

brackets in the heading of this document. Any objections received in response to the regulation may be seen in the Dockets Management Branch between 9 a.m. and 4 p.m., Monday through Friday.

VI. References

The following reference has been placed on display in the Dockets Management Branch (address above) and may be seen by interested persons between 9 a.m. and 4 p.m., Monday through Friday.

1. Memorandum from Z. Olempska-Beer, Division of Product Manufacture and Use, FDA, to R. Angeles, Division of Product Policy, FDA, November 21, 1995.

List of Subjects in 21 CFR Part 172

Food additives, Reporting and recordkeeping requirements.

Therefore, under the Federal Food, Drug, and Cosmetic Act and under authority delegated to the Commissioner of Food and Drugs and redelegated to the Director, Center for Food Safety and Applied Nutrition, 21 CFR part 172 is amended as follows:

PART 172—FOOD ADDITIVES PERMITTED FOR DIRECT ADDITION TO FOOD FOR HUMAN CONSUMPTION

1. The authority citation for 21 CFR part 172 continues to read as follows:

Authority: 21 U.S.C. 321, 341, 342, 348, 371, 379e.

2. Section 172.841 is amended by revising paragraph (c) to read as follows:

§ 172.841 Polydextrose.

(c) Polydextrose is used in accordance with current good manufacturing practices as a bulking agent, formulation aid, humectant, and texturizer in the following foods when standards of identity established under section 401 of the act do not preclude such use:

- (1) Baked goods and baking mixes (restricted to fruit, custard, and pudding-filled pies, cakes, cookies, and similar baked products);
- (2) Chewing gum;
- (3) Confections and frostings;
- (4) Dressings for salads;
- (5) Film coatings on single and multiple vitamin and mineral supplement tablets;
- (6) Frozen dairy desserts and mixes;
- (7) Fruit and water ices;
- (8) Fruit spreads;
- (9) Gelatins, puddings and fillings;
- (10) Hard and soft candy;
- (11) Peanut spread;
- (12) Sweet sauces, toppings, and syrups;

(13) Tablespreads.

* * * * *

Dated: December 12, 2000.

Janice F. Oliver,

Deputy Director, Center for Food Safety and Nutrition.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8913]

RIN 1545-AW71

Guidance Under Section 355(d); Recognition of Gain on Certain Distributions of Stock or Securities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to recognition of gain on certain distributions of stock or securities of a controlled corporation. These final regulations affect corporations and their shareholders. These regulations reflect the enactment of section 355(d) of the Internal Revenue Code by the Omnibus Budget Reconciliation Act of 1990.

DATES: *Effective Date:* These regulations are effective December 20, 2000.

Applicability Date: These regulations apply to distributions occurring after December 20, 2000, except they do not apply to distributions occurring pursuant to a written agreement which is (subject to customary conditions) binding on December 20, 2000, and at all times thereafter.

FOR FURTHER INFORMATION CONTACT: Michael N. Kaibni, (202) 622-7550 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On May 3, 1999, the IRS and Treasury issued a notice of proposed rulemaking (REG-106004-98) in the **Federal Register** (64 FR 23554) setting forth rules under section 355(d) of the Internal Revenue Code relating to the recognition of gain on certain distributions of stock or securities of a controlled corporation. Generally, section 355(d) requires recognition of gain on a distribution of stock or securities of a controlled corporation (Controlled) (as though the Controlled stock or securities were sold to the distributee at its fair market value) if,

immediately after the distribution, any person holds disqualified stock of the distributing corporation (Distributing) or of any distributed Controlled that constitutes a 50 percent or greater interest. Disqualified stock is stock in Distributing acquired by purchase after October 9, 1990, and during the five-year period (taking into account section 355(d)(6)) ending on the date of distribution (the five-year period), or Controlled stock either (1) acquired by purchase during the five-year period or (2) distributed with respect to either disqualified Distributing stock or on Distributing securities acquired by purchase during the five-year period. No public hearing regarding these proposed regulations was held. Written comments to the notice were received. After consideration of all the comments, the proposed regulations are adopted as revised by this Treasury decision. The principal revisions are discussed below.

Explanation of Revisions and Summary of Comments

1. Purposes of Section 355(d) Not Violated

Generally, Congress intended section 355(d) to prevent taxpayers from using section 355 to dispose of subsidiaries in sale-like transactions, or to obtain a fair market value stepped-up basis for future dispositions, without incurring a corporate level tax. See H.R. Rep 101-881, at 341 (1990). Under proposed § 1.355-6(b)(3), section 355(d) does not apply to a distribution that does not violate its purposes (the purpose exception). As proposed, the purpose exception applies if the effect of the distribution and any related transaction is that a disqualified person neither increases an interest in Distributing or Controlled nor obtains a purchased basis in Controlled stock. A *disqualified person* is any person that, immediately after a distribution, holds disqualified stock in Distributing or Controlled that constitutes a 50 percent or greater interest (under section 355(d)(4) and proposed § 1.355-6(c)). The proposed regulations define *purchased basis* as basis in Controlled stock that is disqualified stock, unless the Controlled stock and the Distributing stock on which the Controlled stock is distributed are treated as acquired by purchase solely under the attribution rules of section 355(d)(8) and proposed § 1.355-6(e)(1). Commentators have expressed concern that certain distributions of stock may technically constitute disqualified distributions under the proposed regulations, yet do not appear to violate the purposes of section 355(d). Section 1.355-6(b)(3) has

been expanded and clarified in the final regulations to prevent the application of section 355(d) in the case of certain transactions that do not violate its purposes. (Under the final regulations, certain references to stock include securities.) The revisions are explained below.

a. Technical Clarification of Disqualified Person

The definition of “disqualified person” in the proposed regulations could be read to include persons who hold disqualified stock in Distributing or Controlled but who did not directly or indirectly purchase that stock. This could result in certain distributions that should not violate the purposes of section 355(d) nevertheless being disqualified distributions. The final regulations clarify that the term “disqualified person” includes only a person that meets that definition because of its own purchase of “disqualified stock” (or who receives stock in Controlled with respect to stock that the person purchased).

b. Related Transactions

Commentators suggested that some “related acquisitions” of stock in Distributing or Controlled prior to or following a distribution should not be taken into account in determining if the purpose rule applies. The IRS and Treasury agree that in many cases a related acquisition that increases a disqualified person’s interest in Distributing or Controlled should not be taken into account. In addition, the IRS and Treasury are concerned that the proposed regulations could be interpreted to allow taxpayers, by relying on certain other related transactions, to avoid section 355(d) inappropriately, where a distribution of stock, if viewed independently, would constitute a disqualified distribution. For example, where a distribution of Controlled stock to a Distributing shareholder constitutes a disqualified distribution, a subsequent but related distribution of that stock should not have the effect of “cleansing” the prior disqualified distribution. Based on these concerns, and a belief that other provisions of the final regulations will adequately address the effect of related transactions (e.g., the anti-avoidance provision, § 1.355-6(b)(4)), the final regulations remove the reference to related transactions in the purpose rule.

c. Fractional Shares

Some commentators requested that de minimis increases in interest in the stock of Distributing or Controlled should be disregarded in determining

whether the purpose rule applies. The final regulations provide that an issuance of cash in lieu of fractional shares is disregarded in applying the purpose exception.

2. Disqualified Stock

Generally, under the proposed regulations, disqualified stock is any stock in Distributing or Controlled acquired by purchase during the five-year period and any Controlled stock received in a distribution to the extent attributable to distributions on any stock in Distributing acquired by purchase during the five-year period. The definition of disqualified stock has been modified in the final regulations. The final regulations provide that stock of Distributing or Controlled that is acquired by a purchase within the five-year period (including such stock treated as indirectly acquired by purchase under section 355(d)(8) or § 1.355-6(e)(1), (2), (3) or (4) of the final regulations) ceases to be acquired by that purchase if the basis resulting from the purchase is eliminated. Basis in the stock of a corporation (or in an interest in another entity) is eliminated if (and when) it would no longer be taken into account by any person in determining gain or loss on a sale or exchange of any stock of such corporation (or an interest in the other entity). Basis is not eliminated, however, if it is allocated between stock of two corporations under § 1.358-2(a).

For example, under the proposed regulations, a direct purchase by Distributing of all of the stock in Controlled, followed by a distribution of the Controlled corporation stock is a disqualified distribution. Under the final regulations, because the distribution of Controlled will result in an elimination of the basis that resulted from Distributing’s purchase of Controlled stock, the Controlled stock would no longer be treated as purchased. The Controlled stock is therefore not disqualified stock and the distribution of Controlled would not be a disqualified distribution. Further, any purchases of stock of lower tier subsidiaries of Controlled that arise under section 355(d)(8) as a result of Distributing’s purchase of Controlled also would cease to be treated as purchased when Distributing’s basis in Controlled is eliminated. Thus, in the example above, if Controlled has a subsidiary that would have been deemed purchased by Distributing when Distributing purchased the Controlled stock, the stock of that subsidiary would cease to be treated as purchased when Distributing’s basis in Controlled is eliminated.

In general, basis of stock resulting from a purchase also is treated as eliminated if such stock is transferred to another person in an exchange or other transfer to which § 1.355-6(e)(2) or (3) (relating to carryover basis and exchange basis transactions) applies. The elimination of basis as a result of the transfer, however, does not affect the deemed purchase under § 1.355-6(e)(2) or (3) that arises as a result of the transfer. Thus, for example, if A purchases Controlled stock and subsequently transfers that stock to Distributing in a reorganization qualifying under section 368(a)(1)(B) in exchange for Distributing stock, A’s basis in Controlled is eliminated. Under § 1.355-6(e)(3), A is deemed to purchase the Distributing stock on the date A purchased the Controlled stock. The elimination of A’s basis in Controlled does not affect A’s deemed purchase of its stock in Distributing (*i.e.*, A’s exchanged basis in its Distributing stock resulting from its deemed purchase of that stock is not eliminated). Also, Distributing is deemed under § 1.355-6(e)(2) to have purchased the Controlled stock on the date A purchased the Controlled stock. The elimination of A’s basis in Controlled does not affect the deemed purchase by Distributing of the Controlled stock (*i.e.*, Distributing’s carryover basis in its Controlled stock resulting from its deemed purchase of that stock is not eliminated).

Under section 355(d)(3)(b)(ii) and § 1.355-6(b)(2)(i)(B)(2), disqualified stock includes Controlled stock received in exchange for Distributing stock acquired by purchase. In a split-off or split-up, the distributee shareholder will exchange its stock in Distributing for Controlled stock in an exchange described in § 1.355-6(e)(3). Technically, under the basis elimination rule, this would cause the Distributing stock held by such shareholder to no longer be treated as “acquired by purchase” at the time of the distribution. As a result, the distributed Controlled stock would not be received in exchange for Distributing stock “acquired by purchase,” and thus, would not be disqualified stock. In order to prevent this result, § 1.355-6(b)(2)(iii)(B)(3) provides that basis resulting from a purchase of Distributing stock that is exchanged for Controlled stock is not eliminated notwithstanding that § 1.355-6(e)(3) applies to the exchange.

The modified definition of disqualified stock eliminates the need for the “purchased interest no longer held” rule of § 1.355-6(b)(3)(iv) of the proposed regulations, since transactions that result in the purchased interest no

longer being held also will result in an elimination of basis. Accordingly, that paragraph has been deleted. Examples have been added illustrating the effect of the changes discussed.

3. Purchase

Section 355(d)(5) provides that, with certain exceptions, a purchase means any acquisition, but only if (1) the basis of the property acquired in the hands of the acquirer is not determined in whole or in part by reference to the adjusted basis of such property in the hands of the person from whom acquired, or under section 1014(a), and (2) the property is not acquired in an exchange to which section 351, 354, 355 or 356 applies. The proposed regulations follow the statutory definition of a purchase and provide examples of both purchase and non-purchase acquisitions. See § 1.355-6(d).

a. Section 338

An example in the proposed regulations illustrates that if a section 338 election is made pursuant to an acquisition of stock, the stock acquired is treated as purchased for purposes of section 355(d)(5)(A) (See § 1.355-6(d)(1)(iii) *Example 2*). The example further illustrates that any stock held by the acquired target (and deemed sold to new target) also is purchased stock. The final regulations provide that stock acquired in a qualified stock purchase with respect to which a section 338 election (or a section 338(h)(10) election) is made is not treated as purchased for purposes of section 355(d)(5)(A). However, the final regulations retain the rule that any stock held by old target that is treated as purchased by new target is treated as acquired by purchase for purposes of section 355(d)(5)(A) (unless a section 338 election or 338(h)(10) election also is made with respect to that purchase).

b. Partnerships

Section 1.355-6(d)(2)(v)(A) of the final regulations clarifies that an acquisition of stock (or an interest in another entity) by a partner pursuant to the liquidation of a partnership interest is a purchase of the stock (or other interest) acquired at the time of the liquidation of the partnership. Under § 1.355-6(d)(2)(v)(B) of the final regulations, if the adjusted basis of stock (or an interest in another entity) held by a partnership is increased under section 734(b), a proportionate amount of the stock (or other interest) will be treated as purchased at the time of the basis adjustment. The amount purchased is determined by reference to the amount of the basis adjustment over the fair

market value of the stock (or other interest) at the time of the adjustment.

c. Transfers of Cash, Cash Items, Marketable Stock and Debt of the Transferor

i. *Transferred With Respect to an Active Trade or Business.* Under section 355(d)(5)(B), a purchase includes any acquisition of property in an exchange to which section 351 applies to the extent the property is acquired in exchange for any cash or cash item, any marketable stock or security, or any debt of the transferor. The proposed regulations provide certain exceptions to purchase treatment under section 355(d)(5)(B). An acquisition of stock in exchange for any cash or cash item, marketable stock or debt of the transferor in a section 351 transaction generally is not a purchase if the transferor transfers the items as part of an active trade or business and the transferred items do not exceed the reasonable needs of the trade or business (the active business exception). See § 1.355-6(d)(3)(iv). The proposed regulations require, in part, that the transferee continue the active conduct of the trade or business. Commentators have expressed concern that this requirement would prevent a retransfer of the assets to a lower tier corporation within the same affiliated group. In § 1.355-6(d)(3)(iv)(4)(E), the final regulations clarify that a transfer of assets does not fail to meet the active business exception solely because the transferee transfers the assets to another member of the transferee's affiliated group if the requirements for the active business exception in § 1.355-6(d)(3)(iv)(A)(1), (2), (3) and (4) would be met if the transferor had transferred the assets directly to the final transferee.

ii. *Transfers Between Members of the Same Affiliated Group.* Under the proposed regulations, an acquisition of stock in exchange for any cash or cash item, marketable stock or security, or debt of the transferor in a section 351 transaction is generally not a purchase if the transferor corporation or corporations, the transferee corporation (whether formed in the transaction or already existing), and any distributed controlled corporation of the transferee corporation are members of the same affiliated group as defined in section 1504(a) before the section 351 transaction (if the transferee corporation is in existence before the transaction). See § 1.355-6(d)(3)(v) for additional requirements. The final regulations clarify that the cash or cash item, marketable stock or security, or debt of the transferor that is transferred must not have been acquired from a

nonmember in a related transaction in which section 362(a) or (b) applies to determine the basis in the acquired assets. Examples in the final regulations have been modified to reflect this clarification. See § 1.355-6(d)(4)(iii) and (d)(5)(iii) illustrating the effects of a forward and reverse triangular merger, respectively. The final regulations also eliminate the requirement that distributed controlled corporations be a member of the group before the section 351 transaction.

iii. *Certain Section 355 and Section 305 Distributions.* Under § 1.355-6(d)(1)(i)(B) of the proposed regulations, stock acquired in a distribution to which section 355 applies, whether in exchange for stock or pro rata, is not a purchase within the meaning of section 355(d). The final regulations in § 1.355-6(e)(4) modify this rule to provide that if a distributing corporation distributes any stock of a controlled corporation with respect to recently purchased distributing stock in a distribution that qualifies under section 355, the stock is deemed to be acquired by purchase by the distributee on the date the distributee acquired the recently purchased distributing stock. For this purpose, recently purchased distributing stock is stock in the distributing corporation acquired by purchase (determined without regard to the attribution rules of section 355(d)(8) and § 1.355-6(e)(1)) by the distributee during the five-year period with respect to that distribution. A similar rule is added with respect to distributions of stock under section 305(a) to the extent section 307(a) applies to determine the recipient's basis.

4. Whether a Person Holds a 50 Percent or Greater Interest

a. Exchanged Basis Rule and Plan or Arrangement

Section 1.355-6(c) of the proposed regulations provides rules for determining if a person holds a 50 percent or greater interest in Distributing or Controlled. Under section 355(d)(7)(B) and § 1.355-6(c)(4), if two or more persons act pursuant to a plan or arrangement with respect to acquisitions of stock or securities in Distributing or Controlled, those persons are treated as one person for purposes of section 355(d). A rule has been added to the final regulations clarifying the application of this rule in the context of an exchanged basis transaction with respect to purchased stock. If two or more persons do not act pursuant to a plan or arrangement with respect to an acquisition of stock in a corporation (the first corporation), a

subsequent exchange basis acquisition will not result in such persons being treated as one person, even if the acquisition of the second corporation's stock is pursuant to a plan or arrangement. An example has been added illustrating the effect of this rule.

b. Options

Section 1.355-6(c)(3) of the proposed and final regulations generally provides that options outstanding when the distribution occurs are treated as exercised when issued or last transferred if two criteria are met. First, the deemed exercise would cause a person to be a disqualified person. Second, immediately after the distribution, taking into account all the facts and circumstances, it is reasonably certain the option will be exercised. Commentators suggested that the "reasonably certain to be exercised" test be replaced with a "principal purpose to avoid section 355(d)" standard patterned on the regulations under section 382. The IRS and Treasury continue to believe, however, that the more objective standard of the proposed regulations is appropriate.

In response to a comment, the final regulations exclude from the definition of options cash settlement options, phantom stock, stock appreciation rights, and national principal contracts. However, to the extent that such instruments are exercisable into stock, they still would be subject to the deemed exercise rule of the final regulations under § 1.355-6(c)(3)(v) as an "other instrument that provides for the right to purchase, issue, redeem, or transfer stock." The final regulations have also added a rule for substituted options treating the substituted option as issued on the date the original option was issued.

5. Statistical Sampling

Under § 1.355-6(f)(1) of the proposed regulations, a distributing corporation must determine whether a disqualified person holds its stock or the stock of any distributed controlled corporation. Under § 1.355-6(f)(4), a distributing corporation may, absent actual knowledge with regard to a particular shareholder, presume that no less-than-five-percent shareholder of a corporation acquired stock or securities by purchase during the five-year period. In § 1.355-6(f)(5) *Example 3*, the final regulations clarify that application of statistical sampling procedures to estimate the basis of shares acquired in certain reorganizations does not have the effect of giving actual knowledge of a purchase of stock beyond the sample group.

6. Administrative Remedies

A comment urged the adoption of various forms of administrative relief from the recognition of gain in a disqualified distribution. The suggested forms of relief included the issuance of private letter rulings granting tax free treatment in appropriate cases, gain recognition agreements, stock basis waivers, or some combination of the above. Section 355(d) applies at a specific time (at the time of the disqualified distribution) and requires Distributing to recognize gain as if it had sold Controlled at its fair market value at that time. Accordingly, the IRS and Treasury Department do not believe that it would be appropriate to adopt any of these administrative relief provisions. Basis reduction or gain recognition agreements could result in either a complete avoidance or a deferral of gain recognition. Moreover, the IRS and Treasury do not believe that granting exceptions to section 355(d) by private letter ruling is appropriate. However, the final regulations include a new provision stating that the Commissioner may provide by guidance published in the Internal Revenue Bulletin that other distributions are not disqualified distributions because they do not violate the purposes of section 355(d).

Special Analyses

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

Drafting Information

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

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

Authority: 26 U.S.C. 7805 * * *
Section 1.355-6 also issued under 26 U.S.C. 355(d)(9). * * *

Par. 2. Section 1.355-0 is amended by revising the section heading, adding introductory text, removing the existing entry for § 1.355-6, and adding new entries for § 1.355-6 to read as follows:

§ 1.355-0 Table of contents.

To facilitate the use of §§ 1.355-1 through 1.355-6, this section lists the following major paragraphs in those sections:

* * * * *

§ 1.355-6 *Recognition of gain on certain distributions of stock or securities in controlled corporation.*

- (a) Conventions.
- (1) Examples.
- (2) Five-year period.
- (3) Distributing securities.
- (4) Marketable securities.
- (b) General rules and purposes of section 355(d).
- (1) Disqualified distributions in general.
- (2) Disqualified stock.
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 - (ii) Purchase.
 - (iii) Exceptions.
 - (A) Purchase eliminated.
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 - (1) General rule.
 - (2) Special rule for transferred and exchanged basis property.
 - (3) Special rule for Split-offs and Split-ups.
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 - (3) Certain distributions not disqualified distributions because purposes of section 355(d) not violated.
 - (i) In general.
 - (ii) Disqualified person.
 - (iii) Purchased basis.
 - (iv) Increase in interest because payment of cash in lieu of fractional shares.
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 - (c) Whether a person holds a 50 percent or greater interest.
 - (1) In general.
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 - (3) Effect of options, warrants, convertible obligations, and other similar interests.
 - (i) Application.
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(iii) Options deemed newly issued and substituted options.

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(B) Certain compensatory options.

(C) Substituted options.

(iv) Effect of treating an option as exercised.

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(v) Instruments treated as options.

(vi) Instruments generally not treated as options.

(A) Escrow, pledge, or other security agreements.

(B) Compensatory options.

(1) General rule.

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(C) Certain stock conversion features.

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(E) Rights of first refusal.

(F) Other enumerated instruments.

(vii) Reasonably certain that the option will be exercised.

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(B) Stock purchase agreement or similar arrangement.

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(A) Subsequent disposition.

(B) Example.

(d) Purchase.

(1) In general.

(i) Definition of purchase under section 355(d)(5)(A).

(ii) Section 355 distributions.

(iii) Example.

(2) Exceptions to definition of purchase under section 355(d)(5)(A).

(i) Acquisition of stock in a transaction which includes other property or money.

(A) Transferors and shareholders of transferor or distributing corporations.

(1) In general.

(2) Exception.

(B) Transferee corporations.

(1) In general.

(2) Exception.

(C) Examples.

(ii) Acquisition of stock in a distribution to which section 305(a) applies.

(iii) Section 1036(a) exchange.

(iv) Section 338 elections.

(A) In general.

(B) Example.

(v) Partnership distributions.

(A) Section 732(b).

(B) Section 734(b).

(3) Certain section 351 exchanges treated as purchases.

(i) In general.

(A) Treatment of stock received by transferor.

(B) Multiple classes of stock.

(ii) Cash item, marketable stock.

(iii) Exception for certain acquisitions.

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(B) Example.

(iv) Exception for assets transferred as part of an active trade or business.

(A) In general.

(B) Active conduct of a trade or business.

(C) Reasonable needs of the trade or business.

(D) Consideration of all facts and circumstances.

(E) Successive transfers.

(v) Exception for transfer between members of the same affiliated group.

(A) In general.

(B) Examples.

(4) Triangular asset reorganizations.

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(ii) Treatment.

(iii) Example.

(5) Reverse triangular reorganizations other than triangular asset reorganizations.

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(ii) Letter ruling and closing agreement.

(iii) Example.

(6) Treatment of group structure changes.

(i) In general.

(ii) Adjustments to basis of higher-tier members.

(iii) Example.

(7) Special rules for triangular asset reorganizations, other reverse triangular reorganizations, and group structure changes.

(e) Deemed purchase and timing rules.

(1) Attribution and aggregation.

(i) In general.

(ii) Purchase of additional interest.

(iii) Purchase between persons treated as one person.

(iv) Purchase by a person already treated as holding stock under section 355(d)(8)(A).

(v) Examples.

(2) Transferred basis rule.

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(4) Certain section 355 or section 305 distributions.

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(ii) Section 305.

(5) Substantial diminution of risk.

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(f) Duty to determine stockholders.

(1) In general.

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securities filings.

(3) Presumptions as to securities filings.

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(5) Examples.

(g) Effective date.

Par. 3. Section 1.355-6 is revised to read as follows:

§ 1.355-6 Recognition of gain on certain distributions of stock or securities in controlled corporation.

(a) *Conventions*—(1) *Examples.* For purposes of the examples in this section, unless otherwise stated, assume that P, S, T, X, Y, N, HC, D, D1, D2, D3, and C are corporations, A and B are individuals, shareholders are not treated as one person under section 355(d)(7), stock has been owned for more than five years and section 355(d)(6) and paragraph (e)(4) of this section do not

apply, no election under section 338 (if available) is made, and all transactions described are respected under general tax principles, including the step transaction doctrine. No inference should be drawn from any example as to whether any requirements of section 355 other than those of section 355(d), as specified, are satisfied.

(2) *Five-year period.* For purposes of this section, the term five-year period means the five-year period (determined after applying section 355(d)(6) and paragraph (e)(4) of this section) ending on the date of the distribution, but in no event beginning earlier than October 10, 1990.

(3) *Distributing securities.* For purposes of determining if stock of any controlled corporation received in the distribution is disqualified stock described in section 355(d)(3)(B)(ii)(II) (relating to a distribution of controlled corporation stock on any securities in the distributing corporation acquired by purchase during the five-year period), references in this section to stock of a corporation that is or becomes a distributing corporation includes securities of the corporation. Similarly, a reference to stock in paragraph (c)(4) of this section (relating to a plan or arrangement) includes securities.

(4) *Marketable securities.* Unless otherwise stated, any reference in this section to marketable stock includes marketable securities.

(b) *General rules and purposes of section 355(d)*—(1) *Disqualified distributions in general.* In the case of a disqualified distribution, any stock or securities in the controlled corporation shall not be treated as qualified property for purposes of section 355(c)(2) or 361(c)(2). In general, a disqualified distribution is any distribution to which section 355 (or so much of section 356 as relates thereto) applies if, immediately after the distribution—

(i) Any person holds disqualified stock in the distributing corporation that constitutes a 50 percent or greater interest in such corporation; or

(ii) Any person holds disqualified stock in the controlled corporation (or, if stock of more than one controlled corporation is distributed, in any controlled corporation) that constitutes a 50 percent or greater interest in such corporation.

(2) *Disqualified stock*—(i) *In general.* *Disqualified stock* is—

(A) Any stock in the distributing corporation acquired by purchase during the five-year period; and

(B) Any stock in any controlled corporation—

(1) Acquired by purchase during the five-year period; or

(2) Received in the distribution to the extent attributable to distributions on any stock in the distributing corporation acquired by purchase during the five-year period.

(ii) *Purchase*. For the definition of a purchase for purposes of section 355(d) and this section, see section 355(d)(5) and paragraph (d) of this section.

(iii) *Exceptions*—(A) *Purchase eliminated*. Stock (or an interest in another entity) that is acquired by purchase (including stock (or another interest) that is treated as acquired by purchase under paragraph (e)(2), (3), or (4) of this section) ceases to be acquired by that purchase if (and when) the basis resulting from the purchase is eliminated. For purposes of this paragraph (b)(2)(iii), basis resulting from the purchase is basis in the stock (or in an interest in another entity) that is directly purchased during the five-year period or that is treated as acquired by purchase during such period under paragraph (e)(2), (3), or (4) of this section.

(B) *Deemed purchase eliminated*. Stock (or an interest in another entity) that is deemed purchased under section 355(d)(8) or paragraph (e)(1) of this section shall cease to be treated as purchased if (and when) the basis resulting from the purchase that effects the deemed purchase is eliminated.

(C) *Elimination of basis*—(1) *General rule*. Basis in the stock of a corporation (or in an interest in another entity) is eliminated if (and when) it would no longer be taken into account by any person in determining gain or loss on a sale or exchange of any stock of such corporation (or an interest in the other entity). Basis is not eliminated, however, if it is allocated between stock of two corporations under § 1.358-2(a).

(2) *Special rule for transferred and exchanged basis property*. Basis of stock (or an interest in another entity) resulting from a purchase (the first purchase) is eliminated if (and when) such stock (or other interest) is subsequently transferred to another person in an exchange or other transfer to which paragraph (e)(2) or (3) of this section applies (the second purchase). The elimination of basis in stock (or in another interest) resulting from the first purchase, however, does not eliminate the basis resulting from the second purchase in the stock (or other interest) that is treated as acquired by purchase by the acquirer in a transaction to which paragraph (e)(2) of this section applies or by the person making the exchange in a transaction to which paragraph (e)(3) of this section applies.

(3) *Special rule for Split-offs and Split-ups*. Under section 355(d)(3)(B)(ii)

and paragraph (b)(2)(i)(B)(2) of this section, disqualified stock includes controlled corporation stock received in exchange for distributing corporation stock acquired by purchase. Solely for purposes of determining whether controlled corporation stock received in a distribution in exchange for distributing corporation stock is disqualified stock described in that section and paragraph immediately after the distribution, paragraph (b)(2)(iii)(C)(2) of this section does not apply to the exchange to eliminate basis resulting from a purchase of that distributing corporation stock (notwithstanding that paragraph (e)(3) of this section applies to the exchange).

(D) *Special rule if basis allocated between two corporations*. If the shareholder of a distributing corporation, pursuant to § 1.358-2, allocates basis resulting from a purchase between the stock of two or more corporations then, following such allocation, the determination of whether such basis has been eliminated shall be made separately with respect to the stock of each such corporation.

(3) *Certain distributions not disqualified distributions because purposes of section 355(d) not violated*—(i) *In general*.

Notwithstanding the provisions of section 355(d)(2) and this paragraph (b), a distribution is not a disqualified distribution if the distribution does not violate the purposes of section 355(d) as provided in this paragraph (b)(3). A distribution does not violate the purposes of section 355(d) if the effect of the distribution is neither—

(A) To increase ownership (combined direct and indirect) in the distributing corporation or any controlled corporation by a disqualified person; nor

(B) To provide a disqualified person with a purchased basis in the stock of any controlled corporation.

(ii) *Disqualified person*. A disqualified person is any person (taking into account section 355(d)(7) and paragraph (c)(4) of this section) that, immediately after a distribution, holds (directly or indirectly under section 355(d)(8) and paragraph (e)(1) of this section) disqualified stock in the distributing corporation or controlled corporation that—

(A) The person—

(1) Acquired by purchase under section 355(d)(5) or (8) and paragraphs (d) and (e) of this section during the five-year period, or

(2) Received in the distribution to the extent attributable to distributions on any stock in the distributing corporation acquired by purchase under section

355(d)(5) or (8) and paragraphs (d) and (e) of this section by that person during the five-year period; and

(B) Constitutes a 50 percent or greater interest in such corporation (under section 355(d)(4) and paragraph (c) of this section).

(iii) *Purchased basis*. In general, a purchased basis is basis in controlled corporation stock that is disqualified stock. However, basis in controlled corporation stock that is disqualified stock will not be treated as purchased basis if the controlled corporation stock and any distributing corporation stock with respect to which the controlled corporation stock is distributed are treated as acquired by purchase solely under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. The prior sentence will not apply, however, if the distributing corporation stock is treated as acquired by purchase under the attribution rules as a result of the acquisition of an interest in a partnership (the purchased partnership), and following the distribution, the controlled corporation stock is directly held by the purchased partnership (or a chain of partnerships that includes the purchased partnership).

(iv) *Increase in interest because of payment of cash in lieu of fractional shares*. Any increase in direct or indirect ownership in the distributing corporation or any controlled corporation by a disqualified person because of a payment of cash in lieu of issuing fractional shares will be disregarded for purposes of paragraph (b)(3)(i)(A) of this section if the payment of the cash is solely to avoid the expense and inconvenience of issuing fractional share interests, and does not represent separately bargained for consideration.

(v) *Other exceptions*. The Commissioner may provide by guidance published in the Internal Revenue Bulletin that other distributions are not disqualified distributions because they do not violate the purposes of section 355(d).

(vi) *Examples*. The following examples illustrate this paragraph (b)(3):

Example 1. Stock distributed in spin-off; no purchased basis. D owns all of the stock of D1, and D1 owns all of the stock of C. A purchases 60 percent of the D stock for cash. Within five years of A's purchase, D1 distributes the C stock to D. A is treated as having purchased 60 percent of the stock of both D1 and C on the date A purchases 60 percent of the D stock under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. The C stock received by D is attributable to a distribution on purchased D1 stock under section 355(d)(3)(B)(ii). Accordingly, the D1 and C stock each is

disqualified stock under section 355(d)(3) and paragraph (b)(2) of this section, and A is a disqualified person under paragraph (b)(3)(ii) of this section. However, the purposes of section 355(d) under paragraph (b)(3)(i) of this section are not violated. A did not increase direct or indirect ownership in D1 or C. In addition, D's basis in the C stock is not a purchased basis under paragraph (b)(3)(iii) of this section because both the D1 and the C stock are treated as acquired by purchase solely under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. Accordingly, D1's distribution of the C stock to D is not a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

Example 2. Stock distributed in spin-off; purchased basis. The facts are the same as *Example 1*, except that D immediately further distributes the C stock to its shareholders (including A) pro rata. The D and C stock each is disqualified stock under section 355(d)(3) and paragraph (b)(2) of this section, and A is a disqualified person under paragraph (b)(3)(ii) of this section. The purposes of section 355(d) under paragraph (b)(3)(i) of this section are violated. A did not increase direct or indirect ownership in D or C. However, A's basis in the C stock is a purchased basis under paragraph (b)(3)(iii) of this section because the D stock is not treated as acquired by purchase solely under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. Accordingly, the further distribution is a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

Example 3. Stock distributed in split-off with ownership increase; purchased basis. The facts are the same as *Example 1*, except that D immediately further distributes the C stock to A in exchange for A's purchased stock in D. The C stock received by A is attributable to a distribution on purchased D stock under section 355(d)(3)(B)(ii), and A's basis in the C stock is determined by reference to the adjusted basis of A's purchased D stock under paragraph (e)(3) of this section. (Under paragraph (b)(2)(iii)(B)(3) of this section, the basis resulting from A's purchase of D stock is not eliminated solely for purposes of determining if the C stock acquired by A is disqualified stock immediately after the distribution, notwithstanding that paragraph (e)(3) of this section applies to the exchange.) Accordingly, the D stock and the C stock each is disqualified stock under section 355(d)(3) and paragraph (b)(2) of this section, and A is a disqualified person under paragraph (b)(3)(ii) of this section. The purposes of section 355(d) under paragraph (b)(3)(i) of this section are violated because A increased its ownership in C from a 60 percent indirect interest to a 100 percent direct interest, and because A's basis in the C stock is a purchased basis under paragraph (b)(3)(iii) of this section. Accordingly, the further distribution is a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

Example 4. Stock distributed in spin-off; purchased basis. D1 owns all the stock of C. D purchases all of the stock of D1 for cash. Within five years of D's purchase of D1, P

acquires all of the stock of D1 from D in a section 368(a)(1)(B) reorganization that is not a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E), and D1 distributes all of its C stock to P. P is treated as having acquired the D1 stock by purchase on the date D acquired it under the transferred basis rule of section 355(d)(5)(C) and paragraph (e)(2) of this section. P is treated as having purchased all of the C stock on the date D purchased the D1 stock under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section, and the C stock received by P is attributable to a distribution on purchased D1 stock under section 355(d)(3)(B)(ii). Accordingly, the D1 and C stock each is disqualified stock under section 355(d)(3) and paragraph (b)(2) of this section, and P is a disqualified person under paragraph (b)(3)(ii) of this section. The purposes of section 355(d) under paragraph (b)(3)(i) of this section are violated. P did not increase direct or indirect ownership in D1 or C. However, P's basis in the C stock is a purchased basis under paragraph (b)(3)(iii) of this section because the D1 stock is not treated as acquired by purchase solely under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. Accordingly, D1's distribution of the C stock to P is a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

Example 5. Stock distributed in split-off with ownership increase; no purchased basis. P owns 50 percent of the stock of D, the remaining D stock is owned by unrelated persons, D owns all the stock of C, and A purchases all of the P stock from the P shareholders. Within five years of A's purchase, D distributes all of the C stock to P in exchange for P's D stock. A is treated as having purchased 50 percent of the stock of both D and C on the date A purchases the P stock under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. The C stock received by P is attributable to a distribution on purchased D stock under section 355(d)(3)(B)(ii). Accordingly, the D stock and the C stock each is disqualified stock under section 355(d)(3) and paragraph (b)(2) of this section, and A is a disqualified person under paragraph (b)(3)(ii) of this section. The purposes of section 355(d) under paragraph (b)(3)(i) of this section are violated because, even though P's basis in the C stock is not a purchased basis under paragraph (b)(3)(iii) of this section, A increased its direct or indirect ownership in C from a 50 percent indirect interest to a 100 percent indirect interest. Accordingly, D's distribution of the C stock to P is a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

Example 6. Stock distributed in split-off with no ownership increase; no purchased basis. A purchases all of the stock of T. T later merges into D in a section 368(a)(1)(A) reorganization and A exchanges its purchased T stock for 60 percent of the stock of D. D owns all of the stock of D1 and D2, D1 and D2 each owns 50 percent of the stock of D3, and D3 owns all of the stock of C. Within five years of A's purchase of the T stock, D3 distributes the C stock to D1 in exchange for all of D1's D3 stock. A is treated as having acquired 60 percent of the D stock

by purchase on the date A purchases the T stock under paragraph (e)(3) of this section. A is treated as having purchased 60 percent of the stock of D1, D2, D3, and C on the date A purchases the T stock under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. The C stock received by D1 is attributable to a distribution on purchased D3 stock under section 355(d)(3)(B)(ii). Accordingly, the D3 stock and the C stock each is disqualified stock under section 355(d)(3) and paragraph (b)(2) of this section, and A is a disqualified person under paragraph (b)(3)(ii) of this section. However, the purposes of section 355(d) under paragraph (b)(3)(i) of this section are not violated. A did not increase direct or indirect ownership in D3 or C, and D1's basis in the C stock is not a purchased basis under paragraph (b)(3)(iii) of this section because the D3 stock is treated as acquired by purchase solely under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. Accordingly, D3's distribution of the C stock to D1 is not a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

Example 7. Purchased basis eliminated by liquidation; stock distributed in spin-off. P owns 30 percent of the stock of D, D owns all of the stock of D1, and D1 owns all of the stock of C. P purchases the remaining 70 percent of the D stock for cash. Within five years of P's purchase, P liquidates D in a transaction qualifying under sections 332 and 337(a), and D1 then distributes the stock of C to P. Prior to the liquidation, P is treated as having purchased 70 percent of the stock of D1 and C on the date P purchases the D stock under the attribution rules of section 355(d)(8)(B) and paragraph (e)(1) of this section. After the liquidation, however, under paragraph (b)(2)(iii) of this section, P is not treated as having acquired by purchase the D1 or the C stock under section 355(d)(8)(B) and paragraph (e)(1) of this section because P's basis in the D stock is eliminated in the liquidation of D. Under section 334(b)(1), P's basis in the D1 stock is determined by reference to D's basis in the D1 stock and not by reference to P's basis in D. Paragraph (d)(2)(i)(B) of this section does not treat the D1 stock as newly purchased in P's hands because no gain or loss was recognized by D in the liquidation. Accordingly, neither the D1 stock nor the C stock is disqualified stock under section 355(d)(3) and paragraph (b)(2) of this section in P's hands, and the distribution is not a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

Example 8. Purchased basis eliminated by upstream merger; stock distributed in spin-off. D owns all of the stock of D1, and D1 owns all of the stock of C. P purchases 60 percent of the D stock for cash. Within five years of P's purchase, D merges into P in a section 368(a)(1)(A) reorganization, with the D shareholders other than P receiving solely P stock in exchange for their D stock, and D1 then distributes the stock of C to P. Prior to the merger, P is treated as having purchased 60 percent of the stock of D1 and C on the date P purchases the D stock under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. After the

merger, however, under paragraph (b)(2)(iii) of this section, P is not treated as having acquired by purchase the D1 or the C stock under section 355(d)(8)(B) and paragraph (e)(1) of this section because P's basis in the D stock is eliminated in the merger. Under section 362(b), P's basis in the D1 stock is determined by reference to D's basis in the D1 stock and not by reference to P's basis in D. Paragraph (d)(2)(i)(B) of this section does not treat the D1 stock as newly purchased in P's hands because no gain or loss was recognized by D in the merger. Accordingly, neither the D1 stock nor the C stock is disqualified stock under section 355(d)(3) and paragraph (b)(2) of this section in P's hands, and the distribution is not a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

Example 9. Purchased basis eliminated by distribution; stock distributed in spin-off. A purchases all the stock of C for cash on Date 1. D acquires all of the stock of C from A in a section 368(a)(1)(B) reorganization that is not a reorganization under section 368(a)(1)(A) by reason of section 368(A)(1)(E). A receives ten percent of the D stock in the transaction. The remaining D stock is owned by B. Within five years of A's purchase of the C stock, D distributes all the stock of C pro rata to A and B. Under the transferred basis rule of paragraph (e)(2) of this section, D is treated as having purchased all of the C stock on the date A acquired it. Under the exchanged basis rule of paragraph (e)(3) of this section, A is treated as having purchased its D stock on Date 1 and A is treated as having purchased ten percent of the C stock on Date 1 under the attribution rules of section 355(d)(8) and paragraph (e)(3) of this section. Moreover, under paragraph (b)(2)(iii)(C) of this section, A's basis in the C stock resulting from A's Date 1 purchase of C stock is eliminated. After the distribution, A's and B's bases in their C stock are determined by reference to the bases of their D stock under § 1.358-2(a)(2) (and not by reference to D's basis in the C stock). D's basis in the stock of C resulting from its deemed purchase of that stock under paragraph (e)(2) of this section is eliminated by the distribution of the C stock because it would no longer be taken into account by any person in determining gain or loss on the sale of C stock. Therefore, the C stock distributed to A and B is not disqualified stock as a result of D's purchase of C. However, A's basis in its D stock resulting from its deemed purchase of that stock under paragraph (e)(3) of this section is not eliminated. Therefore, A's ten percent interest in the stock of D is disqualified stock. Furthermore, A's ten percent interest in the stock of C is disqualified stock because the distribution of the C stock is attributable to A's D stock that was acquired by purchase. However, there has not been a disqualified distribution because no person, immediately after the distribution, holds disqualified stock in either D or C that constitutes a 50 percent or greater interest in such corporation.

Example 10. Allocation of purchased basis analyzed separately.—(i) P owns all the stock of D. D purchases all the stock of D1 for cash on Date 1. D1 owns all the stock of C (which owns all the stock of C1) and S.

Within five years of Date 1, D1 distributes all the stock of C to D. The D1 and C stock each is disqualified stock under section 355(d)(3) and paragraph (b)(2) of this section, and D is a disqualified person under paragraph (b)(3)(ii) of this section. The purposes of section 355(d) under paragraph (b)(3)(i) of this section are violated. D did not increase direct or indirect ownership in D1 or C. However, D's basis in the C stock is a purchased basis under paragraph (b)(3)(iii) of this section because the D1 stock is not treated as acquired by purchase solely under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. Accordingly, the distribution is a disqualified distribution under section 355(d) and paragraph (b)(1) of this section. D's basis in the D1 stock is allocated pursuant to § 1.358-2 between the D1 stock and the C stock. Therefore, under paragraph (e)(4) of this section, the C stock is deemed to be acquired by purchase on Date 1, the date D purchased all the stock of D1. If thereafter, and within five years of Date 1, C were to distribute all the stock of C1 to D, that distribution would also be a disqualified distribution because of D's deemed purchase of the stock of C.

(ii) Following the distribution of the stock of C by D1, and within five years of Date 1, D distributes all the stock of D1 to P. Under paragraph (b)(2)(iii)(D) of this section, the determination of whether D's basis in D1 has been eliminated shall be made without regard to D's allocated basis in C. After the distribution, P's basis in the D1 stock is determined by reference to its basis in its D stock under § 1.358-2(a)(2) (and not by reference to D's basis in the D1 stock). D's basis in the D1 stock resulting from the purchase of that stock is eliminated by the distribution of the D1 stock because it would no longer be taken into account by any person in determining gain or loss on the sale of D1 stock. Therefore, the D1 stock distributed to P is not disqualified stock as a result of D's purchase of D1. Moreover, a subsequent distribution of the S stock by D1 to P would not be a disqualified distribution because both the D1 and S stock would cease to be treated as purchased when D's basis in D1 has been eliminated.

(4) **Anti-avoidance rule**—(i) *In general.* Notwithstanding any provision of section 355(d) or this section, the Commissioner may treat any distribution as a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section if the distribution or another transaction or transactions are engaged in or structured with a principal purpose to avoid the purposes of section 355(d) or this section with respect to the distribution. Without limiting the preceding sentence, the Commissioner may determine that the existence of a related person, intermediary, pass-through entity, or similar person (an intermediary) should be disregarded, in whole or in part, if the intermediary is formed or availed of with a principal purpose to avoid the purposes of section 355(d) or this section.

(ii) *Example.* The following example illustrates this paragraph (b)(4):

Example. Post-distribution redemption. B wholly owns D, which wholly owns C. With a principal purpose to avoid the purposes of section 355(d), A, B, D, and C engage in the following transactions. A purchases 45 of 100 shares of the only class of D stock. Within five years after A's purchase, D distributes all of its 100 shares in C to A and B pro rata. D then redeems 20 shares of B's D stock, and C redeems 20 shares of B's C stock. After the redemption, A owns 45 shares and B owns 35 shares in each of D and C. Under paragraph (b)(4)(i) of this section, the Commissioner may treat A as owning disqualified stock in D and C that constitutes a 50 percent or greater interest in D and C immediately after the distribution. Under that treatment, the distribution is a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

(c) **Whether a person holds a 50 percent or greater interest**—(1) *In general.* Under section 355(d)(4), 50 percent or greater interest means stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock.

(2) **Valuation.** For purposes of section 355(d)(4) and this section, all shares of stock within a single class are considered to have the same value. But see paragraph (c)(3)(vii)(A) of this section (determination of whether it is reasonably certain that an option will be exercised).

(3) **Effect of options, warrants, convertible obligations, and other similar interests**—(i) *Application.* This paragraph (c)(3) provides rules to determine when an option is treated as exercised for purposes of section 355(d) (other than section 355(d)(6)). Except as provided in this paragraph (c)(3), an option is not treated as exercised for purposes of section 355(d). This paragraph (c)(3) does not affect the determination of whether an instrument is an option or stock under general principles of tax law (such as substance over form).

(ii) **General rule.** In determining whether a person has acquired by purchase a 50 percent or greater interest under section 355(d)(4), an option to acquire stock (as described in paragraphs (c)(3)(v) and (vi) of this section) that has not been exercised when a distribution occurs is treated as exercised on the date it was issued or most recently transferred if—

(A) Its exercise (whether by itself or in conjunction with the deemed exercise of one or more other options) would cause a person to become a disqualified person; and

(B) Immediately after the distribution, it is reasonably certain (as described in paragraph (c)(3)(vii) of this section) that the option will be exercised.

(iii) *Options deemed newly issued and substituted options*—(A) *Exchange, adjustment, or alteration of existing option.* For purposes of this paragraph (c)(3), each of the following is treated as a new issuance or transfer of an existing option only if it materially increases the likelihood that an option will be exercised—

(1) An exchange of an option for another option or options;

(2) An adjustment to the terms of an option (including an adjustment pursuant to the terms of the option);

(3) An adjustment to the terms of the underlying stock (including an adjustment pursuant to the terms of the stock);

(4) A change to the capital structure of the issuing corporation; and

(5) An alteration to the fair market value of issuing corporation stock through an asset transfer (other than regular, ordinary dividends) or through any other means.

(B) *Certain compensatory options.* An option described in paragraph (c)(3)(vi)(B)(2) of this section is treated as issued on the date it becomes transferable.

(C) *Substituted options.* If an option (existing option) is exchanged for another option or options (substituted option or options) and paragraph (c)(3)(iii)(A) of this section does not apply to treat such exchange as a new issuance or transfer of the existing option, the substituted option or options will be treated as issued or most recently transferred on the date that the existing option was issued or most recently transferred.

(iv) *Effect of treating an option as exercised*—(A) *In general.* For purposes of section 355(d), an option that is treated as exercised under this paragraph (c)(3) is treated as exercised both for purposes of determining the percentage of the voting power of stock owned by the holder and for purposes of determining the percentage of the value of stock owned by the holder.

(B) *Stock purchase agreement or similar arrangement.* If a stock purchase agreement or similar arrangement is deemed exercised, the purchaser is treated as having purchased the stock under the terms of the agreement or arrangement as though all covenants had been satisfied and all contingencies met. The agreement or arrangement is deemed to have been exercised as of the date it is entered into or most recently assigned.

(v) *Instruments treated as options.* For purposes of this paragraph (c)(3), except to the extent provided in paragraph (c)(3)(vi) of this section, the following are treated as options: A call option, warrant, convertible obligation, the conversion feature of convertible stock, put option, redemption agreement (including a right to cause the redemption of stock), notional principal contract (as defined in § 1.446–3(c)) that provides for the payment of amounts in stock, stock purchase agreement or similar arrangement, or any other instrument that provides for the right to purchase, issue, redeem, or transfer stock (including an option on an option).

(vi) *Instruments generally not treated as options.* For purposes of this paragraph (c)(3), the following are not treated as options, unless issued, transferred, or listed with a principal purpose to avoid the application of section 355(d) or this section:

(A) *Escrow, pledge, or other security agreements.* An option that is part of a security arrangement in a typical lending transaction (including a purchase money loan), if the arrangement is subject to customary commercial conditions. For this purpose, a security arrangement includes, for example, an agreement for holding stock in escrow or under a pledge or other security agreement, or an option to acquire stock contingent upon a default under a loan.

(B) *Compensatory options*—(1) *General rule.* An option to acquire stock in a corporation with customary terms and conditions, provided to an employee, director, or independent contractor in connection with the performance of services for the corporation or a person related to it under section 355(d)(7)(A) (and that is not excessive by reference to the services performed) and that—

(i) Is nontransferable within the meaning of § 1.83–3(d); and

(ii) Does not have a readily ascertainable fair market value as defined in § 1.83–7(b).

(2) *Exception.* Paragraph (c)(3)(vi)(B)(1) of this section ceases to apply to an option that becomes transferable.

(C) *Certain stock conversion features.* The conversion feature of convertible stock, provided that—

(1) The stock is not convertible for at least five years after issuance or transfer; and

(2) The terms of the conversion feature do not require the tender of any consideration other than the stock being converted.

(D) *Options exercisable only upon death, disability, mental incompetency, or separation from service.* Any option entered into between stockholders of a corporation (or a stockholder and the corporation) with respect to the stock of either stockholder that is exercisable only upon the death, disability, mental incompetency of the stockholder, or, in the case of stock acquired in connection with the performance of services for the corporation or a person related to it under section 355(d)(7)(A) (and that is not excessive by reference to the services performed), the stockholder's separation from service.

(E) *Rights of first refusal.* A bona fide right of first refusal regarding the corporation's stock with customary terms, entered into between stockholders of a corporation (or between the corporation and a stockholder).

(F) *Other enumerated instruments.* Any other instruments specified in regulations, a revenue ruling, or a revenue procedure. See § 601.601(d)(2) of this chapter.

(vii) *Reasonably certain that the option will be exercised*—(A) *In general.* The determination of whether, immediately after the distribution, an option is reasonably certain to be exercised is based on all the facts and circumstances. In applying the previous sentence, the fair market value of stock underlying an option is determined by taking into account control premiums and minority and blockage discounts.

(B) *Stock purchase agreement or similar arrangement.* A stock purchase agreement or similar arrangement is treated as reasonably certain to be exercised if the parties' obligations to complete the transaction are subject only to reasonable closing conditions.

(viii) *Examples.* The following examples illustrate this paragraph (c)(3):

Example 1. D owns all of the stock of C. A purchases 40 percent of D's only class of stock and an option to purchase D stock from D, that if deemed exercised, would result in A owning a total of 60 percent of the stock of D. Assume that no control premium or minority or blockage discount applies to the D stock underlying the option. The option permits A to acquire the D stock at \$30 per share, and D's stock has a fair market value of \$27 per share on the date the option is issued. The option is subject to no contingencies or restrictive covenants, may be exercised within five years after its issuance, and is not described in paragraph (c)(3)(vi) of this section (regarding instruments generally not treated as options). Within five years of A's purchase of the D stock and option, D distributes the stock of its subsidiary C pro rata and A receives 40 percent of the C stock in the distribution. Immediately after the distribution, D's stock

has a fair market value of \$30 per share and C's stock has a fair market value of \$15 per share. At the time of the distribution, A exchanges A's option for an option to purchase 20 percent of the D stock at \$20 per share and an option to purchase 20 percent of the C stock at \$10 per share. The exchange of the options in D for options in D and C did not materially increase the likelihood that the options would be exercised. Nonetheless, based on all the facts and circumstances, it is reasonably certain, immediately after the distribution, that A will exercise its options. Under paragraph (c)(3)(iii)(C) of this section, the substituted options are treated as issued on the date the original option was issued. Accordingly, the options are treated as exercised by A on the date that A purchased the original option. A is treated as owning 60 percent of the D stock and 60 percent of the C stock that is disqualified stock, and the distribution is a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

Example 2. D owns all of the stock of C. A purchases 37 percent of D's only class of stock. B owns 38 percent of the D stock, and the remaining 25 percent is owned by 20 individuals, each of whom owns less than five percent of D's stock. A purchases an option to purchase an additional 14 percent of the D stock from shareholders other than B for \$50 per share. The option is subject to no contingencies or restrictive covenants, may be exercised within five years after its issuance, and is not described in paragraph (c)(3)(vi) of this section. Within five years of A's purchase of the option and 37 percent interest in D, D distributes the stock of its subsidiary C pro rata and A receives 37 percent of the C stock in the distribution. At the time of the distribution, A exchanges its option for an option to purchase 14 percent of the D stock at \$25 per share and an option to purchase 14 percent of the C stock at \$25 per share. Assume that, although a shareholder that owned no D or C stock would pay only \$20 per share for D or C stock immediately after the distribution, a shareholder in A's position would pay \$30 per share for 14 percent of the stock of D or C because of the control premium which attaches to the shares. The control premium is taken into account under paragraph (c)(3)(vii)(A) of this section to determine whether A is reasonably certain to exercise the options. The exchange of the options in D for options in D and C did not materially increase the likelihood that the options would be exercised. Nonetheless, based on all the facts and circumstances, it is reasonably certain, immediately after the distribution, that A will exercise its options. Under paragraph (c)(3)(iii)(C) of this section, the substituted options are treated as issued on the date the original option was issued. Accordingly, the options are treated as exercised by A on the date that A purchased the original option. Under paragraph (c)(2) of this section, all shares of D and C are considered to have the same value to determine the amount of stock A is treated as purchasing under the options. A is treated as owning 51 percent of the D stock and 51 percent of the C stock that is disqualified stock, and the distribution is a disqualified distribution under section 355(d)(2).

(4) *Plan or arrangement*—(i) *In general.* Under section 355(d)(7)(B), if two or more persons act pursuant to a plan or arrangement with respect to acquisitions of stock in the distributing corporation or controlled corporation, those persons are treated as one person for purposes of section 355(d).

(ii) *Understanding.* For purposes of section 355(d)(7)(B), two or more persons who are (or will after an acquisition become) shareholders (or are treated as shareholders under paragraph (c)(3)(ii) of this section) act pursuant to a plan or arrangement with respect to an acquisition of stock only if they have a formal or informal understanding among themselves to make a coordinated acquisition of stock. A principal element in determining if such an understanding exists is whether the investment decision of each person is based on the investment decision of one or more other existing or prospective shareholders. However, the participation by creditors in formulating a plan for an insolvency workout or a reorganization in a title 11 or similar case (whether as members of a creditors' committee or otherwise) and the receipt of stock by creditors in satisfaction of indebtedness pursuant to the workout or reorganization do not cause the creditors to be considered as acting pursuant to a plan or arrangement.

(iii) *Examples.* The following examples illustrate paragraph (c)(4)(ii) of this section:

Example 1. D has 1,000 shares of common stock outstanding. A group of 20 unrelated individuals who previously owned no D stock (the Group) agree among themselves to acquire 50 percent or more of D's stock. The Group is not a person under section 7701(a)(1). Subsequently, pursuant to their understanding, the members of the Group purchase 600 shares of D common stock from the existing D shareholders (a total of 60 percent of the D stock), with each member purchasing 30 shares. Under paragraph (c)(4)(ii) of this section, the members of the Group have a formal or informal understanding among themselves to make a coordinated acquisition of stock. Their interests are therefore aggregated under section 355(d)(7)(B), and they are treated as one person that purchased 600 shares of D's stock for purposes of section 355(d).

Example 2. D has 1,000 shares of outstanding stock owned by unrelated individuals. D's management is concerned that D may become subject to a takeover bid. In separate meetings, D's management meets with potential investors who own no stock and are friendly to management to convince them to acquire D's stock based on an understanding that D will assemble a group that in the aggregate will acquire more than 50 percent of D's stock. Subsequently, 15 of these investors each purchases four percent of D's outstanding stock. Under paragraph (c)(4)(ii) of this section, the 15 investors have

a formal or informal understanding among themselves to make a coordinated acquisition of stock. Their interests are therefore aggregated under section 355(d)(7)(B), and they are treated as one person that purchased 600 shares of D stock for purposes of section 355(d).

Example 3. (i) D has 1,000 shares of outstanding stock owned by unrelated individuals. An investment advisor advises its clients that it believes D's stock is undervalued and recommends that they acquire D stock. Acting on the investment advisor's recommendation, 20 unrelated individuals each purchases 30 shares of the outstanding D stock. Each client's decision was not based on the investment decisions made by one or more other clients. Because there is no formal or informal understanding among the clients to make a coordinated acquisition of D stock, their interests are not aggregated under section 355(d)(7)(B) and they are treated as making separate purchases.

(ii) The facts are the same as in paragraph (i) of this *Example 3*, except that the investment advisor is also the underwriter (without regard to whether it is a firm commitment or best efforts underwriting) for a primary or secondary offering of D stock. The result is the same.

(iii) The facts are the same as in paragraph (i) of this *Example 3*, except that, instead of an investment advisor recommending that clients purchase D stock, the trustee of several trusts qualified under section 401(a) sponsored by unrelated corporations causes each trust to purchase the D stock. The result is the same, provided that the trustee's investment decision made on behalf of each trust was not based on the investment decision made on behalf of one or more of the other trusts.

(iv) *Exception—(A) Subsequent disposition.* If two or more persons do not act pursuant to a plan or arrangement within the meaning of this paragraph (c)(4) with respect to an acquisition of stock in a corporation (the first corporation), a subsequent acquisition in which such persons exchange their stock in the first corporation for stock in another corporation (the second corporation) in a transaction in which the basis of the second corporation's stock in the hands of such persons is determined in whole or in part by reference to the basis of their stock in the first corporation, will not result in such persons being treated as one person, even if the acquisition of the second corporation's stock is pursuant to a plan or arrangement.

(B) *Example.* The following example illustrates this paragraph (c)(4)(iv):

Example. In an initial public offering of D stock on Date 1, 100 investors independently purchase one percent each of the D stock. Two years later, D merges into P (in a reorganization described in section 368(a)(1)(A)) and, pursuant to the plan of reorganization, the D shareholders exchange their D stock for 50 percent of the stock of

P. The D shareholders approve the plan by a two-thirds vote, as required by state law. Under section 358(a), each shareholder's basis in its P stock is determined by reference to the basis of the D stock it purchased. Under paragraph (e)(3) of this section, the former D shareholders are treated as purchasing their P stock on Date 1. The investors do not become a single person under paragraph (c)(4) of this section with respect to the deemed purchase of the P stock on Date 1 by virtue of their acquisition of the P stock pursuant to the merger on Date 2.

(d) *Purchase—(1) In general—(i) Definition of purchase under section 355(d)(5)(A).* Under section 355(d)(5)(A), except as otherwise provided in section 355(d)(5)(B) and (C), a *purchase* means any acquisition, but only if—

(A) The basis of the property acquired in the hands of the acquirer is not determined—

(1) In whole or in part by reference to the adjusted basis of such property in the hands of the person from whom acquired; or

(2) Under section 1014(a); and

(B) The property is not acquired in an exchange to which section 351, 354, 355, or 356 applies.

(ii) *Section 355 distributions.*

Paragraph (d)(1)(i)(B) of this section includes all section 355 distributions, whether in exchange (in whole or in part) for stock or pro rata.

(iii) *Example.* The following example illustrates this paragraph (d)(1):

Example. Section 304(a)(1) acquisition. A, who owns all of the stock of P and T, sells the T stock to P for cash. The T stock is not marketable stock under section 355(d)(5)(B)(ii) and paragraph (d)(3)(ii) of this section. A is treated under section 304(a)(1) as receiving a distribution in redemption of the P stock. Under section 302(d), the deemed redemption is treated as a section 301 distribution. Assume that under sections 304(b)(2) and 301(c)(1), all of the distribution is a dividend. A and P are treated in the same manner as if A had transferred the T stock to P in exchange for stock of P in a transaction to which section 351(a) applies, and P had then redeemed the stock P was treated as issuing in the transaction. Under section 362(a), P's basis in the T stock is determined by reference to A's adjusted basis in the T stock, and there is no basis increase in the T stock because A recognizes no gain on the deemed transfer. Accordingly, P's acquisition of the T stock from A is not a purchase by P under section 355(d)(5)(A)(i)(I) and paragraphs (d)(1)(i)(A)(1) and (d)(2)(i)(B) of this section.

(2) *Exceptions to definition of purchase under section 355(d)(5)(A).* The following acquisitions are not treated as purchases under section 355(d)(5)(A):

(i) *Acquisition of stock in a transaction which includes other*

property or money—(A) Transferors and shareholders of transferor or distributing corporations—(1) In general. An acquisition of stock permitted to be received by a transferor of property without the recognition of gain under section 351(a), or permitted to be received without the recognition of gain under section 354, 355, or 356 is not a purchase to the extent section 358(a)(1) applies to determine the recipient's basis in the stock received, whether or not the recipient recognizes gain under section 351(b) or 356. But see paragraph (e)(3) of this section (interest received in exchange for purchased interest in exchanged basis transaction treated as purchased).

(2) *Exception.* To the extent there is received in the exchange or distribution, in addition to stock described in paragraph (d)(2)(i)(A)(1) of this section, stock that is other property under section 351(b) or 356(a)(1), the stock is treated as purchased on the date of the exchange or distribution for purposes of section 355(d).

(B) *Transferee corporations—(1) In general.* An acquisition of stock by a corporation is not a purchase to the extent section 334(b) or 362(a) or (b) applies to determine the corporation's basis in the stock received. But see section 355(d)(5)(C) and paragraph (e)(2) of this section (purchased property transferred in transferred basis transaction is treated as purchased by transferee).

(2) *Exception.* If a corporation acquires stock, the stock is treated as purchased on the date of the stock acquisition for purposes of section 355(d)—

(i) If the liquidating corporation recognizes gain or loss with respect to the transferred stock as described in section 334(b)(1); or

(ii) To the extent the basis of the transferred stock is increased through the recognition of gain by the transferor under section 362(a) or (b).

(C) *Examples.* The following examples illustrate this paragraph (d)(2)(i):

Example 1. (i) A owns all the stock of T. T merges into D in a transaction qualifying under section 368(a)(1)(A), with A exchanging all of the T stock for D stock and \$100 cash. Under section 356(a)(1), A recognizes \$100 of the realized gain on the transaction. Under section 358(a)(1), A's basis in the D stock equals A's basis in the T stock, decreased by the \$100 received and increased by the gain recognized, also \$100. Under paragraph (d)(2)(i)(A) of this section, A is not treated as having purchased the D stock for purposes of section 355(d)(5).

(ii) The facts are the same as in paragraph (i) of this *Example 1*, except that rather than D stock and \$100 cash, A receives D stock

and stock in C, a corporation not a party to the reorganization, with a fair market value of \$100. Under section 358(a)(2), A's basis in the C stock is its fair market value, or \$100. Under paragraph (d)(2)(i)(A)(2) of this section, A is treated as having purchased the C stock, but not the D stock, for purposes of section 355(d)(5).

Example 2. A purchases all of the stock of D, which is not marketable stock, on Date 1 for \$90. Within five years of A's purchase, on Date 2, A contributes the D stock to P in exchange for P stock worth \$90 and \$10 cash in a transaction qualifying under section 351. A recognizes a gain of \$10 as a result of the transfer. Under section 362(a), P's basis in D is \$100. P is treated as having purchased 90 percent (\$90 worth) of the D stock on Date 1 under section 355(d)(5)(C) and paragraph (e)(2) of this section and as having purchased 10 percent (\$10 worth) of the D stock on Date 2 under paragraph (d)(2)(i)(B)(2)(ii) of this section.

(ii) *Acquisition of stock in a distribution to which section 305(a) applies.* An acquisition of stock in a distribution qualifying under section 305(a) is not a purchase to the extent section 307(a) applies to determine the recipient's basis. However, to the extent the distribution is of rights to acquire stock, see paragraph (c)(3) of this section for rules regarding options, warrants, convertible obligations, and other similar interests.

(iii) *Section 1036(a) exchange.* An exchange of stock qualifying under section 1036(a) is not a purchase by either party to the exchange to the extent the basis of the property acquired equals that of the property exchanged under section 1031(d).

(iv) *Section 338 elections—(A) In general.* Stock acquired in a qualified stock purchase with respect to which a section 338 election (or a section 338(h)(10) election) is made is not treated as a purchase for purposes of section 355(d)(5)(A). However, any stock (or an interest in another entity) held by old target that is treated as purchased by new target is treated as acquired by purchase for purposes of section 355(d)(5)(A) unless a section 338 election or section 338(h)(10) election also is made for that stock. See § 1.338-2T(c) for the definitions of section 338 election, section 338(h)(10) election, old target, and new target.

(B) *Example.* The following example illustrates this paragraph (d)(2)(iv):

Example. T owns all of the stock of S and no other assets. X acquires all of the T stock from the T shareholders for cash and makes an election under section 338. Under section 338(a) and (b), T, as Old T, is treated as having sold all of its assets at fair market value and purchased the assets as a new corporation, New T, as of the beginning of the day after the acquisition date. Under paragraph (d)(2)(iv)(A) of this section, X is

not treated as having purchased the T stock. Absent a section 338 election or a section 338(h)(10) election with respect to S, New T is treated as having purchased all of the S stock under section 355(d)(5)(A).

(v) *Partnership distributions*—(A) *Section 732(b)*. An acquisition of stock (or an interest in another entity) in a liquidation of a partner's interest in a partnership in which basis is determined pursuant to section 732(b) is a purchase at the time of the liquidation.

(B) *Section 734(b)*. If the adjusted basis of stock (or an interest in another entity) held by a partnership is increased under section 734(b), a proportionate amount of the stock (or other interest) will be treated as purchased at the time of the basis adjustment, determined by reference to the amount of the basis adjustment (but not in excess of the fair market value of the stock (or other interest) at the time of the adjustment) over the fair market value of the stock (or other interest) at the time of the adjustment.

(3) *Certain section 351 exchanges treated as purchases*—(i) *In general*—(A) *Treatment of stock received by transferor*. Under section 355(d)(5)(B), a purchase includes any acquisition of property in an exchange to which section 351 applies to the extent the property is acquired in exchange for any cash or cash item, any marketable stock, or any debt of the transferor. The property treated as acquired by purchase is the property received by the transferor in the exchange.

(B) *Multiple classes of stock*. If the transferor in a transaction described in section 355(d)(5)(B) receives stock or securities of more than one class, or receives both stock and securities, then the amount of stock or securities purchased is determined in a manner that corresponds to the allocation of basis to the stock or securities under section 358. See § 1.358-2(b).

(ii) *Cash item, marketable stock*. For purposes of section 355(d)(5)(B) and this paragraph (d)(3), either or both of the terms cash item and marketable stock include personal property within the meaning of section 1092(d)(1) and § 1.1092(d)-1, without giving effect to section 1092(d)(3).

(iii) *Exception for certain acquisitions*—(A) *In general*. Except to the extent provided in paragraph (e)(3) of this section (interest received in exchange for purchased interest in exchanged basis transaction treated as purchased), an acquisition of stock in a corporation in a section 351 transaction by one or more persons in exchange for an amount of stock in another corporation (the transferred corporation) that meets the requirements of section

1504(a)(2) is not a purchase by the transferor or transferors, regardless of whether the stock of the transferred corporation is marketable stock under section 355(d)(5)(B)(ii) and paragraph (d)(3)(ii) of this section.

(B) *Example*. The following example illustrates this paragraph (d)(3)(iii):

Example. D's two classes of stock, voting common and nonvoting preferred, are both widely held and publicly traded. The nonvoting preferred stock is stock described in section 1504(a)(4). Assume that all of the D stock is marketable stock under section 355(d)(5)(B)(ii) and paragraph (d)(3)(ii) of this section. D's board of directors proposes that, for valid business purposes, D's common stock should be held by a holding company, HC, but its preferred stock should not be transferred to HC. As proposed, the D common shareholders exchange their D stock solely for HC common stock in a section 351(a) transaction. The D preferred shareholders retain their stock. HC acquires an amount of D stock that meets the requirements of section 1504(a)(2). Although the D common stock was marketable stock in the hands of the D shareholders immediately before the transfer, and the D nonvoting preferred stock is marketable stock after the transfer, the D shareholders are not treated as having acquired the HC stock by purchase (except to the extent the exchanged basis rule of paragraph (e)(3) of this section may apply to treat HC stock as purchased on the date the exchanged D stock was purchased).

(iv) *Exception for assets transferred as part of an active trade or business*—(A) *In general*. Except to the extent provided in paragraph (e)(3) of this section, an acquisition not described in paragraph (d)(3)(iii) of this section of stock in exchange for any cash or cash item, any marketable stock, or any debt of the transferor in a section 351 transaction is not a purchase if—

(1) The transferor is engaged in the active conduct of a trade or business under paragraph (d)(3)(iv)(B) of this section and the transferred items (including debt incurred in the ordinary course of the trade or business) are used in the trade or business;

(2) The transferred items do not exceed the reasonable needs of the trade or business under paragraph (d)(3)(iv)(C) of this section;

(3) The transferor transfers the items as part of the trade or business; and

(4) The transferee continues the active conduct of the trade or business.

(B) *Active conduct of a trade or business*. For purposes of this paragraph (d)(3)(iv), whether, with respect to the trade or business at issue, the transferor and transferee are engaged in the active conduct of a trade or business is determined under § 1.355-3(b)(2) and (3), except that—

(1) Conduct is tested before the transfer (with respect to the transferor)

and after the transfer (with respect to the transferee) rather than immediately after a distribution; and

(2) The trade or business need not have been conducted for five years before its transfer, but it must have been conducted for a sufficient period of time to establish that it is a viable and ongoing trade or business.

(C) *Reasonable needs of the trade or business*. For purposes of this paragraph (d)(3)(iv), the reasonable needs of the trade or business include only the amount of cash or cash items, marketable stock, or debt of the transferor that a prudent business person apprised of all relevant facts would consider necessary for the present and reasonably anticipated future needs of the business.

Transferred items may be considered necessary for reasonably anticipated future needs only if the transferor and transferee have specific, definite, and feasible plans for their use. Those plans must require that items intended for anticipated future needs rather than present needs be used as expeditiously as possible consistent with the business purpose for retention of the items. Future needs are not reasonably anticipated if they are uncertain or vague or where the execution of the plan for their use is substantially postponed. The reasonable needs of a trade or business are generally its needs at the time of the transfer of the business including the items. However, for purposes of applying section 355(d) to a distribution, events and conditions after the transfer and through the date immediately after the distribution (including whether plans for the use of transferred items have been consummated or substantially postponed) may be considered to determine whether at the time of the transfer the items were necessary for the present and reasonably anticipated future needs of the business.

(D) *Consideration of all facts and circumstances*. All facts and circumstances are considered in determining whether this paragraph (d)(3)(iv) applies.

(E) *Successive transfers*. A transfer of assets does not fail to meet the requirements of paragraph (d)(3)(iv)(A)(4) of this section solely because the transferee transfers the assets directly (or indirectly through other members) to another member of the transferee's affiliated group, as defined in § 1.355-3(b)(4)(iv) (the final transferee), if the requirements of paragraphs (d)(3)(iv)(A)(1), (2), (3) and (4) of this section would be met if the transferor had transferred the assets directly to the final transferee.

(v) *Exception for transfer between members of the same affiliated group—*
(A) *In general.* Except to the extent provided in paragraph (e)(3) of this section, an acquisition of stock (whether actual or constructive) not described in paragraphs (d)(3)(iii) and (iv) of this section in exchange for any cash or cash item, marketable stock, or debt of the transferor in a section 351 transaction is not a purchase if—

(1) The transferor corporation or corporations and the transferee corporation (whether formed in the transaction or already existing) are members of the same affiliated group as defined in section 1504(a) before the section 351 transaction (if the transferee corporation is in existence before the transaction);

(2) The cash or cash item, marketable stock or debt of the transferor are not included in assets that are acquired (or treated as acquired) by the transferor (or another member of the transferor's affiliated group) from a nonmember in a related transaction in which section 362(a) or (b) applies to determine the basis in the acquired assets; and

(3) The transferor corporation or corporations, the transferee corporation, and any distributed controlled corporation of the transferee corporation do not cease to be members of such affiliated group in any transaction pursuant to a plan that includes the section 351 transaction (including any distribution of a controlled corporation by the transferee corporation). But see paragraph (b)(4) of this section where the transfer is made for a principal purpose to avoid the purposes of section 355(d).

(B) *Examples.* The following examples illustrate this paragraph (d)(3)(v):

Example 1. Publicly traded P has wholly owned S since 1990. S is engaged in the telecommunications business and the business of computer software development. S is developing new software for use in the managed health care industry. Over a period of four years beginning on January 31, 2000, P contributes a substantial amount of cash to S solely for the purpose of funding the software development. On completion of the software in January of 2004, 60 percent of the value of the S stock is attributable to the cash contributions made within the last four years. The P group's primary lender requires that S separately incorporate the software and related assets and distribute the new subsidiary to P as a condition of providing required funding to market the software. Accordingly, on February 1, 2004, S forms N, contributes the software and related assets to N, and distributes all of the N stock to P in a transaction intended to qualify under section 355(a). P, S, and N will not leave the affiliated group in any transaction related to the cash contributions. Under paragraph

(d)(3)(v)(A) of this section, P's cash contributions to S are not treated as purchases of additional S stock, and the distribution of N from S to P is not a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

Example 2. On Date 1, P contributes cash to its subsidiary S with a principal purpose to increase its stock basis in S. Sixty percent of the value of P's S stock is attributable to the cash contribution. Under paragraph (b)(4) of this section (anti-avoidance rule), 60 percent of the S stock is treated as purchased under section 355(d)(5)(B), notwithstanding paragraph (d)(3)(v)(A) of this section. Accordingly, any distribution of a subsidiary of S to P within the five-year period after Date 1 will be a disqualified distribution, regardless of whether P, S, and any distributed S subsidiary remain affiliated after the distribution and any transactions related to the cash contribution.

(4) *Triangular asset reorganizations—*
(i) *Definition.* A triangular asset reorganization is a reorganization that qualifies under—

(A) Section 368(a)(1)(A) or (G) by reason of section 368(a)(2)(D);

(B) Section 368(a)(1)(A) by reason of section 368(a)(2)(E) (regardless of whether section 368(a)(3)(E) applies), unless the transaction also qualifies as either a section 351 transfer or a reorganization under section 368(a)(1)(B); or

(C) Section 368(a)(1)(C), and stock of the controlling corporation rather than the acquiring corporation is exchanged for the acquired corporation's properties.

(ii) *Treatment.* Notwithstanding section 355(d)(5)(A), for purposes of section 355(d), the controlling corporation in a triangular asset reorganization is treated as having—

(A) Acquired the assets of the acquired corporation (and as having assumed any liabilities assumed by the controlling corporation's subsidiary corporation or to which the acquired corporation's assets were subject (the acquired liabilities)) in a transaction in which the controlling corporation's basis in the acquired corporation's assets was determined under section 362(b); and

(B) Transferred the acquired assets and acquired liabilities to its subsidiary corporation in a section 351 transfer.

(iii) *Example.* The following example illustrates this paragraph (d)(4):

Example. Forward triangular reorganization. P forms S with \$25 of cash and T merges into S in a reorganization qualifying under section 368(a)(1)(A) by reason of section 368(a)(2)(D) in which the T shareholders receive \$70 of P stock and \$15 of cash in exchange for their T stock. T is not a common parent of a consolidated group of corporations. The remaining \$10 of cash with which P formed S will not be used in the

acquired business. T's assets consist only of assets part of and used in its business with a value of \$80, and \$5 of cash that is not part of or used in T's business. T has no liabilities. S will use T's business assets in T's business (which will become S's business), but will invest the \$5 of cash in an unrelated passive investment. Under paragraph (d)(4)(ii) of this section, P is treated as acquiring the T assets in a transaction in which P's basis in the T assets was determined under section 362(b) and contributing them to S in a section 351 transfer. Under paragraph (d)(3)(v) of this section, \$10 (of the total \$25) of cash contributed by P to S upon S's formation is not treated as a purchase of S stock. The \$15 (of the total \$25) of cash contributed by P to S upon S's formation that is paid to T's shareholders is not treated as a purchase of S stock. The exception in paragraph (d)(3)(v) of this section does not apply to the \$5 of cash from T's business because P is treated as having acquired T's assets in a related transaction in which section 362(b) applies to determine P's basis in such assets. Accordingly, P is treated under section 355(d)(5)(B) and paragraph (d)(3)(iv) of this section as having purchased \$5 of the S stock, but is not deemed to have purchased the remaining \$80 of the S stock.

(5) *Reverse triangular reorganizations other than triangular asset reorganizations—*
(i) *In general.* Except as provided in paragraph (d)(5)(ii) of this section, if a transaction qualifies as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E) and also as either a reorganization under section 368(a)(1)(B) or a section 351 transfer, then either section 355(d)(5)(B) (and paragraphs (d)(3)(i) through (iv) of this section) or 355(d)(5)(C) (and paragraph (e)(2) of this section) applies. Regardless of which method the controlling corporation employs to determine its basis in the surviving corporation stock under § 1.358-6(c)(2)(ii) or § 1.1502-30(b), the total amount of surviving corporation stock treated as purchased by the controlling corporation will equal the higher of—

(A) The amount of surviving corporation stock that would be treated as purchased (on the date of the deemed section 351 transfer) by the controlling corporation if the controlling corporation acquired the surviving corporation's assets and assumed its liabilities in a transaction in which the controlling corporation's basis in the surviving corporation assets was determined under section 362(b), and then transferred the acquired assets and liabilities to the surviving corporation in a section 351 transfer (see §§ 1.358-6(c)(1) and (2)(ii)(A), and 1.1502-30(b)); or

(B) The amount of surviving corporation stock that would be treated

as purchased (on the date the surviving corporation shareholders purchased their surviving corporation stock) if the controlling corporation acquired the stock of the surviving corporation in a transaction in which the basis in the surviving corporation's stock was determined under section 362(b) (see §§ 1.358-6(c)(2)(ii)(B) and 1.1502-30(b)).

(ii) *Letter ruling and closing agreement.* If a controlling corporation obtains a letter ruling and enters into a closing agreement under section 7121 in which it agrees to determine its basis in surviving corporation stock under § 1.358-6(c)(2)(ii)(A), or under § 1.1502-30(b) by applying § 1.358-6(c)(2)(ii)(A) (deemed asset acquisition and transfer by controlling corporation), then section 355(d)(5)(B) and paragraphs (d)(3)(i) through (iv) of this section apply, and section 355(d)(5)(C) and paragraph (e)(2) of this section do not apply. If a controlling corporation obtains a letter ruling and enters into a closing agreement under section 7121 under which it agrees to determine its basis in surviving corporation stock under § 1.358-6(c)(2)(ii)(B), or under § 1.1502-30(b) by applying § 1.358-6(c)(2)(ii)(B) (deemed stock acquisition), then section 355(d)(5)(C) and paragraph (e)(2) of this section apply, and section 355(d)(5)(B) and paragraphs (d)(3)(i) through (iv) of this section do not apply.

(iii) *Example.* The following example illustrates this paragraph (d)(5):

Example. Reverse triangular reorganization; purchase. (i) A purchases 60 percent of the stock of D on Date 1. D owns no cash items, marketable stock, or transferor debt, but holds cash that is not part of or used in D's trade or business under paragraph (d)(3)(iv) of this section and that represents 20 percent of D's value. On Date 2, P forms S, and S merges into D in a reorganization qualifying under section 368(a)(1)(B) and under section 368(a)(1)(A) by reason of section 368(a)(2)(E). In the reorganization, P acquires all of the D stock in exchange solely for P stock. After Date 2, and within five years after Date 1, D distributes its wholly owned subsidiary C to P. P does not obtain a letter ruling and enter into a closing agreement under paragraph (d)(5)(ii) of this section. P would acquire 20 percent of the D stock by purchase on Date 2 under paragraph (d)(5)(i)(A) of this section by operation of section 355(d)(5)(B) and paragraph (d)(3)(iv) of this section. The exception in paragraph (d)(3)(v) of this section does not apply because D was not affiliated with P before the transaction in which the section 351 transfer is deemed to occur and D's assets are treated as acquired by P in a related transaction in which section 362(b) applies to determine P's basis in the D assets. P would acquire 60 percent of the D stock by purchase on Date 1 under paragraph (d)(5)(i)(B) of this section because, under the transferred basis rule of section

355(d)(5)(C) and paragraph (e)(2) of this section, P is treated as though P purchased the D stock on the date A purchased it. Accordingly, under paragraph (d)(5)(i) of this section, P is treated as acquiring the higher amount (60 percent) by purchase on Date 1. D's distribution of C to P is a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section. In addition, A is treated as acquiring the P stock by purchase on Date 1 under paragraph (e)(3) of this section because A's basis in the P stock is determined by reference to A's basis in the D stock.

(ii) The facts are the same as in paragraph (i) of this *Example*, except that P obtains a letter ruling and enters into a closing agreement under which it agrees to determine its basis in the D stock under § 1.358-6(c)(2)(ii)(A). Under paragraph (d)(5)(ii) of this section, section 355(d)(5)(B) (and paragraphs (d)(3)(i) through (iv) of this section) applies, and section 355(d)(5)(C) (and paragraph (e)(2) of this section) does not apply. Accordingly, P is treated as acquiring only 20 percent of the D stock by purchase on Date 2. D's distribution of C to P is not a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

(6) *Treatment of group structure changes—(i) In general.*

Notwithstanding section 355(d)(5)(A), for purposes of section 355(d), if a corporation succeeds another corporation as the common parent of a consolidated group in a group structure change to which § 1.1502-31 applies, the new common parent is treated as having acquired the assets and assumed the liabilities of the former common parent in a transaction in which the new common parent's basis in the former common parent's assets was determined under section 362(b), and then transferred the acquired assets and liabilities to the former common parent (or, if the former common parent does not survive, to the new common parent's subsidiary) in a section 351 transfer, with the new common parent and former common parent being treated as not in the same affiliated group at the time of the transfer for purposes of applying paragraph (d)(3)(v) of this section (notwithstanding § 1.1502-31(c)(2)).

(ii) *Adjustments to basis of higher-tier members.* A higher-tier member that indirectly owns all or part of the former common parent's stock after a group structure change is treated as having purchased the stock of an immediate subsidiary to the extent that the higher-tier member's basis in the subsidiary is increased under § 1.1502-31(d)(4).

(iii) *Example.* The following example illustrates this paragraph (d)(6):

Example. P is the common parent of a consolidated group, and T is the common parent of another group. P has owned S for more than five years, and the fair market

value of the S stock is \$50. T's assets consist only of non-marketable stock of direct and indirect wholly owned subsidiaries with a value of \$50, assets used in its business with a value of \$50, and \$50 of marketable stock that is not part of or used in T's business. T has no liabilities. T merges into S with the T shareholders receiving solely P stock with a value of \$150 in exchange for their T stock in a section 368(a)(2)(D) reorganization. S will use T's business assets in T's business (which will become S's business), but will hold the \$50 of marketable stock for investment purposes. Assume that the transaction is a reverse acquisition under § 1.1502-75(d)(3) because the T shareholders, as a result of owning T stock, own more than 50 percent of the value of P's stock immediately after the transaction. Thus, the transaction is a group structure change under § 1.1502-33(f)(1). Under paragraph (d)(6) of this section, P is treated as having acquired the assets of T in a transaction in which P's basis in the T assets was determined under section 362(b), and then transferred the acquired assets to S in a section 351 transfer, with P and T being treated as not in the same affiliated group at the time of the transfer solely for purposes of paragraph (d)(3)(v) of this section. The exception in paragraph (d)(3)(v) of this section (transfers within an affiliated group) does not apply. Accordingly, P is treated under section 355(d)(5)(B) and paragraph (d)(3)(iv) of this section as having purchased \$50 of the S stock (attributable to the marketable stock), but is not deemed to have purchased the remaining \$150 of the S stock.

(7) *Special rules for triangular asset reorganizations, other reverse triangular reorganizations, and group structure changes.* The amount of acquiring subsidiary, surviving corporation, or former common parent stock that is treated as purchased under paragraph (c)(4), (5)(i)(A), or (6) of this section (by operation of section 355(d)(5)(B) and paragraphs (d)(3)(i) through (iv) of this section) is adjusted to reflect any basis adjustment under—

(i) Section 1.358-6(c)(2)(i)(B) and (C) (reduction of basis adjustment in reverse triangular reorganization where controlling corporation acquires less than all of the surviving corporation stock), § 1.1502-30(b) (applying § 1.358-6(c)(2)(i)(B) and (C) to a consolidated group), and § 1.1502-31(d)(2)(ii) (reduction of basis adjustment in group structure change where new common parent acquires less than all of the former common parent stock); or

(ii) Section 1.358-6(d) (reduction of basis adjustment in any triangular reorganization to the extent controlling corporation does not provide consideration), § 1.1502-30(b) (applying § 1.358-6(d) (except § 1.358-6(d)(2)) to a consolidated group), and § 1.1502-31(d)(1) (reduction of basis adjustment in group structure change to the extent

new common parent does not provide consideration).

(e) *Deemed purchase and timing rules*—(1) *Attribution and aggregation*—

(i) *In general.* Under section 355(d)(8)(B), if any person acquires by purchase an interest in any entity, and the person is treated under section 355(d)(8)(A) as holding any stock by reason of holding the interest, the stock shall be treated as acquired by purchase on the later of the date of the purchase of the interest in the entity or the date the stock is acquired by purchase by such entity.

(ii) *Purchase of additional interest.* If a person and an entity are treated as a single person under section 355(d)(7), and the person later purchases an additional interest in the entity, the person is treated as purchasing on the date of the later purchase the amount of stock attributed from the entity to the person under section 355(d)(8)(A) as a result of the additional interest.

(iii) *Purchase between persons treated as one person.* If two persons are treated as one person under section 355(d)(7), and one later purchases stock from the other, the date of the later purchase is used for purposes of determining when the five-year period commences.

(iv) *Purchase by a person already treated as holding stock under section 355(d)(8)(A).* If a person who is already treated as holding stock under section 355(d)(8)(A) later directly purchases such stock, the date of the later direct purchase is used for purposes of determining when the five-year period commences.

(v) *Examples.* The following examples illustrate this paragraph (e)(1):

Example 1. On Date 1, A purchases 10 percent of the stock of P, which has held 100 percent of the stock of T for more than five years at the time of A's purchase. A is deemed to have purchased 10 percent of P's T stock on Date 1. If A later purchases an additional 41 percent of the stock of P on Date 2, A is deemed to have purchased an additional 41 percent of P's T stock on Date 2. Because A and P are now related persons under section 267(b), they are treated as one person under section 355(d)(7)(A), and A is treated as owning all of P's T stock. A is treated as acquiring 51 percent of the T stock by purchase at the times of A's respective purchases of P stock on Date 1 and Date 2. The remaining 49 percent of T stock is treated as acquired when P acquired the T stock, more than five years before Date 1. If P distributes T after Date 2 and within five years after Date 1, the distribution will be a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

Example 2. A has owned 60 percent of the stock of P for more than five years, and P has owned 40 percent of the stock of T for more than five years. A and P are treated as one person, and A is treated as owning 40 percent

of the stock of T for more than five years. If P later purchases an additional 20 percent of the stock of T on Date 1, A is treated as acquiring by purchase the additional 20 percent of T stock on Date 1. If A then purchases an additional 10 percent of the stock of P on Date 2, under paragraph (e)(1)(i) of this section, A is deemed to have purchased on Date 2 an additional four percent of the T stock (10 percent of the 40 percent that P originally owned). In addition, even though A and P were already treated as one person under section 355(d)(7)(A), A also is deemed to have purchased two percent of the T stock on Date 2 (10 percent of the 20 percent of the T stock that it was treated as purchasing on Date 1). A is still treated as owning all 60 percent of the T stock owned by P. However, of the 60 percent, A is treated as having purchased 18 percent of the T stock on Date 1 and 6 percent of the T stock on Date 2, for a total of 24 percent purchased stock.

Example 3. A purchases a 20 percent interest in partnership M on Date 1. M has owned 30 percent of the stock and 25 percent of the securities of P for more than five years. P has owned 40 percent of the stock and 100 percent of the securities of T for more than five years. Under section 318(a)(2)(C) as modified by section 355(d)(8)(A), M is deemed to own 12 percent of the stock (30 percent of the 40 percent P owns) and 30 percent of the securities (30 percent of the 100 percent P owns) of T. Under sections 318(a)(2)(A) and 355(d)(8)(B), A is deemed to have purchased 2.4 percent of the stock (20 percent of the 12 percent M is deemed to own) and 6 percent of the securities (20 percent of the 30 percent M is deemed to own) of T on Date 1. Similarly, A is deemed to have purchased 6 percent of the stock (20 percent of the 30 percent M owns) and five percent of the securities (20 percent of the 25 percent M owns) of P on Date 1. If M later purchases an additional 10 percent of P stock on Date 2, M is deemed to have purchased four percent of the stock (10 percent of the 40 percent P owns) and 10 percent of the securities (10 percent of the 100 percent P owns) of T on Date 2. A is deemed to have purchased two percent of the stock of P on Date 2 (20 percent of the 10 percent M purchased). A is also deemed to have purchased 0.8 percent of the stock (20 percent of the four percent M is deemed to have purchased) and two percent of the securities (20 percent of the 10 percent M is deemed to have purchased) of T on Date 2.

Example 4. A and B are brother and sister. For more than five years, A has owned 75 percent of the stock of P, and B has owned 25 percent of the stock of P. A and B are treated as one person under section 267(b), and the stock of each is treated as purchased on the date it was purchased by A and B, respectively. If B later purchases 50 percent of the P stock from A on Date 1, A and B are still treated as one person. However, under paragraph (e)(3)(iii) of this section, the 50 percent of P stock that B purchased from A is treated as purchased on Date 1.

(2) *Transferred basis rule.* If any person acquires property from another person who acquired the property by

purchase (determined with regard to section 355(d)(5) and paragraphs (d) and (e)(2), (3) and (4) of this section, but without regard to section 355(d)(8) and paragraph (e)(1) of this section), and the adjusted basis of the property in the hands of the acquirer is determined in whole or in part by reference to the adjusted basis of the property in the hands of the other person, the acquirer is treated as having acquired the property by purchase on the date it was so acquired by the other person. The rule in this paragraph (e)(2) applies, for example, where stock of a corporation acquired by purchase is subsequently acquired in a section 351 transfer or a reorganization qualifying under section 368(a)(1)(B), but does not apply if the stock of a former common parent is acquired in a group structure change to which § 1.1502-31 applies. But see paragraph (d)(2)(i)(B)(2) of this section for situations where the stock is treated as purchased on the date of a transfer.

(3) *Exchanged basis rule*—(i) *In general.* If any person acquires an interest in an entity (the first interest) by purchase (determined with regard to section 355(d)(5) and paragraphs (d) and (e)(2), (3) and (4) of this section, but without regard to section 355(d)(8) and paragraph (e)(1) of this section), and the first interest is exchanged for an interest in the same or another entity (the second interest) where the adjusted basis of the second interest is determined in whole or in part by reference to the adjusted basis of the first interest, then the second interest is treated as having been purchased on the date the first interest was purchased. The rule in this paragraph (e)(3) applies only to exchanges that are not treated otherwise treated as purchases under section 355(d)(5) and paragraph (d) of this section. The rule in this paragraph (e)(3) applies, for example, where stock of a corporation acquired by purchase is subsequently exchanged for other stock in a section 351, 354, or 1036(a) exchange. But see paragraph (d)(2)(i)(A)(2) of this section for situations where the stock is treated as purchased on the date of an exchange or distribution.

(ii) *Example.* The following example illustrates this paragraph (e)(3):

Example. A purchases 50 percent of the stock of T on Date 1. On Date 2, T merges into D in a section 368(a)(1)(A) reorganization, with A exchanging all of the T stock solely for stock of D. Under section 358(a), A's basis in the D stock is determined by reference to the basis of the T stock it purchased. Accordingly, A is treated as having purchased the D stock on Date 1, and has a purchased basis in the D stock under paragraph (b)(3)(iii) of this section.

(4) *Certain section 355 or section 305 distributions*—(i) *Section 355*. If a distributing corporation distributes any stock of a controlled corporation with respect to recently purchased distributing stock in a distribution that qualifies under section 355 (or so much of section 356 as relates to section 355), such controlled corporation stock is deemed to be acquired by purchase by the distributee on the date the distributee acquired the recently purchased distributing stock. Recently purchased distributing stock is stock in the distributing corporation acquired by purchase (determined with regard to section 355(d)(5) and paragraphs (d) and (e)(2), (3), and (4) of this section, but without regard to section 355(d)(8) and paragraph (e)(1) of this section) by the distributee during the five-year period with respect to that distribution.

(ii) *Section 305*. If a corporation distributes its stock in a distribution that qualifies under section 305(a), the stock received in the distribution (to the extent section 307(a) applies to determine the recipient's basis) is deemed to be acquired by purchase by the recipient on the date (if any) that the recipient acquired by purchase (determined with regard to section 355(d)(5) and paragraphs (d) and (e)(2), (3), and (4) of this section), the stock with respect to which the distribution is made.

(5) *Substantial diminution of risk*—(i) *In general*. If section 355(d)(6) applies to any stock for any period, the running of any five-year period set forth in section 355(d)(3) is suspended during such period.

(ii) *Property to which suspension applies*. Section 355(d)(6) applies to any stock for any period during which the holder's risk of loss with respect to such stock, or with respect to any portion of the activities of the corporation, is (directly or indirectly) substantially diminished by an option, a short sale, any special class of stock, or any other device or transaction.

(iii) *Risk of loss substantially diminished*. Whether a holder's risk of loss is substantially diminished under section 355(d)(6) and paragraph (e)(5)(ii) of this section will be determined based on all facts and circumstances relating to the stock, the corporate activities, and arrangements for holding the stock.

(iv) *Special class of stock*. For purposes of section 355(d)(6) and paragraph (e)(5)(ii) of this section, the term special class of stock includes a class of stock that grants particular rights to, or bears particular risks for, the holder or the issuer with respect to the earnings, assets, or attributes of less than all the assets or activities of a

corporation or any of its subsidiaries. The term includes, for example, tracking stock and stock (or any related instruments or arrangements) the terms of which provide for the distribution (whether or not at the option of any party or in the event of any contingency) of any controlled corporation or other specified assets to the holder or to one or more persons other than the holder.

(f) *Duty to determine stockholders*—(1) *In general*. In determining whether section 355(d) applies to a distribution of controlled corporation stock, a distributing corporation must determine whether a disqualified person holds its stock or the stock of any distributed controlled corporation. This paragraph (f) provides rules regarding this determination and the extent to which a distributing corporation must investigate whether a disqualified person holds stock.

(2) *Deemed knowledge of contents of securities filings*. A distributing corporation is deemed to have knowledge of the existence and contents of all schedules, forms, and other documents filed with or under the rules of the Securities and Exchange Commission, including without limitation any Schedule 13D or 13G (or any similar schedules) and amendments, with respect to any relevant corporation.

(3) *Presumption as to securities filings*. Absent actual knowledge to the contrary, in determining whether section 355(d) applies to a distribution, a distributing corporation may presume, with respect to stock that is reporting stock (while such stock is reporting stock), that every shareholder or other person required to file a schedule, form, or other document with or under the rules of the Securities and Exchange Commission as of a given date has filed the schedule, form, or other document as of that date and that the contents of filed schedules, forms, or other documents are accurate and complete. Reporting stock is stock that is described in Rule 13d-1(i) of Regulation 13D (17 CFR 240.13d-1(i)) (or any rule or regulation to generally the same effect) promulgated by the Securities and Exchange Commission under the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*).

(4) *Presumption as to less-than-five-percent shareholders*. Absent actual knowledge (or deemed knowledge under paragraph (f)(2) of this section) immediately after the distribution to the contrary with regard to a particular shareholder, a distributing corporation may presume that no less-than-five-percent shareholder of a corporation

acquired stock or securities by purchase under section 355(d)(5) or (8) and paragraphs (d) and (e) of this section during the five-year period. For purposes of this paragraph (f), a less-than-five-percent shareholder is a person that, at no time during the five-year period, holds directly (or by application of paragraph (c)(3)(ii) of this section, but not by application of section 355(d)(7) or (8)) stock possessing five percent or more of the total combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation. However, this presumption does not apply to any less-than-five-percent shareholder that, at any time during the five-year period—

(i) Is related under section 355(d)(7)(A) to a shareholder in the corporation that is, at any time during the five-year period, not a less-than-five-percent shareholder;

(ii) Acted pursuant to a plan or arrangement, with respect to acquisitions of the corporation's stock or securities under section 355(d)(7)(B) and paragraph (c)(4) of this section, with a shareholder in the corporation that is, at any time during the five-year period, not a less-than-five-percent shareholder; or

(iii) Holds stock or securities that is attributed under section 355(d)(8)(A) to a shareholder in the corporation that is, at any time during the five-year period, not a less-than-five-percent shareholder.

(5) *Examples*. The following examples illustrate this paragraph (f):

Example 1. Publicly traded corporation; no schedules filed. D is a widely held and publicly traded corporation with a single class of reporting stock and no other class of stock. Assume that applicable federal law requires any person that directly holds five percent or more of the D stock to file a schedule with the Securities and Exchange Commission within 10 days after an acquisition. D distributes its wholly owned subsidiary C pro rata. D determines that no schedule, form, or other document has been filed with respect to its stock or the stock of any other relevant corporation during the five-year period or within 10 days after the distribution. Immediately after the distribution, D has no knowledge that any of its shareholders are (or were at any time during the five-year period) not less-than-five-percent shareholders, or that any particular shareholder acquired D stock by purchase under section 355(d)(5) or (8) and paragraphs (d) and (e) of this section during the five-year period. Under paragraph (f)(3) of this section, D may presume it has no shareholder that is or was not a less-than-five-percent shareholder during the five-year period due to the absence of any filed schedules, forms, or other documents. Under paragraph (f)(4) of this section, D may presume that none of its less-than-five-

percent shareholders acquired D's stock by purchase during the five-year period. Accordingly, D may presume that section 355(d) does not apply to the distribution of C.

Example 2. Publicly traded corporation; schedule filed. The facts are the same as those in *Example 1*, except that D determines that, as of 10 days after the distribution, only one schedule has been filed with respect to its stock. That schedule discloses that X acquired 15 percent of the D stock one year before the distribution. Absent contrary knowledge, D may rely on the presumptions in paragraph (f)(3) of this section and so may presume that X is its only shareholder that is or was not a less-than-five-percent shareholder during the five-year period. D may not rely on the presumption in paragraph (f)(4) of this section with respect to X. In addition, D may not rely on the presumption in paragraph (f)(4) of this section with respect to any less-than-five-percent shareholder that, at any time during the five-year period, is related to X under section 355(d)(7)(A), acted pursuant to a plan or arrangement with X under section 355(d)(7)(B) and paragraph (c)(4) of this section with respect to acquisitions of D stock, or holds stock that is attributed to X under section 355(d)(8)(A). Accordingly, under paragraph (f)(1) of this section, to determine whether section 355(d) applies, D must determine: whether X acquired its directly held D stock by purchase under section 355(d)(5) and paragraphs (d) and (e)(2) and (3) of this section during the five-year period; whether X is treated as having purchased any additional D stock under section 355(d)(8) and paragraph (e)(1) of this section during the five-year period; and whether X is related to, or acquired its D stock pursuant to a plan or arrangement with, one or more of D's other shareholders during the five-year period under section 355(d)(7)(A) or (B) and paragraph (c)(4) of this section, and if so, whether those shareholders acquired their D stock by purchase under section 355(d)(5) or (8) and paragraphs (d) and (e) of this section during the five-year period.

Example 3. Acquisition of publicly traded corporation. The facts are the same as those in *Example 1*, except that P acquires all of the D stock in a section 368(a)(1)(B) reorganization that is not also a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E), and D distributes C to P one year later. Because D was widely held, P applies statistical sampling procedures that involve less than 50% of D's outstanding shares, to estimate the basis of all shares acquired, instead of surveying each shareholder. Under the deemed purchase rule of section 355(d)(5)(C) and paragraph (e)(2) of this section, P is treated as having acquired the D stock by purchase on the date the D shareholders acquired the D stock by purchase. Even though D has no less-than-five-percent shareholder immediately after the distribution, D may rely on the presumptions in paragraphs (f)(3) and (4) of this section to determine whether and to what extent the D stock is treated as purchased during the five-year period in P's hands under the deemed

purchase rule of section 355(d)(5)(C) and paragraph (e)(2) of this section. Accordingly, D may presume that section 355(d) does not apply to the distribution of C to P. This result would not change even if the statistical sampling that involves less than 50 percent of D's outstanding shares indicated that more than 50% of D's shares were acquired by purchase during the five-year period.

Example 4. Non-publicly traded corporation. D is owned by 20 shareholders and has a single class of stock that is not reporting stock. D knows that A owns 40 percent of the D stock, and D does not know that any other shareholder has owned as much as five percent of the D stock at any time during the five-year period. D may not rely on the presumption in paragraph (f)(3) of this section because its stock is not reporting stock. D may not rely on the presumption in paragraph (f)(4) of this section with respect to A. In addition, D may not rely on the presumption in paragraph (f)(4) of this section for any less-than-five-percent shareholder that, at any time during the five-year period, is related to A under section 355(d)(7)(A), acted pursuant to a plan or arrangement with A under section 355(d)(7)(B) and paragraph (c)(4) of this section with respect to acquisitions of D stock, or holds stock that is attributed to A under section 355(d)(8)(A). D may rely on the presumption in paragraph (f)(4) of this section for less-than-five-percent shareholders that during the five-year period are not related to A, did not act pursuant to a plan or arrangement with A, and do not hold stock attributed to A. Accordingly, under paragraph (f)(1) of this section, to determine whether section 355(d) applies, D must determine: that A is its only shareholder that is (or was at any time during the five-year period) not a less-than-five-percent shareholder; whether A acquired its directly held D stock by purchase under section 355(d)(5) and paragraphs (d) and (e)(2) and (3) of this section during the five-year period; whether A is treated as having purchased any additional D stock under section 355(d)(8) and paragraph (e)(1) of this section during the five-year period; and whether A is related to, or acquired its D stock pursuant to a plan or arrangement with, one or more of D's other shareholders during the five-year period under section 355(d)(7)(A) or (B) and paragraph (c)(4) of this section, and if so, whether those shareholders acquired their D stock by purchase under section 355(d)(5) or (8) and paragraphs (d) and (e) of this section during the five-year period.

(g) *Effective date.* This section applies to distributions occurring after December 20, 2000, except that they do not apply to any distributions occurring pursuant to a written agreement which is (subject to customary conditions)

binding on December 20, 2000, and at all times thereafter.

Robert E. Wenzel,

Deputy Commissioner of Internal Revenue.

Approved: December 11, 2000.

Jonathan Talisman,

Acting Assistant Secretary of the Treasury.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 26

[TD 8912]

RIN 1545-AX08

Generation-Skipping Transfer Issues

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the application of the effective date rules of the generation-skipping transfer (GST) tax imposed under chapter 13 of the Internal Revenue Code (Code). These regulations provide guidance with respect to the type of trust modifications that will not affect the exempt status of a trust. In addition, these regulations clarify the application of the effective date rules in the case of property transferred pursuant to the exercise of a general power of appointment. These regulations are necessary to provide guidance to taxpayers so that they may properly determine if chapter 13 of the Code is applicable to a particular trust.

DATES: These regulations are effective December 20, 2000.

SUPPLEMENTARY INFORMATION:

Background

On November 18, 1999, the Treasury Department and the IRS published in the **Federal Register** (64 FR 62997) a notice of proposed rulemaking (REG-103841-99) relating to the application of the GST tax provisions where the terms of a trust that was irrevocable before the effective date of the statute are changed or modified after that date. The IRS received comments on the notice of proposed rulemaking. In addition, a public hearing was held on March 15, 2000. This document adopts final regulations with respect to the notice of proposed rulemaking. A summary of the principle comments received is provided below.