made with respect to any such taxable year, shall not expire prior to one year after the last day for making an election under subsection (c). An election by a taxpayer under subsection (c) shall be considered as a consent to the application of the provisions of this subsection.

(e) *Terms; applicability of other laws.* Except where otherwise distinctly expressed or manifestly intended, terms used in this section shall have the same meaning as when used in the Internal Revenue Code of 1954 (or corresponding provisions of the Internal Revenue Code of 1939) and all provisions of law shall apply with respect to this section as if this section were a part of such Code (or corresponding provisions of the Internal Revenue Code of 1939).

(f) *Regulations.* The Secretary of the Treasury or his delegate shall prescribe such regulations as may be necessary to carry out the provisions of this section.

(Sec. 2(f), 75 Stat. 683; 26 U.S.C. 613 note)

[T.D. 6583, 26 FR 12077, Dec. 16, 1961]

§ 1.9005–1 Election relating to the determination of gross income from the property for taxable years beginning prior to 1961 in the case of clay and quartzite used in making refractory products.

(a) *In general.* Section 2 of the Act of September 26, 1961 (Pub. L. 87–321, 75 Stat. 683), provides that certain taxpayers may elect to apply the provisions of such section to all taxable years beginning before January 1, 1961, with respect to which the election is effective. Section 2 of the Act prescribes special rules for the application of section 613(c) of the Internal Revenue Code of 1954 (and corresponding provisions of the Internal Revenue Code of 1939) in the case of quartzite and clay used by the mine owner or operator in the production of refractory products.

(b) *Election.* The election to apply the provisions of section 2 of the Act may be made only in the case of quartzite and clay used in the production of products generally recognized as refractory products by the refractories industry. Examples of such products are clay firebrick, silica brick, and refractory bonding mortars. The election may be made only by a taxpayer who both mined the clay or quartzite and used it in the production of refractory products. The election must be made in accordance with §1.9005–4 on or before February 14, 1962, and the election shall become irrevocable on that date.

(c) *Years to which the election is applicable.* If the election described in paragraph (b) of this section is made by the taxpayer, the provisions of section 2 of the Act shall be effective on and after January 1, 1951, for all taxable years beginning before January 1, 1961, in respect of which the:

(1) Assessment of a deficiency,

(2) Refund or credit of an overpayment, or

(3) Commencement of a suit for recovery of a refund under section 7405 of the Internal Revenue Code of 1954,

was not prevented on September 26, 1961, by the operation of any law or rule of law. The election is also effective on and after January 1, 1951, for any taxable year beginning before January 1, 1961, in respect of which an assessment of a deficiency has been made but not collected on or before September 26, 1961.

(Sec. 2(f), 76 Stat. 683, 26 U.S.C. 613 note)

[T.D. 6583, 26 FR 12078, Dec. 16, 1961]

§ 1.9005–2 Effect of election.

(a) *In general.* If a taxpayer makes the election described in paragraph (b) of §1.9005–1, he shall be deemed to have consented to the application of section 2 of the Act with respect to all the clay and quartzite described in that paragraph for all taxable years for which the election is effective whether or not the taxpayer is litigating the issue for any of such years. Thus, in applying section 613(c) of the Internal Revenue Code of 1954 (and corresponding provisions of the Internal Revenue Code of 1939) to those years:

(1) The term ''ordinary treatment processes'' shall include crushing, grinding, and separating the mineral from waste, but shall not include any subsequent process; and

(2) The gross income from mining for each short ton of quartzite or clay mined by the taxpayer and used by him in the production of all refractory products sold during the taxable year shall be equal to 87½ percent of the lesser of:

(i) The average lowest published or advertised price, or

(ii) The average lowest actual selling price at which the mine owner or operator offered to sell or sold any such quartzite or clay during the taxable year.

(b) *Rules for applying paragraph (a) of this section.* (1) The price described in paragraph (a)(2) of this section and any price described in this paragraph shall be determined with reference to quartzite or clay in the form and condition of such products after the application of only the processes described in paragraph (a)(1) of this section and before transportation from the plant in which such processes were applied.

(2) If quartzite and clay were mined and used by the taxpayer in the production of refractory products, a separate price shall be used with respect to each mineral.

(3) There shall be used for each mineral the lowest price at which it was sold or offered for sale by the taxpayer during the taxable year. Thus, only one price shall be used with respect to each mineral regardless of variations in type or grade.

(4) For purposes of this paragraph, exceptional, unusual, or nominal sales of quartzite or clay shall be disregarded. Thus, for example, if the taxpayer made an accommodation sale during the taxable year at other than the regular price, such sale is to be disregarded.

(5) If the taxpayer made no sales during the taxable year of quartzite or clay in the form and condition described in subparagraph (1) of this paragraph, or if his sales were exceptional, unusual, or nominal, there shall be used the lowest recognized selling price for the taxpayer's marketing area for quartzite or clay (of the same grade and type as that used by him) which was published for the taxable year in a trade journal or other industry publication.

(6) If subparagraph (5) of this paragraph does not apply for the reason that there is no recognized selling price published in a trade journal or other industry publication for the taxpayer's marketing area, there shall be used the lowest price at which quartzite or clay comparable to that used by the taxpayer was sold or offered for sale during the taxable year in that area by other producers similarly circumstanced as the taxpayer or, if appropriate, the lowest price paid by

the taxpayer for purchased quartzite or clay.

(7) If the lowest selling price otherwise applicable under the preceding provisions of this paragraph fluctuated during the taxable year, the two or more lowest selling prices shall be averaged according to the number of days during the taxable year that each such price was in effect.

(c) The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example 1. (i) *Facts.* Taxpayer A, a calendar year taxpayer, mined quartzite and clay and used them in the production of recognized refractory products. During the taxable year, the lowest price for which A sold clay after the application of crushing and grinding was $13.75 per short ton. He also sold some ground clay of a different type at $20.00 per short ton. A sold quartzite after the application of crushing and grinding for various prices, depending upon type, ranging from $14.00 per short ton to $20.00 per short ton. During the taxable year, the prices for the various types of ground clay and quartzite did not change. None of the sales by A of ground clay or quartzite were exceptional, unusual, or nominal.

(ii) *Determination of gross income from mining.* If A makes the election described in paragraph (b) of §1.9005–1, the gross income from mining per short ton of clay mined by A and used in the production of refractory products sold during the taxable year is $12.03 (87½ percent of $13.75), and the gross income from mining per short ton of quartzite mined by A and used in the production of refractory products sold during the taxable year is $12.25 (87½ percent of $14.00). To determine his gross income from mining, A must compute the sum of:

(a) $12.03 multiplied by the number of short tons of clay which were mined by A (whether or not during the taxable year) and which were used by A in the production of refractory products (refractory bonding mortar, fire brick, etc.) sold during the taxable year; plus

(b) $12.25 multiplied by the number of short tons of quartzite which were mined by A (whether or not during the taxable year) and which were used by A in the production of refractory products sold during the taxable year.

Example 2. Assume the same facts as in example (1) except that on October 1 of the taxable year A's lowest price for clay after the application of crushing and grinding increased to $14.40 per short ton. In this case, the average lowest price for which A sold ground clay during the taxable year must be determined by taking into account the price adjustment of October 1. Under these circumstances, the average lowest price for the ground clay would be $13.91, that is $13.75 × 273/365 plus $14.40 × 92/365.

(d) *Effect on depletion rates and other items.* The election shall have no effect on the applicable rate of percentage depletion for the taxable years for which the election is effective. In applying the election to the years affected there shall be taken into account the effect that any adjustments resulting from the election shall have on other items affected thereby, such as charitable contributions, foreign tax credit, net operating loss, and the effect that adjustments to any such items shall have on other taxable years. The provisions of section 2 of the Act are applicable with respect to taxable years subject to the Internal Revenue Code of 1939 for purposes of applying sections 450 and 453 of that Code. The election shall have no effect on the determination of the treatment processes which are to be considered as mining or on the determination of gross income from mining for any taxable year beginning after December 31, 1960.

(Sec. 2(f), 75 Stat. 683; 26 U.S.C. 613 note)

[T.D. 6583, 26 FR 12078, Dec. 16, 1961]

§ 1.9005–3 Statutes of limitation.

Notwithstanding any provision of law to the contrary, the period within which the assessment of any deficiency attributable to the election may be made, or within which the credit or refund of any overpayment attributable to the election may be made, shall not expire sooner than one year after the last day for making the election. Thus, if assessment of a deficiency or credit or refund of an overpayment, whichever is applicable, was not prevented on September 26, 1961, the time for making assessment or credit or refund shall not expire for at least one year after the last day for making the election. Even though assessment of a deficiency was prevented on September 26, 1961, if commencement of a suit for recovery of a refund under section 7405 of the Internal Revenue Code of 1954 may have been made on such date, then any deficiency resulting from the election may be assessed at any time within one year after the last day for making the

election. If a taxpayer makes the election, he shall be deemed to have consented to the application of the provisions of section 2 of the Act extending the time for assessing a deficiency attributable to the election. Section 2 of the Act does not shorten the period of limitations otherwise applicable. An agreement may be entered into under section 6501(c)(4) of the Internal Revenue Code of 1954 and corresponding provisions of prior law to extend the period for assessment.

(Sec. 2(f), 75 Stat. 683; 26 U.S.C. 613 note)

[T.D. 6583, 26 FR 12079, Dec. 16, 1961]

§ 1.9005–4 Manner of exercising election.

(a) *By whom election is to be made.* Generally, the taxpayer whose tax liability is affected by the election shall make the election. In the case of a partnership, or a corporation electing under the provisions of subchapter S, chapter 1 of the Internal Revenue Code of 1954, the election shall be exercised by the partnership or such corporation, as the case may be.

(b) *Time and manner of making election.* The election shall be made on or before February 14, 1962, by filing a statement with the district director with whom the taxpayer's income tax return for the taxable year in which the election is made is required to be filed. The statement shall include the following:

(1) A clear indication that an election is being made under section 2 of the Act, and

(2) The taxable years to which the election applies.

Amended income tax returns reflecting any increase or decrease in tax attributable to the election shall be filed for the taxable years to which the election applies. In the case of partnerships and electing small business corporations under subchapter S, chapter 1 of the Internal Revenue Code of 1954, amended returns shall be filed by the partnership or electing small business corporation, as well as by the partners or shareholders, as the case may be. Any amended return shall be filed with the office of the district director with whom the taxpayer files his income tax return for the taxable year in which the election is made, and, if practicable, on the same date the statement of election is filed, but amended returns shall be filed in no event later than May 31, 1962, unless an extension of time is granted under section 6081 of the Internal Revenue Code of 1954. Whenever the amended returns do not accompany the statement of election, a copy of the statement shall be submitted with the amended returns. The amended returns shall be accompanied by payment of the additional tax (together with interest thereon) resulting from the election.

(Sec. 2(f), 75 Stat. 683; 26 U.S.C. 613 note)

[T.D. 6583, 26 FR 12079, Dec. 16, 1961]

§ 1.9005–5 Terms; applicability of other laws.

All other terms which are not otherwise specifically defined shall have the same meaning as when used in the Internal Revenue Code of 1954 (or the corresponding provisions of prior law) except where otherwise distinctly expressed or manifestly intended to the contrary. Further, all provisions of law contained in the Code (or the corresponding provisions of prior law) shall apply to the extent that they can apply. Thus, all the provisions of subtitle F of the Code (and the corresponding provisions of prior law) shall apply to the extent they can apply, including the provisions of law relating to assessment, collection, credit or refund, and limitations. For purposes of this section and §§ 1.9005–1 to 1.9005–4, inclusive, the term ''Act'' means the Act of September 26, 1961 (Pub. L. 87–321, 75 Stat. 683).

(Sec. 2(f), 75 Stat. 683; 26 U.S.C. 613 note)

[T.D. 6583, 26 FR 12079, Dec. 16, 1961]

TAX REFORM ACT OF 1969

§ 1.9006 Statutory provisions; Tax Reform Act of 1969.

Section 946 of the Tax Reform Act of 1969 (83 Stat. 729) provides as follows:

SEC. 946. *Interest and penalties in case of certain taxable years*—(a) *Interest on underpayment.* Notwithstanding section 6601 of the Internal Revenue Code of 1954, in the case of any taxable year ending before the date of the enactment of this Act, no interest on any