

Rules and Regulations

Federal Register

Vol. 65, No. 95

Tuesday, May 16, 2000

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8883]

RIN 1545-AW53

Guidance Under Section 1032 Relating to the Treatment of a Disposition by An Acquiring Entity of the Stock of a Corporation in a Taxable Transaction

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the treatment of a disposition by a corporation or partnership (the acquiring entity) of the stock of a corporation (the issuing corporation) in a taxable transaction. The final regulations interpret section 1032 of the Internal Revenue Code. They affect persons engaging in certain taxable transactions, as described in the final regulations, occurring after May 16, 2000.

EFFECTIVE DATE: These regulations are effective May 16, 2000.

FOR FURTHER INFORMATION CONTACT: Filiz Serbes, (202) 622-7550 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On September 23, 1998, the Treasury and the IRS issued a notice of proposed rulemaking in the *Federal Register* (63 FR 50816), setting forth rules relating to the treatment of a disposition by a corporation (the acquiring corporation) of the stock of another corporation (the issuing corporation) in a taxable transaction. A public hearing regarding these proposed regulations was held on January 7, 1999. Written comments responding to the notice were received. After consideration of all of the

comments, the proposed regulations are adopted as revised by this Treasury decision.

Explanation of Revisions and Summary of Comments

The Immediacy Requirement

The proposed regulations adopted a cash purchase model in which certain transactions involving a contribution of issuing corporation stock by an issuing corporation to an acquiring corporation are recast as a contribution of cash by the issuing corporation to the acquiring corporation, which is used by the acquiring corporation to purchase issuing corporation stock from the issuing corporation. As a condition for application of the cash purchase model of the proposed regulations, the proposed regulations adopted the requirement of § 1.1502-13(f)(6)(ii)(B) that the issuing corporation stock received by the acquiring corporation be immediately transferred to acquire money or other property.

A number of commentators requested that the term "immediately" be explicitly defined. Some suggested replacing the temporal requirement with a transactional approach, requiring only that the stock be disposed of "pursuant to a plan of acquisition." Others suggested that the immediacy requirement be waived in certain circumstances, such as with respect to a nonqualified deferred compensation arrangement involving a grantor trust (commonly referred to as a "Rabbi Trust") that is established to provide future benefits to the employees of an acquiring corporation and that is funded with issuing corporation stock.

After considering the purposes of section 1032 and issues of administrative burden and technical complexity, the Treasury and the IRS believe that the immediacy requirement should neither be waived nor construed to permit the acquiring corporation to hold issuing corporation stock for a period of time during which the value of the stock could fluctuate.

The Treasury and the IRS believe that, in a case where the issuing corporation contributes its stock to the acquiring corporation and the acquiring corporation does not immediately dispose of that stock, it is not appropriate to increase the basis of either the issuing corporation stock transferred to the acquiring corporation

or the stock of the acquiring corporation held by the issuing corporation. In the cases addressed by the proposed regulations, in which the acquiring corporation exchanges the stock immediately for property owned by a third party, the transaction is indistinguishable from one in which the issuing corporation directly exchanges its stock for the property of the third party (an exchange to which section 1032 would apply) and contributes that property to the acquiring corporation, a transaction whose tax result would be the same as the cash purchase model set forth in the proposed regulations. However, in cases where the acquiring corporation's ownership of the issuing corporation stock is more than transitory, there appears to be no comparable transaction which would generate the same tax consequences as the cash purchase model.

Implementation of an approach that waives the immediacy requirement would raise administrative and policy concerns. If the acquiring corporation were to be permitted to hold the issuing corporation stock for a period of time, the regulations would have to adopt one of two alternative approaches. Under the first alternative, the regulations would provide that the cash purchase model would be deemed to apply at the time that the stock is contributed to the acquiring corporation, giving the acquiring corporation a fair market value basis in the stock. However, such an approach would raise at least two concerns. First, in the case that the issuing corporation stock is not publicly traded, such an approach would impose administrative burdens requiring a valuation of the stock at a time when there is no related transaction to assist in such valuation. Thus, there is a potential for the stock to be overvalued, with a result of inflating the basis in both the contributed issuing corporation stock and the acquiring corporation stock held by the issuing corporation.

Second, even if the valuation were accurate, providing for the cash purchase model on the date of the contribution would facilitate selective loss recognition. If the acquiring corporation could receive the stock at a fair market value basis and hold on to it, then if the value of the stock decreased, the subsidiary could sell the stock and recognize a loss. The Treasury and the IRS believe that it is

inappropriate to issue regulations facilitating selective loss recognition.

Under the second alternative, the regulations would suspend the operation of the cash purchase model until such time as the acquiring corporation actually disposes of the issuing corporation stock. However, such an approach also would give rise to inappropriate tax results. In addition to precluding gain recognition attributable to the zero basis result, this alternative would allow a subsidiary to avoid recognition of gain attributable to real appreciation in this asset.

Assume, for example, a case where the issuing corporation contributes issuing corporation stock worth \$100 to the acquiring corporation, the acquiring corporation retains that stock while it appreciates to \$300, and then sells the stock for \$300 in cash. Absent an immediacy requirement, under the second alternative, the acquiring corporation would be deemed to have purchased the stock for \$300 in cash contributed by the issuing corporation immediately before the sale of the stock to the third party. As a result, the acquiring corporation would not recognize any gain or loss, and the issuing corporation would increase its basis in the stock of the acquiring corporation by \$300. More than merely avoiding a zero basis result (*i.e.*, taxation on the \$100 value in the stock when contributed to the acquiring corporation), neither the acquiring corporation nor the issuing corporation would ever be taxed on the further \$200 in appreciation of the issuing corporation stock which occurred while such stock was held by the acquiring corporation. Such a result, which effectively would provide full section 1032 protection for a subsidiary's gain in certain parent stock, would go well beyond addressing the zero basis result, the scope of these regulations.

Because each of those alternatives would be unsatisfactory for the reasons discussed above, the final regulations retain the immediacy requirement without further exception.

Consistent with that determination, and as in the case of any other transaction, the cash purchase model of these regulations applies to arrangements involving Rabbi Trusts only if the immediacy requirement is satisfied. Thus, these regulations do not apply to Rabbi Trust arrangements in which the stock of an issuing corporation is treated for federal tax purposes as owned for a period of time by its subsidiary. However, the Treasury and the IRS have reconsidered certain aspects of Rabbi Trust arrangements and have determined that the fact that trust

assets are subject to the claims of creditors of the subsidiary corporation does not necessarily establish that the subsidiary should be treated as a grantor of the trust at the time the trust is funded. Guidance regarding the effects of this reconsideration on existing Rabbi Trusts will be forthcoming. In addition, the final regulations contain a new example describing an arrangement in which the issuing corporation (and not the subsidiary) is treated as the grantor and owner of the Rabbi Trust, with the result that the immediacy requirement is satisfied upon the transfer of issuing corporation stock by the trust to the subsidiary's employees.

Taxpayers could have reasonably anticipated that Rabbi Trust arrangements could not be structured without causing subsidiaries to be treated as grantors and owners of the trust. For that reason and because of the potential ambiguities in interpreting Rev. Rul. 80-76 (1980-1 C.B. 15), the IRS will not challenge a taxpayer's position that no gain is recognized by an acquiring corporation upon the disposition by a Rabbi Trust, established on or before June 15, 2000, of issuing corporation stock if that stock was contributed by the issuing corporation to the Rabbi Trust on or before May 16, 2001.

Exchanges by the Acquiring Corporation of Stock of the Issuing Corporation for Other Issuing Corporation Stock

Commentators noted that, unlike § 1.1502-13(f)(6)(ii), the recast of the proposed regulations applies even where the acquiring corporation exchanges stock of the issuing corporation for other issuing corporation stock. Allowing a subsidiary to receive parent stock it immediately swaps for other parent stock, which it could hold long term with a cost basis, would facilitate selective loss recognition with respect to parent stock by a subsidiary. Accordingly, the final regulations adopt, as a precondition for the recast, a requirement that the issuing corporation stock not be exchanged for other issuing corporation stock.

Exchanges by the Acquiring Corporation of Stock of the Issuing Corporation for Acquiring Corporation Debt

Commentators contended that it is unclear whether the proposed regulations are applicable when the acquiring corporation uses issuing corporation stock to satisfy acquiring corporation debt. The Treasury and the IRS believe that the regulations do apply to an exchange of issuing corporation stock for acquiring corporation debt. Although section 1032 refers to an

exchange for money or other property and does not expressly refer to exchanges of stock for debt, it is generally acknowledged that section 1032 applies to an exchange of a corporation's stock for its debt, subject to sections 61(a)(12) and 108, which provide that a corporation may have income from a cancellation of indebtedness on an exchange of its stock for its own debt (that is, cancellation of indebtedness income can be realized and recognized when debt is satisfied with stock of the debtor corporation, even though no gain is recognized on the issuance of the stock). Similarly, therefore, the requirement set forth in these regulations that the acquiring corporation transfer issuing corporation stock to acquire money or other property is satisfied where the stock is used to satisfy acquiring corporation debt (although the acquiring corporation may be subject to sections 61(a)(12) and 108). No modifications to the language of the final regulations are needed to achieve this result.

Similarly, a commentator expressed concern that the proposed regulations do not expressly apply to an acquiring corporation's exchange of issuing corporation stock for the acquiring corporation's own outstanding acquiring corporation stock held by a shareholder other than the issuing corporation. The Treasury and the IRS believe that the regulations do apply to such an exchange.

Acquiring Corporation's Use of Issuing Corporation's Debt

Commentators also requested that the regulations be extended to issuing corporation debt instruments used by the acquiring corporation to acquire money or other property from unrelated third parties. Because section 1032 only refers to corporate stock, debt instruments are beyond the scope of these final regulations.

Reorganizations Coupled With Taxable Transactions

The proposed regulations do not apply if any party to the exchange receives a substituted basis in the issuing corporation stock. Commentators suggested that the final regulations provide that the above rule does not preclude application of the final regulations if a taxable exchange of issuing corporation stock for property accompanies a reorganization.

The Treasury and the IRS believe that a taxable transaction to which the regulations apply can accompany a reorganization, provided that the exchanges are separate and that the assets acquired in the taxable

transaction and the assets acquired as part of the reorganization can be identified. If these elements can be established, the substituted basis prohibition should not preclude application of the final regulations to the taxable portion of the exchange. Accordingly, clarifying language has been added to § 1.1032-3(c)(3).

Options Without a Readily Ascertainable Fair Market Value

Several commentators asked how the proposed regulations apply to a compensatory stock option without a readily ascertainable fair market value. Pursuant to section 83(e)(3) and § 1.83-7(a), the grant of such options is effectively treated as an open transaction. Section § 1.83-7(a) provides that section 83(a) and (b) applies at the time the option is exercised or is otherwise disposed of. An example has been added to confirm that the final regulations do not apply to such options.

When the option is exercised, section 83(a) and (b) applies to the transfer of stock pursuant to the exercise. If all of the requirements of § 1.1032-3 are met, those regulations apply to determine the treatment accorded the issuing corporation and the acquiring corporation upon transfer of the issuing corporation stock to the employee.

Reversionary Interest in Issuing Corporation Stock

Examples 4 and 5 of the proposed regulations set forth situations in which either the issuing corporation (X) or the acquiring corporation (Y) retains a reversionary interest in the issuing corporation stock. One commentator pointed out that the preamble of the proposed regulations does not articulate reasons for concern with reversionary interests.

These facts were included in the examples in the proposed regulations to indicate ownership of the stock for tax purposes.

Example 6 of the final regulations has been modified to state that X retains the only reversionary interest in the X stock in the event that A forfeits the right to the stock.

Actual Payment for Issuing Corporation Stock

Under the cash purchase model of the proposed regulations, the acquiring corporation is deemed to have purchased the issuing corporation stock from the issuing corporation for fair market value with cash contributed to the acquiring corporation by the issuing corporation. Commentators requested clarification of the tax consequences in cases where the acquiring corporation or another party makes an actual payment

to the issuing corporation for issuing corporation stock. Specifically, concern was expressed as to whether any or all of the amounts actually paid to the issuing corporation are treated as a distribution by the acquiring corporation to the issuing corporation. Assume, for example, that the issuing corporation, which owns all the stock of the acquiring corporation, transfers an option for issuing corporation stock to an employee of the acquiring corporation. At a time when one share of issuing corporation stock has a fair market value of \$100, that employee exercises the option to acquire one share of issuing corporation stock and pays a strike price of \$80 to the issuing corporation. The acquiring corporation pays some or all of the "spread" of \$20 to the issuing corporation.

The Treasury and the IRS do not believe that an actual payment to the issuing corporation for issuing corporation stock should be taxed as a distribution with respect to acquiring corporation stock. Accordingly, the final regulations have been modified to provide that the amount of cash deemed contributed by the issuing corporation to the acquiring corporation in the cash purchase model is equal to the difference between the fair market value of the issuing corporation stock and the fair market value of the money or other property received by the issuing corporation as payment from the employee or the acquiring corporation. An example to such effect has been added to the final regulations.

Although in other contexts partial payments received by a shareholder of an acquiring corporation should be characterized as boot under section 351(b), these final regulations integrate such payments into the cash purchase model described above. Because the property transferred by the issuing corporation to the acquiring corporation in this context is the issuing corporation's stock (or is deemed to be cash under the recast of these regulations), characterization of the payment as boot in this context would have no effect. No inference should be drawn from the recast in the final regulations to transactions in which a shareholder receives money or other property in exchange for property other than its own stock.

Section 1.83-6 is currently under study. A cross-reference in § 1.83-6(d) to these final regulations has been added to indicate that the mechanics of § 1.1032-3, rather than the mechanics of § 1.83-6(d), apply to a corporate shareholder's transfer of its own stock to any person in consideration of services performed for another entity where the

conditions of the final regulations are satisfied.

Applicability of the Final Regulations in the Partnership Context

Consistent with a suggestion by commentators that the regulations be expanded to apply to transactions involving partnerships, the final regulations treat an acquiring partnership's disposition of the stock of the issuing corporation in the same manner as an acquiring corporation's disposition of such stock. The regulations also have been expanded to apply to transactions in which the stock of the issuing corporation is obtained indirectly by the acquiring entity in any combination of exchanges under sections 721 and 351.

In certain situations where the recast of the final regulations does not apply to the disposition by a partnership of a corporate partner's stock (for example, because the immediacy requirement is not satisfied), realized gain or loss that is allocated to that corporate partner may nonetheless not be recognized pursuant to section 1032. See Rev. Rul. 99-57 (1999-51 I.R.B. 678).

Status of § 1.1502-13(f)(6)(ii)

The Treasury and the IRS believe that the finalization of these § 1.1032-3 regulations renders § 1.1502-13(f)(6)(ii) superfluous because there should be no cases which would be subject to recast under § 1.1502-13(f)(6)(ii), but in which a member would "otherwise recognize gain" as required for § 1.1502-13(f)(6)(ii) to apply. Accordingly, the effective date paragraph in the § 1.1502-13(f)(6) regulations has been modified to limit the applicability of § 1.1502-13(f)(6)(ii) and the last sentence of § 1.1502-13(f)(6)(iv)(A) to periods before the effective date of these regulations.

Status of Rev. Rul. 80-76

The preamble to the proposed regulations states that Rev. Rul. 80-76 (1980-1 C.B. 15) addresses the same issues as the proposed regulations and that, when finalized, the regulations will render Rev. Rul. 80-76 obsolete. In Rev. Rul. 80-76, a majority shareholder of parent transfers parent stock to an employee of its subsidiary corporation as compensation. The holding of the revenue ruling that the subsidiary does not recognize gain or loss on the transfer of the parent stock is now governed by these regulations. An example has been added to the final regulations to clarify how general tax principles (see *Commissioner v. Fink*, 483 U.S. 89 (1987)) and these final regulations interact when a shareholder of the parent/issuing corporation compensates

an employee of the subsidiary/acquiring corporation. With the finalization of these regulations, Rev. Rul. 80-76 is obsolete.

Additional Issues and Future Guidance

Since issuance of the proposed regulations, commentators have raised questions regarding the tax treatment of restricted stock and options granted to employees before or in connection with a transaction in which an issuing corporation distributes the stock of the acquiring corporation under section 355 (commonly referred to as a "spin off"). For example, assume that employees of both X corporation and its subsidiary Y corporation have outstanding options to acquire stock in X corporation. In connection with a spin off of the Y stock by X, the employees of both corporations have their outstanding options converted into options to acquire stock of both X and Y, with option terms preserving the overall values of the original options. Commentators have requested guidance on the tax consequences to X when, after the spin off, employees of X exercise options to acquire Y stock and, likewise, the tax consequences to Y when, after the spin off, employees of Y exercise options to acquire X stock. Guidance addressing these issues will be forthcoming.

Effective Date

Commentators suggested that taxpayers who engaged in transactions described in these final regulations prior to the effective date should be eligible for the tax treatment prescribed by the regulations. While the final regulations are applicable only prospectively, the IRS will not challenge a taxpayer's position taken in a prior period that is consistent with the requirements set forth in the final regulations.

For a discussion of transitional relief concerning certain Rabbi Trust arrangements, see the discussion of the immediacy requirement above.

Effect on Other Documents

Rev. Rul. 80-76 (1980-1 C.B. 15) is obsolete.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because these regulations do not impose a collection of information on small entities, the

Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notices of proposed rulemaking preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information: The principal author of these final regulations is Filiz Serbes of the Office of the Assistant Chief Counsel (Corporate), IRS. However, other personnel from the IRS and the Treasury Department participated in its 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 continues to read in part as follows:

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

Par. 2. Section 1.83-6 is amended by adding two sentences to the end of paragraph (d)(1) to read as follows:

§ 1.83-6 Deduction by employer.

* * * * *

(d) * * * (1) * * * For special rules that may apply to a corporation's transfer of its own stock to any person in consideration of services performed for another corporation or partnership, see § 1.1032-3. The preceding sentence applies to transfers of stock and amounts paid for such stock occurring on or after May 16, 2000.

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Par. 3. Section 1.1032-2 is amended by:

1. Revising paragraph (e).
2. Adding paragraph (f).

The addition and revision read as follows:

§ 1.1032-2 Disposition by a corporation of stock of a controlling corporation in certain triangular reorganizations.

* * * * *

(e) *Stock options.* The rules of this section shall apply to an option to buy or sell P stock issued by P in the same manner as the rules of this section apply to P stock.

(f) *Effective dates.* This section applies to triangular reorganizations occurring on or after December 23, 1994, except for paragraph (e) of this section, which applies to transfers of stock

options occurring on or after May 16, 2000.

Par. 4. Section 1.1032-3 is added to read as follows:

§ 1.1032-3 Disposition of stock or stock options in certain transactions not qualifying under any other nonrecognition provision.

(a) *Scope.* This section provides rules for certain transactions in which a corporation or a partnership (the acquiring entity) acquires money or other property (as defined in § 1.1032-1) in exchange, in whole or in part, for stock of a corporation (the issuing corporation).

(b) *Nonrecognition of gain or loss—(1) General rule.* In a transaction to which this section applies, no gain or loss is recognized on the disposition of the issuing corporation's stock by the acquiring entity. The transaction is treated as if, immediately before the acquiring entity disposes of the stock of the issuing corporation, the acquiring entity purchased the issuing corporation's stock from the issuing corporation for fair market value with cash contributed to the acquiring entity by the issuing corporation (or, if necessary, through intermediate corporations or partnerships). For rules that may apply in determining the issuing corporation's adjustment to basis in the acquiring entity (or, if necessary, in determining the adjustment to basis in intermediate entities), see sections 358, 722, and the regulations thereunder.

(2) *Special rule for actual payment for stock of the issuing corporation.* If the issuing corporation receives money or other property in payment for its stock, the amount of cash deemed contributed under paragraph (b)(1) of this section is the difference between the fair market value of the issuing corporation stock and the amount of money or the fair market value of other property that the issuing corporation receives as payment.

(c) *Applicability.* The rules of this section apply only if, pursuant to a plan to acquire money or other property—

(1) The acquiring entity acquires stock of the issuing corporation directly or indirectly from the issuing corporation in a transaction in which, but for this section, the basis of the stock of the issuing corporation in the hands of the acquiring entity would be determined, in whole or in part, with respect to the issuing corporation's basis in the issuing corporation's stock under section 362(a) or 723;

(2) The acquiring entity immediately transfers the stock of the issuing corporation to acquire money or other property (from a person other than an

entity from which the stock was directly or indirectly acquired);

(3) The party receiving stock of the issuing corporation in the exchange specified in paragraph (c)(2) of this section from the acquiring entity does not receive a substituted basis in the stock of the issuing corporation within the meaning of section 7701(a)(42); and

(4) The issuing corporation stock is not exchanged for stock of the issuing corporation.

(d) *Stock options.* The rules of this section shall apply to an option issued by a corporation to buy or sell its own stock in the same manner as the rules of this section apply to the stock of an issuing corporation.

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

Example 1. (i) *X*, a corporation, owns all of the stock of *Y* corporation. *Y* reaches an agreement with *C*, an individual, to acquire a truck from *C* in exchange for 10 shares of *X* stock with a fair market value of \$100. To effectuate *Y*'s agreement with *C*, *X* transfers to *Y* the *X* stock in a transaction in which, but for this section, the basis of the *X* stock in the hands of *Y* would be determined with respect to *X*'s basis in the *X* stock under section 362(a). *Y* immediately transfers the *X* stock to *C* to acquire the truck.

(ii) In this *Example 1*, no gain or loss is recognized on the disposition of the *X* stock by *Y*. Immediately before *Y*'s disposition of the *X* stock, *Y* is treated as purchasing the *X* stock from *X* for \$100 of cash contributed to *Y* by *X*. Under section 358, *X*'s basis in its *Y* stock is increased by \$100.

Example 2. (i) Assume the same facts as *Example 1*, except that, rather than *X* stock, *X* transfers an option with a fair market value of \$100 to purchase *X* stock.

(ii) In this *Example 2*, no gain or loss is recognized on the disposition of the *X* stock option by *Y*. Immediately before *Y*'s disposition of the *X* stock option, *Y* is treated as purchasing the *X* stock option from *X* for \$100 of cash contributed to *Y* by *X*. Under section 358, *X*'s basis in its *Y* stock is increased by \$100.

Example 3. (i) *X*, a corporation, owns all of the outstanding stock of *Y* corporation. *Y* is a partner in partnership *Z*. *Z* reaches an agreement with *C*, an individual, to acquire a truck from *C* in exchange for 10 shares of *X* stock with a fair market value of \$100. To effectuate *Z*'s agreement with *C*, *X* transfers to *Y* the *X* stock in a transaction in which, but for this section, the basis of the *X* stock in the hands of *Y* would be determined with respect to *X*'s basis in the *X* stock under section 362(a). *Y* immediately transfers the *X* stock to *Z* in a transaction in which, but for this section, the basis of the *X* stock in the hands of *Z* would be determined under section 723. *Z* immediately transfers the *X* stock to *C* to acquire the truck.

(ii) In this *Example 3*, no gain or loss is recognized on the disposition of the *X* stock by *Z*. Immediately before *Z*'s disposition of the *X* stock, *Z* is treated as purchasing the *X* stock from *X* for \$100 of cash indirectly contributed to *Z* by *X* through an

intermediate corporation, *Y*. Under section 722, *Y*'s basis in its *Z* partnership interest is increased by \$100, and, under section 358, *X*'s basis in its *Y* stock is increased by \$100.

Example 4. (i) *X*, a corporation, owns all of the outstanding stock of *Y* corporation. *B*, an individual, is an employee of *Y*. Pursuant to an agreement between *X* and *Y* to compensate *B* for services provided to *Y*, *X* transfers to *B* 10 shares of *X* stock with a fair market value of \$100. Under § 1.83-6(d), but for this section, the transfer of *X* stock by *X* to *B* would be treated as a contribution of the *X* stock by *X* to the capital of *Y*, and immediately thereafter, a transfer of the *X* stock by *Y* to *B*. But for this section, the basis of the *X* stock in the hands of *Y* would be determined with respect to *X*'s basis in the *X* stock under section 362(a).

(ii) In this *Example 4*, no gain or loss is recognized on the deemed disposition of the *X* stock by *Y*. Immediately before *Y*'s deemed disposition of the *X* stock, *Y* is treated as purchasing the *X* stock from *X* for \$100 of cash contributed to *Y* by *X*. Under section 358, *X*'s basis in its *Y* stock is increased by \$100.

Example 5. (i) *X*, a corporation, owns all of the outstanding stock of *Y* corporation. *B*, an individual, is an employee of *Y*. To compensate *B* for services provided to *Y*, *B* is offered the opportunity to purchase 10 shares of *X* stock with a fair market value of \$100 at a reduced price of \$80. *B* transfers \$80 and *Y* transfers \$10 to *X* as partial payment for the *X* stock.

(ii) In this *Example 5*, no gain or loss is recognized on the deemed disposition of the *X* stock by *Y*. Immediately before *Y*'s deemed disposition of the *X* stock, *Y* is treated as purchasing the *X* stock from *X* for \$100, \$80 of which *Y* is deemed to have received from *B*, \$10 of which originated with *Y*, and \$10 of which is deemed to have been contributed to *Y* by *X*. Under section 358, *X*'s basis in its *Y* stock is increased by \$10.

Example 6. (i) *X*, a corporation, owns stock of *Y*. To compensate *Y*'s employee, *B*, for services provided to *Y*, *X* issues 10 shares of *X* stock to *B*, subject to a substantial risk of forfeiture. *B* does not have an election under section 83(b) in effect with respect to the *X* stock. *X* retains the only reversionary interest in the *X* stock in the event that *B* forfeits the right to the stock. Several years after *X*'s transfer of the *X* shares, the stock vests. At the time the stock vests, the 10 shares of *X* stock have a fair market value of \$100. Under § 1.83-6(d), but for this section, the transfer of the *X* stock by *X* to *B* would be treated, at the time the stock vests, as a contribution of the *X* stock by *X* to the capital of *Y*, and immediately thereafter, a disposition of the *X* stock by *Y* to *B*. The basis of the *X* stock in the hands of *Y*, but for this section, would be determined with respect to *X*'s basis in the *X* stock under section 362(a).

(ii) In this *Example 6*, no gain or loss is recognized on the deemed disposition of *X* stock by *Y* when the stock vests. Immediately before *Y*'s deemed disposition of the *X* stock, *Y* is treated as purchasing *X*'s stock from *X* for \$100 of cash contributed to *Y* by *X*. Under section 358, *X*'s basis in its *Y* stock is increased by \$100.

Example 7. (i) Assume the same facts as in *Example 6*, except that *Y* (rather than *X*)

retains a reversionary interest in the *X* stock in the event that *B* forfeits the right to the stock. Several years after *X*'s transfer of the *X* shares, the stock vests.

(ii) In this *Example 7*, this section does not apply to *Y*'s deemed disposition of the *X* shares because *Y* is not deemed to have transferred the *X* stock to *B* immediately after receiving the stock from *X*. For the tax consequences to *Y* on the deemed disposition of the *X* stock, see § 1.83-6(b).

Example 8. (i) *X*, a corporation, owns all of the outstanding stock of *Y* corporation. In Year 1, *X* issues to *Y*'s employee, *B*, a nonstatutory stock option to purchase 10 shares of *X* stock as compensation for services provided to *Y*. The option is exercisable against *X* and does not have a readily ascertainable fair market value (determined under § 1.83-7(b)) at the time the option is granted. In Year 2, *B* exercises the option by paying *X* the strike price of \$80 for the *X* stock, which then has a fair market value of \$100.

(ii) In this *Example 8*, because, under section 83(e)(3), section 83(a) does not apply to the grant of the option, paragraph (d) of this section also does not apply to the grant of the option. Section 83 and § 1.1032-3 apply in Year 2 when the option is exercised; thus, no gain or loss is recognized on the deemed disposition of *X* stock by *Y* in Year 2. Immediately before *Y*'s deemed disposition of the *X* stock in Year 2, *Y* is treated as purchasing the *X* stock from *X* for \$100, \$80 of which *Y* is deemed to have received from *B* and the remaining \$20 of which is deemed to have been contributed to *Y* by *X*. Under section 358, *X*'s basis in its *Y* stock is increased by \$20.

Example 9. (i) *A*, an individual, owns a majority of the stock of *X*. *X* owns stock of *Y* constituting control of *Y* within the meaning of section 368(c). *A* transfers 10 shares of its *X* stock to *B*, a key employee of *Y*. The fair market value of the 10 shares on the date of transfer was \$100.

(ii) In this *Example 9*, *A* is treated as making a nondeductible contribution of the 10 shares of *X* to the capital of *X*, and no gain or loss is recognized by *A* as a result of this transfer. See *Commissioner v. Fink*, 483 U.S. 89 (1987). *A* must allocate his basis in the transferred shares to his remaining shares of *X* stock. No gain or loss is recognized on the deemed disposition of the *X* stock by *Y*. Immediately before *Y*'s disposition of the *X* stock, *Y* is treated as purchasing the *X* stock from *X* for \$100 of cash contributed to *Y* by *X*. Under section 358, *X*'s basis in its *Y* stock is increased by \$100.

Example 10. (i) In Year 1, *X*, a corporation, forms a trust which will be used to satisfy deferred compensation obligations owed by *Y*, *X*'s wholly owned subsidiary, to *Y*'s employees. *X* funds the trust with *X* stock, which would revert to *X* upon termination of the trust, subject to the employees' rights to be paid the deferred compensation due to them. The creditors of *X* can reach all the trust assets upon the insolvency of *X*. Similarly, *Y*'s creditors can reach all the trust assets upon the insolvency of *Y*. In Year 5, the trust transfers *X* stock to the employees

of Y in satisfaction of the deferred compensation obligation.

(ii) In this *Example 10*, X is considered to be the grantor of the trust, and, under section 677, X is also the owner of the trust. Any income earned by the trust would be reflected on X's income tax return. Y is not considered a grantor or owner of the trust corpus at the time X transfers X stock to the trust. In Year 5, when employees of Y receive X stock in satisfaction of the deferred compensation obligation, no gain or loss is recognized on the deemed disposition of the X stock by Y. Immediately before Y's deemed disposition of the X stock, Y is treated as purchasing the X stock from X for fair market value using cash contributed to Y by X. Under section 358, X's basis in its Y stock increases by the amount of cash deemed contributed.

(f) *Effective date.* This section applies to transfers of stock or stock options of the issuing corporation occurring on or after May 16, 2000.

Par. 5. In § 1.1502-13, paragraph (f)(6)(v) is amended by adding a sentence after the first sentence to read as follows:

§ 1.1502-13 Intercompany transactions.

* * * * *

(f) * * *

(6) * * *

(v) *Effective date.* * * * However, paragraph (f)(6)(ii) of this section and the last sentence of paragraph (f)(6)(iv)(A) of this section do not apply to dispositions of P stock or options occurring on or after May 16, 2000.

* * * * *

Approved: May 5, 2000.

Robert E. Wenzel,

Deputy Commissioner of Internal Revenue.

Jonathan Talisman;

Assistant Secretary of the Treasury.

[FR Doc. 00-11900 Filed 5-11-00; 2:30 pm]

BILLING CODE 4830-01-P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8882]

RIN 1545-AV86

Reorganizations; Nonqualified Preferred Stock

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to nonqualified preferred stock and rights to acquire nonqualified preferred stock. The regulations are necessary to reflect

changes to the law concerning these instruments that were made by the Taxpayer Relief Act of 1997. The regulations affect shareholders who receive nonqualified preferred stock, or rights to acquire such stock, in certain corporate reorganizations and divisions.

EFFECTIVE DATE: These regulations are effective May 16, 2000.

FOR FURTHER INFORMATION CONTACT: Michael J. Danbury, (202) 622-7750 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

On January 6, 1998, a temporary regulation (TD 8753) was published in the **Federal Register** (63 FR 411). A notice of proposed rulemaking (REG-121755-97) cross-referencing the temporary regulation was published in the **Federal Register** (63 FR 453) on the same day.

The temporary regulation provided that, notwithstanding contemporaneously issued final regulations treating certain rights to acquire stock as securities that can be received tax-free in corporate reorganizations and divisions, nonqualified preferred stock (as defined in section 351(g)(2) of the Internal Revenue Code) (NQPS), or a right to acquire NQPS, will in some circumstances not be treated as stock or securities for purposes of sections 354, 355, and 356. The temporary regulation added § 1.356-6T, and applied to NQPS received in connection with a transaction occurring on or after March 9, 1998 (other than certain recapitalizations of family-owned corporations and transactions described in section 1014(f)(2) of the Taxpayer Relief Act of 1997, Public Law 105-34, 111 Stat. 788, 921). No written comments responding to the notice of proposed rulemaking were received, and no public hearing was requested or held.

The regulation proposed by REG-121755-97 is adopted by this Treasury decision, and the corresponding temporary regulation is removed. Cross-references to the temporary regulation in §§ 1.354-1(e), 1.355-1(c), and 1.356-3(b) have been removed and replaced with cross-references to the final regulation at § 1.356-6.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section

553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. 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 Internal Revenue 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.

Drafting Information

The principal author of these regulations is Michael J. Danbury of the Office of Assistant Chief Counsel (Corporate). However, other personnel from the IRS and Treasury 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 1.356-6 also issued under 26 U.S.C. 351(g)(4). * * *

§ 1.354-1 [Amended]

Par. 2. In § 1.354-1, paragraph (e), first sentence, the language “§ 1.356-6T” is removed and “§ 1.356-6” is added in its place.

§ 1.355-1 [Amended]

Par. 3. In § 1.355-1, paragraph (c), first sentence, the language “§ 1.356-6T” is removed and “§ 1.356-6” is added in its place.

§ 1.356-3 [Amended]

Par. 4. In § 1.356-3, paragraph (b), first sentence, the language “§ 1.356-6T” is removed and “§ 1.356-6” is added in its place.

Par. 5. Section 1.356-6T is redesignated as § 1.356-6 and the section heading is revised to read as follows: