

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

[TD 9244]

RIN 1545-BC05; 1545-BE88

Determination of Basis of Stock or Securities Received in Exchange for, or With Respect to, Stock or Securities in Certain Transactions; Treatment of Excess Loss Accounts**AGENCY:** Internal Revenue Service (IRS), Treasury.**ACTION:** Final and temporary regulations.

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

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

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

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

SUPPLEMENTARY INFORMATION:**Background**

Section 358(a)(1) of the Internal Revenue Code (Code) generally provides that the basis of property received pursuant to an exchange to which section 351, 354, 355, 356, or 361 applies is the same as that of the property exchanged, decreased by the fair market value of any other property (except money) received by the taxpayer, the amount of any money received by the taxpayer, and the amount of loss to the taxpayer which was recognized on such exchange, and

increased by the amount which was treated as a dividend, and the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend). Section 358(b)(1) provides that, under regulations prescribed by the Secretary, the basis determined under section 358(a)(1) must be allocated among the properties received in the exchange or distribution.

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

Under the proposed regulations, the basis of each share of stock or security received in an exchange to which section 354, 355, or 356 applies is generally the same as the basis of the share or shares of stock or security or securities exchanged therefor. In the case of a distribution to which section 355 applies, the proposed regulations provide that the basis of each share of stock or security of the distributing

corporation is allocated between the share of stock or security of the distributing corporation and the share of stock or security received with respect to such share of stock or security of the distributing corporation in proportion to their fair market values.

If a shareholder or security holder is unable to identify which particular share (or portion of a share) of stock or security is exchanged for, or received with respect to, a particular share (or portion of a share) of stock or security, the proposed regulations permit the shareholder or security holder to designate which share or security is received in exchange for, or in respect of, which share or security. Such designation, however, must be consistent with the terms of the exchange or distribution and must be made on or before the first date on which the basis of a share or security received is relevant, for example, the date on which a share or security received is sold, or is transferred in an exchange described in section 351 or section 721 or a reorganization described in section 368.

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

Explanation of Provisions

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

A. Allocation of Consideration Received

As described above, in certain cases, the proposed regulations permit a shareholder to designate which share or security is received in exchange for, or with respect to, which share or security, provided that the designation is consistent with the terms of the exchange or distribution. One commentator observed that in certain cases in which more than one class of stock or securities is received in exchange for more than one block of stock, more than one designation may be consistent with the terms of the exchange. For example, suppose that A owns two blocks of 100 shares of Corporation X common stock. Each block has a value of \$100. A has an

aggregate basis of \$50 in one block and an aggregate basis of \$250 in the other block. Pursuant to the terms of a reorganization, A transfers both blocks in exchange for 100 shares of Corporation Y common stock with a value of \$100 and 100 shares of Corporation Y preferred stock with a value of \$100. Under the proposed regulations, A's designation could reflect that each of the Corporation Y common stock and the Corporation Y preferred stock are allocated to the shares exchanged in proportion to their fair market values. Therefore, Corporation Y common stock with a fair market value of \$50 and Corporation Y preferred stock with a fair market value of \$50 would be treated as received for each block of Corporation X common stock. Alternatively, A's designation could reflect that the low basis Corporation X shares were exchanged for Corporation Y common stock and the high basis Corporation X shares were exchanged for Corporation Y preferred stock or vice versa. Other designations would also seemingly be permitted under the proposed regulations. The commentator requested clarification regarding whether these designations would, in fact, be permitted.

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

surrendered stock and securities. The final regulations also include similar rules that apply to distributions under section 355.

B. Allocation of Boot Received

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

These final regulations adopt rules governing the allocation of boot among stock and securities surrendered (or with respect to which a distribution is made) that are consistent with those rules described above regarding designations of exchanges and distributions when more than one class of stock or securities is received in exchange for, or received with respect to, more than one block of stock. In particular, this Treasury decision includes regulations under section 356 that provide that, for purposes of

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

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

Suppose A holds 100 shares of Corporation T common stock and 100 shares of Corporation T preferred stock. The common shares have an aggregate basis of \$10 and an aggregate fair market value of \$100 and the preferred shares have an aggregate basis of \$150 and an aggregate fair market value of \$100. Corporation T merges with and into Corporation X in a reorganization under section 368. The terms of the exchange specify that A exchanges its shares of Corporation T common stock for 100 shares of Corporation X common stock with an aggregate fair market value of \$100 and exchanges its shares of Corporation T preferred stock for \$100 of cash. Under these final regulations, the terms of the exchange control for purposes of determining gain under section 356 and basis under section 358. Under section 356(c), A realizes a gain of \$90 on the exchange of Corporation T common stock for Corporation X common stock, none of which is

recognized under section 356 and A takes an aggregate basis of \$10 in the shares of Corporation X common stock received in the exchange. However, A realizes a loss of \$50 on the exchange of Corporation T preferred stock for cash. Therefore, A would not be entitled to recognize any of the loss realized. This conclusion is consistent with Revenue Ruling 74-515. In that ruling, a shareholder surrenders common stock of the target corporation in exchange for common stock of the acquiring corporation and preferred stock of the target corporation in exchange for cash. The ruling concludes that the tax consequences of the shareholder's exchange of preferred shares for cash are governed by section 356 and any loss realized is not recognized by reason of section 356(c).

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

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

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

Section 358(b)(2) generally provides that in allocating basis among the property permitted to be received without the recognition of gain or loss in an exchange to which section 355 applies, there shall be taken into account not only the property so

permitted to be received without the recognition of gain or loss, but also the stock or securities (if any) of the distributing corporation that are retained and the allocation of basis must be made among all such properties. Neither the statutory language of section 358(b)(2) nor its legislative history indicates the method of allocation that Congress contemplated when it enacted this provision.

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

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

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

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

D. Stockless Reorganizations

A number of commentators observed that it is not clear how basis should be

determined in the case of a reorganization in which no stock is issued. Such a situation may arise in reorganizations involving commonly controlled acquiring and target corporations where the issuance of additional stock of the acquiring corporation would constitute a meaningless gesture. One commentator suggested an approach that would treat the acquiring corporation as issuing an amount of stock equal to the fair market value of the stock surrendered. The basis of that deemed issued stock would have a basis traced from the shares surrendered in the reorganization under the rules that would have applied had the shareholder actually received such stock. Then, the shareholder's stock in the acquiring corporation would be treated as recapitalized. In the recapitalization, the shareholder would be treated as surrendering all of its shares of the acquiring corporation, including those shares owned immediately prior to the reorganization and those shares the shareholder is deemed to receive, in exchange for the shares that the shareholder actually holds immediately after the reorganization. The basis of the shares that the shareholder actually owns would be determined under the rules that would have applied had the recapitalization actually occurred with respect to the shareholder's actual shares and the shares the shareholder is deemed to have received.

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

shares of P's S2 stock would each have a basis of \$4 and would be treated as having been acquired on Date 2.

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

E. Single Versus Split Basis Approaches

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

The IRS and Treasury Department believe that because the single, aggregated basis approach has the effect of averaging the basis of more than one share, it is inconsistent with the tracing regime adopted in these final regulations. Moreover, as suggested in the preamble of the proposed regulations, the IRS and Treasury Department believe that it is possible for a share to have a split holding period. The IRS and Treasury Department believe that the split basis approach is

a logical corollary to the split holding period approach. Therefore, these final regulations reflect that a share may have not only a split holding period, but also a split basis.

F. Coordination with Section 1036

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

The IRS and Treasury Department believe that those same policies that support the application of a tracing regime in the context of transactions governed solely by section 354 or 356 support the application of a tracing regime in the context of transactions governed by both section 1036, on the one hand, and section 354 or 356, on the other hand. Accordingly, these final regulations provide that the tracing rules apply to determine the basis of a share of stock or security received by a shareholder or security holder in an exchange described in both section 1036, on the one hand, and section 354 or section 356, on the other hand. The IRS and Treasury Department continue to study whether the rules of these final regulations should be adopted in transactions under section 1036 for transactions governed by section 1036, but not section 354 or 356.

G. Application of Tracing Rules to Section 351 Transactions

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

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

the application of the basis tracing regime to exchanges described in section 351 that were included in the proposed regulations.

H. Excess Loss Accounts

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

The limitation on the application of § 1.1502-19(d) to cases in which a basis adjustment or determination is made with respect to shares of a class of stock of the corporation in which the member holds other shares with an excess loss account effectively makes the rule elective. That is, if the transaction occurs in one direction (in the example above, T merges into S), the rule applies. If the transaction occurs in the other direction (in the example above, S merges into T), the rule does not apply. The IRS and Treasury Department believe that this electivity is undesirable. Therefore, the IRS and Treasury Department believe that it is appropriate to expand the scope of the application of the rule of § 1.1502-19(d). Accordingly, the temporary regulations included in this Treasury decision add an additional rule to § 1.1502-19 that provides that if a member would otherwise determine shares of a class of S's stock (a new share) to have an excess

loss account and such member owns one or more other shares of the same class of S's stock, the basis of such other shares is allocated to eliminate and equalize any excess loss account that would otherwise be in the new shares. Therefore, in the example above where S merges into T in a reorganization under section 368(a)(1)(D) in which P receives additional shares of T stock, the basis of P's original T shares will first be applied to eliminate the excess loss account that P would otherwise have in its new T shares. Therefore, P will have an aggregate basis of \$50 in its original T shares and an aggregate basis of \$0 in its new T shares.

Effective Date

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

Effect on Other Documents

The following publication is obsolete as of January 23, 2006:
Revenue Ruling 55-355 (1955-1 C.B. 418).

Special Analyses

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

It has been determined that the temporary regulations issued with respect to section 1502 are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. These temporary regulations are necessary to provide taxpayers with immediate guidance regarding the

application of section 358 when a member of a consolidated group has an excess loss account in the stock of another member and consequences of such application. Accordingly, good cause is found for dispensing with notice and public procedure pursuant to 5 U.S.C. 553(b)(B) and with a delayed effective date pursuant to 5 U.S.C. 553(d)(3). For applicability of the Regulatory Flexibility Act, please refer to the cross-reference notice of proposed rulemaking published elsewhere in the **Federal Register**. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

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

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 1.358-2 also issued under 26 U.S.C. 358. * * *
- Section 1.1502-19T also issued under 26 U.S.C. 1502. * * *
- Section 1.1502-32 also issued under 26 U.S.C. 1502. * * *

■ **Par. 2.** Section 1.356-1 is revised to read as follows:

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

(a) If in any exchange to which the provisions of section 354 or section 355 would apply except for the fact that there is received by the shareholders or security holders other property (in

addition to property permitted to be received without recognition of gain by such sections) or money, then—

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

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

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

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

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

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

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

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

One share of stock worth	\$100
Cash	25
Other property (basis \$25) fair market value	50
 Total fair market value of consideration received	 175
Adjusted basis of stock surrendered in exchange	85

Total gain	90
Gain to be recognized, limited to cash and other property received	75
A's pro rata share of earnings and profits accumulated after February 28, 1913 (taxable dividend)	30
Remainder to be treated as a gain from the exchange of property	45

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

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

(ii) *Analysis.* Under paragraph (b) of this section, because the terms of the exchange do not specify that the cash is received in exchange for shares of Class A or Class B stock of Corporation X, a pro rata portion of the cash received is treated as received in exchange for each share of Class A stock of Corporation X and each share of Class B stock of Corporation X based on the fair market value of the surrendered shares. Therefore, J is treated as receiving shares of Corporation Y stock with a fair market value of \$50 and \$50 of cash in exchange for its shares of Class A stock of Corporation X and shares of Corporation Y stock with a fair market value of \$50 and \$50 of cash in exchange for its shares of Class B stock of Corporation X. J realizes a gain of \$70 on the exchange of shares of Class A stock, \$50 of which is recognized under section 356 and paragraph (a) of this section, and J realizes a gain of \$10 on the exchange of shares of Class B stock of Corporation X, all of which is recognized under section 356 and paragraph (a) of this section. Assuming that J's gain recognized is not treated as a dividend under section 356(a)(2), such gain shall be treated as gain from the exchange of property.

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

(ii) *Analysis.* Under paragraph (b) of this section, because the terms of the exchange specify that J receives 10 shares of stock of Corporation Y in exchange for J's shares of Class A stock of Corporation X and \$100 of cash in exchange for J's shares of Class B stock of Corporation X and such terms are

economically reasonable, such terms control. J realizes a gain of \$70 on the exchange of shares of Class A stock, none of which is recognized under section 356 and paragraph (a) of this section, and J realizes a gain of \$10 on the exchange of shares of Class B stock of Corporation X, all of which is recognized under section 356 and paragraph (a) of this section.

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

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

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

■ **Par. 3.** Section 1.358-1 is revised to read as follows:

§ 1.358-1 Basis to distributees.

(a) In the case of an exchange to which section 354 or 355 applies in which, under the law applicable to the year in which the exchange is made, only nonrecognition property is received, immediately after the transaction, the sum of the basis of all of the stock and securities received in the transaction shall be the same as the basis of all the stock and securities in such corporation surrendered in the transaction, allocated in the manner described in §1.358-2. In the case of a distribution to which section 355 applies in which, under the law applicable to the year in which the distribution is made, only nonrecognition property is received, immediately after the transaction, the sum of the basis of all of the stock and securities with respect to which the distribution is made plus the basis of all stock and securities received in the distribution with respect to such stock and securities shall be the same as the basis of the stock and securities with respect to which the distribution is made immediately before the transaction, allocated in the manner described in §1.358-2. In the case of an exchange to which section 351 or 361 applies in which, under the law applicable to the year in which the exchange was made, only nonrecognition property is received, the basis of all the stock and securities received in the exchange shall be the same as the basis of all property

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

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

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

value of the other property received (\$30) and increased by the sum of the amount treated as a dividend (\$5) and the amount treated as a gain from the exchange of property (\$35). The basis of the other property received is \$30.

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

■ **Par. 4.** Section 1.358-2 is amended by:

- 1. Revising paragraphs (a)(1) and (a)(2).
- 2. Removing paragraphs (a)(3), (a)(4), and (a)(5).
- 3. Revising paragraphs (b)(1) and (c).
- 4. Adding paragraph (d).

The revisions and addition read as follows:

§ 1.358-2 Allocation of basis among nonrecognition property.

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

(2)(i) If a shareholder or security holder surrenders a share of stock or a security in an exchange under the terms of section 354, 355, or 356, the basis of each share of stock or security received in the exchange shall be the same as the basis of the share or shares of stock or security or securities (or allocable portions thereof) exchanged therefor (as adjusted under § 1.358-1). If more than one share of stock or security is received in exchange for one share of stock or one security, the basis of the share of stock or security surrendered shall be allocated to the shares of stock or securities received in the exchange in proportion to the fair market value of the shares of stock or securities received. If one share of stock or security is received in exchange for more than one share of stock or security or if a fraction of a share of stock or security is received, then the basis of the shares of stock or securities surrendered must be allocated to the shares of stock or securities (or allocable portions thereof) received in a manner that reflects, to the greatest extent possible, that a share of stock or security received

is received in respect of shares of stock or securities that were acquired on the same date and at the same price. To the extent it is not possible to allocate basis in this manner, the basis of the shares of stock or securities surrendered must be allocated to the shares of stock or securities (or allocable portions thereof) received in a manner that minimizes the disparity in the holding periods of the surrendered shares of stock or securities whose basis is allocated to any particular share of stock or security received.

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

(iii) For purposes of this section, if a shareholder or security holder surrenders a share of stock or a security in a transaction under the terms of section 354 (or so much of section 356 as relates to section 354) in which such shareholder or security holder receives no property or property (including property permitted by section 354 to be received without the recognition of gain or “other property” or money) with a fair market value less than that of the stock or securities surrendered in the transaction, such shareholder or security holder shall be treated as follows. First, the shareholder or security holder shall be treated as receiving the stock, securities, other property, and money actually received by the shareholder or security holder in the transaction and an amount of stock

of the issuing corporation (as defined in § 1.368-1(b)) that has a value equal to the excess of the value of the stock or securities the shareholder or security holder surrendered in the transaction over the value of the stock, securities, other property, and money the shareholder or security holder actually received in the transaction. If the shareholder owns only one class of stock of the issuing corporation the receipt of which would be consistent with the economic rights associated with each class of stock of the issuing corporation, the stock deemed received by the shareholder pursuant to the previous sentence shall be stock of such class. If the shareholder owns multiple classes of stock of the issuing corporation the receipt of which would be consistent with the economic rights associated with each class of stock of the issuing corporation, the stock deemed received by the shareholder shall be stock of each such class owned by the shareholder immediately prior to the transaction, in proportion to the value of the stock of each such class owned by the shareholder immediately prior to the transaction. The basis of each share of stock or security deemed received and actually received shall be determined under the rules of this section. Second, the shareholder or security holder shall then be treated as surrendering all of its shares of stock and securities in the issuing corporation, including those shares of stock or securities held immediately prior to the transaction, those shares of stock or securities actually received in the transaction, and those shares of stock deemed received pursuant to the previous sentence, in a reorganization under section 368(a)(1)(E) in exchange for the shares of stock and securities of the issuing corporation that the shareholder or security holder actually holds immediately after the transaction. The basis of each share of stock and security deemed received in the reorganization under section 368(a)(1)(E) shall be determined under the rules of this section.

(iv) If a shareholder or security holder receives one or more shares of stock or one or more securities in a distribution under the terms of section 355 (or so much of section 356 as relates to section 355), the basis of each share of stock or security of the distributing corporation (as defined in § 1.355-1(b)), as adjusted under § 1.358-1, shall be allocated between the share of stock or security of the distributing corporation with respect to which the distribution is made and the share or shares of stock or security or securities (or allocable portions

thereof) received with respect to the share of stock or security of the distributing corporation in proportion to their fair market values. If one share of stock or security is received with respect to more than one share of stock or security or if a fraction of a share of stock or security is received, then the basis of each share of stock or security of the distributing corporation must be allocated to the shares of stock or securities (or allocable portions thereof) received in a manner that reflects that, to the greatest extent possible, a share of stock or security received is received with respect to shares of stock or securities acquired on the same date and at the same price. To the extent it is not possible to allocate basis in this manner, the basis of each share of stock or security of the distributing corporation must be allocated to the shares of stock or securities (or allocable portions thereof) received in a manner that minimizes the disparity in the holding periods of the shares of stock or securities with respect to which such shares of stock or securities are received.

(v) If a shareholder or security holder receives shares of stock or securities of more than one class, or receives "other property" or money in addition to stock or securities in a distribution under the terms of section 355 (or so much of section 356 as relates to section 355), then, to the extent the terms of the distribution specify that shares of stock or securities of a particular class or "other property" or money is received with respect to a particular share of stock or security of the distributing corporation or a particular class of stock or securities of the distributing corporation, for purposes of applying the rules of this section, such terms shall control provided that such terms are economically reasonable. To the extent the terms of the distribution do not specify that shares of stock or securities of a particular class or "other property" or money is received with respect to a particular share of stock or security of the distributing corporation or a particular class of stock or securities of the distributing corporation, then, for purposes of applying the rules of this section, a pro rata portion of the shares of stock and securities of each class received and a pro rata portion of the "other property" and money received shall be treated as received with respect to each share of stock and security of the distributing corporation with respect to which the distribution is made, based on the fair market value of each such share of stock or security.

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

(vii) If a shareholder or security holder that purchased or acquired shares of stock or securities in a corporation on different dates or at different prices exchanges such shares of stock or securities under the terms of section 354, 355, or 356, or receives a distribution of shares of stock or securities under the terms of section 355 (or so much of section 356 as relates to section 355), and the shareholder or security holder is not able to identify which particular share of stock or security (or allocable portion of a share of stock or security) is received (or deemed received) in exchange for, or with respect to, a particular share of stock or security, the shareholder or security holder may designate which share of stock or security is received in exchange for, or with respect to, a particular share of stock or security, provided that such designation is consistent with the terms of the exchange or distribution (or an exchange deemed to have occurred pursuant to paragraph (a)(2)(iii) of this section), and the other rules of this section. In the case of an exchange under the terms of section 354 or 356 (including a deemed exchange as a result of the application of paragraph (a)(2)(iii) of this section), the designation must be made on or before the first date on which the basis of a share of stock or a security received (or deemed received in the reorganization under section 368(a)(1)(E) in the case of a transaction to which paragraph (a)(2)(iii) of this section applies) is relevant. In the case of an exchange or distribution under the terms of section 355 (or so much of section 356 as relates to section 355), the designation must be made on or before the first date on which the basis of a share of stock or a security of the distributing corporation or the controlled corporation (as defined

in § 1.355-1(b)) is relevant. The basis of the shares or securities received in an exchange under the terms of section 354 or section 356, for example, is relevant when such shares or securities are sold or otherwise transferred. The designation will be binding for purposes of determining the Federal tax consequences of any sale or transfer of, or distribution with respect to, the shares or securities received. If the shareholder fails to make a designation in a case in which the shareholder is not able to identify which share of stock is received in exchange for, or with respect to, a particular share of stock, then the shareholder will not be able to identify which shares are sold or transferred for purposes of determining the basis of property sold or transferred under section 1012 and § 1.1012-1(c) and, instead, will be treated as selling or transferring the share received in respect of the earliest share purchased or acquired.

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

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

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

* * * * *

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

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

identify which shares of Corporation Y stock are received in exchange for each share of Corporation X stock.

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

Example 2. (i) *Facts.* The facts are the same as in *Example 1*, except that instead of receiving 2 shares of Corporation Y stock in exchange for each share of Corporation X stock, J receives 1½ shares of Corporation Y stock in exchange for each share of Corporation X stock. Therefore, J receives 45 shares of Corporation Y stock. Again, J is not able to identify which shares (or portions of shares) of Corporation Y stock are received in exchange for each share of Corporation X stock.

(ii) *Analysis.* Under paragraph (a)(2)(i) of this section, J has 30 shares of Corporation Y stock each of which has a basis of \$2 and is treated as having been acquired on Date 1 and 15 shares of Corporation Y stock each of which has a basis of \$4 and is treated as having been acquired on Date 2. Under paragraph (a)(2)(vii) of this section, on or before the date on which the basis of a share of Corporation Y stock received becomes relevant, J may designate which of the shares of Corporation Y stock received have a basis of \$2 and which have a basis of \$4.

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

(ii) *Analysis.* Under paragraph (a)(2)(ii) of this section, because the terms of the exchange do not specify that shares of Class C stock or shares of Class D stock of Corporation X are received in exchange for particular shares of Class A stock of Corporation X, a pro rata portion of the shares of Class C stock and shares of Class D stock received will be treated as received in exchange for each share of Class A stock based on the fair market value of the surrendered shares of Class A stock. Therefore, J is treated as receiving one share

of Class C stock and one share of Class D stock in exchange for each share of Class A stock. Under paragraph (a)(2)(i) of this section, J has 10 shares of Class C stock, each of which has a basis of \$1 and is treated as having been acquired on Date 1 and 10 shares of Class C stock, each of which has a basis of \$3 and is treated as having been acquired on Date 2. In addition, J has 10 shares of Class D stock, each of which has a basis of \$2 and is treated as having been acquired on Date 1 and 10 shares of Class D stock, each of which has a basis of \$6 and is treated as having been acquired on Date 2. J's basis in each share of Class B stock remains \$3. Under paragraph (a)(2)(vii) of this section, on or before the date on which the basis of a share of Class C stock or Class D stock received becomes relevant, J may designate which of the shares of Class C stock have a basis of \$1 and which have a basis of \$3, and which of the shares of Class D stock have a basis of \$2 and which have a basis of \$6.

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

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

shares of Corporation Y stock, each of which has a basis of \$5 and is treated as having been acquired on Date 3. Under paragraph (a)(2)(viii) of this section, on or before the date on which the basis of a share of Corporation Y stock received becomes relevant, J may designate which of the shares of Corporation Y stock received have a basis of \$2, which have a basis of \$4, and which have a basis of \$5.

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

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

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

(ii) *Analysis.* Under paragraph (a)(2)(ii) of this section and under section 1.354-1(a), because the terms of the exchange specify that J receives 10 shares of stock of Corporation Y in exchange for J's shares of Class A stock of Corporation X and a Corporation Y security in exchange for its Corporation X security and such terms are economically reasonable, such terms control.

Pursuant to section 354, J recognizes no gain on either exchange. Under paragraph (a)(2)(i) of this section, J has 10 shares of Corporation Y stock, each of which has a basis of \$2 and is treated as having been acquired on Date 1, and a security that has a basis of \$100 and is treated as having been acquired on Date 2.

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

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

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

(ii) *Analysis.* Under paragraph (a)(2)(viii) of this section, because neither section 354 nor section 356 applies to the transfer of land to Corporation Y, the rules of paragraph (a)(2) of this section do not apply to determine J's basis in the Corporation Y stock received in the transaction.

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

(ii) *Analysis.* Under paragraph (a)(2)(viii) of this section, because, in connection with the transfer of the Corporation X stock to Corporation Y, Corporation Y assumed a liability of J, the rules of paragraph (a)(2) of

this section do not apply to determine J's basis in the Corporation Y stock received in the transaction.

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

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

Example 11. (i) Facts. Corporation X has a single class of stock outstanding, all of which is owned by J, an individual. J acquired 100 shares of Corporation X stock on Date 1 for \$1 each. Corporation Y has two classes of stock outstanding, common stock and nonvoting preferred stock. On Date 2, J acquired 100 shares of Corporation Y common stock for \$2 each and 100 shares of Corporation Y preferred stock for \$4 each. On Date 3, Corporation Y acquires the assets of Corporation X in a reorganization under section 368(a)(1)(D). Pursuant to the terms of the plan of reorganization, J surrenders J's 100 shares of Corporation X stock but does not receive any additional Corporation Y stock. Immediately before the effective time of the reorganization, the fair market value of each share of Corporation X stock is \$10, the fair market value of each share of Corporation

Y common stock is \$10, and the fair market value of each share of Corporation Y preferred stock is \$20. Pursuant to section 354, J recognizes no gain or loss.

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

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

(ii) *Analysis.* Under paragraph (a)(2)(iv) of this section, because J receives 2 shares of

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

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

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

Example 14. (i) *Facts.* J, an individual, acquired 10 shares of Corporation X stock on Date 1 for \$3 each, 10 shares of Corporation X stock on Date 2 for \$18 each, 10 shares of Corporation X stock on Date 3 for \$6 each, and 10 shares of Corporation X stock on Date 4 for \$9 each. On Date 5, Corporation Y acquires the assets of Corporation X in a reorganization under section 368(a)(1)(A).

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

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

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

■ **Par. 5.** Section 1.1502-19 is amended as follows:

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

The revisions and additions read as follows:

§ 1.1502-19 Excess loss accounts.

* * * * *

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

* * * * *

(g) * * *

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

* * * * *

(h) *Effective dates.* * * *
(2) * * *

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

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

■ **Par. 6.** Section 1.1502-19T is revised to read as follows:

§ 1.1502-19T Excess Loss Accounts (temporary).

* * * * *

(b)(2) through (c) [Reserved]. For further guidance, see § 1.1502-19(b)(2) through (c).

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

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

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

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

(ii) *Analysis.* Under sections 351 and 354, P does not recognize gain in connection with the transfer. Under § 1.358-2(a)(2)(iii), P is deemed to receive 150 shares of T stock. Without regard to the application of paragraph (d) of this section, under section 358 and § 1.358-2(a)(2)(i), P would have a \$1 basis in each such share. However, because the basis of the additional shares of T stock would be determined when P has an excess loss account in its original shares of T stock,

under paragraph (d)(1) of this section, the basis that P would otherwise have in such additional shares would eliminate the excess loss account in P's original shares of T stock such that each original share of T stock would have a basis of \$0 and each share of T stock deemed received would have a basis of \$0.20. Then, under § 1.358-2(a)(2)(iii), the T stock is deemed to be recapitalized in a reorganization under section 368(a)(1)(E) in which P receives 100 shares of T stock (those shares P actually owns immediately after the transfer) in exchange for those 100 shares of T stock that P held immediately prior to the transfer and those 150 shares of T stock P is deemed to receive in the transfer. Under § 1.358-2(a)(2)(i), immediately after the transfer, P holds 100 shares of T stock, 60 of which each have a basis of \$0.50 and 40 of which each have a basis of \$0. In addition, T takes a \$1 basis in each share of S stock under section 362. (If P had actually received an additional 150 shares of T stock, paragraph (d)(1) of this section would apply to shift basis from such additional T shares to P's original T shares because the basis of the additional T stock would be determined when P has an excess loss account in its original T shares. P would have a basis of \$0 in each of the original T shares and a \$0.20 basis in each of the additional T shares.)

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

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

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

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

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

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

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

■ **Par. 7.** Section 1.1502-32 is amended by:

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

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

■ 3. Adding new paragraph (h)(8).

The revisions and addition read as follows:

§ 1.1502-32 Investment Adjustments.

* * * * *

(b) * * *

(5) * * *

(ii) * * *

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

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

* * * * *

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

(8) *Determination of stock basis in reorganization with boot.* Paragraph (b)(5)(ii) *Example 6* of this section applies only with respect to determinations of the basis of the stock of a subsidiary after January 26, 2006. For determinations of the basis of the

stock of a subsidiary on or before January 26, 2006, see § 1.1502-32(b)(5)(ii) *Example 6* as contained in the 26 CFR part 1 edition revised as of April 1, 2005.

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

Approved: January 17, 2006.

Eric Solomon,

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

[FR Doc. 06-585 Filed 1-23-06; 11:43 am]

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9243]

RIN 1545-BA65

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

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations amending the income tax regulations under various provisions of the Internal Revenue Code (Code) to account for statutory mergers and consolidations under section 368(a)(1)(A) (including such reorganizations described in section 368(a)(2)(D) or (E)) involving one or more foreign corporations. These final regulations are issued concurrently with final regulations (TD 9242) that define a reorganization under section 368(a)(1)(A) to include certain statutory mergers or consolidations effected pursuant to foreign law. This document also contains final regulations under section 6038B which facilitate the electronic filing of Form 926 "Return by a U.S. Transferor of Property to a Foreign Corporation."

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

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

FOR FURTHER INFORMATION CONTACT:

Robert W. Lorence, Jr., (202) 622-3918 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

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

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

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

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

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

Background

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

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

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

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