indistinguishable from sales of property to a partnership or another partner, and believed that these transactions should be treated for tax purposes in a manner consistent with their underlying economic substance. *See* H.R. Rep. No. 432, 98th Cong. 2nd Sess. 1218 (1984) (H.R. Rep.), and S. Prt. No. 169 (Vol. I), 98th Cong. 2nd Sess. 225 (1984) (S. Prt.) (discussing *Communications Satellite Corp.* v. *United States,* 625 F.2d 997 (Ct. Cl. 1980), and *Jupiter Corp.* v. *United States,* 2 Cl. Ct. 58 (1983), both of which involved disguised sales of a partnership interest).

On October 9, 2001, the IRS and the Treasury Department issued Notice 2001–64 (2001–2 CB 316), (*see* § 601.601(d)(2)(ii)(*b*)), announcing that the IRS and the Treasury Department were considering issuing proposed regulations under section 707(a)(2)(B), relating to disguised sales of partnership interests. The IRS and the Treasury Department requested comments on the scope and substance of guidance concerning disguised sales of partnership interests, including any applicable safe harbors or exceptions. Written comments in response to Notice 2001–64 were received and considered in drafting proposed regulations.

In response to requests, on November 26, 2004, the Treasury Department and the IRS published in the **Federal Register** (69 FR 68838) a notice of proposed rulemaking under section 707(a)(2)(B), (REG–149519–03) relating to disguised sales of partnership interests. The proposed regulations sought to amend the existing regulations for disguised sales of property (existing property regulations) by adding rules for disguised sales of partnership interests and by revising the rules relating to disguised sales of property. The proposed regulations for disguised sales of partnership interests include a framework similar to that in the existing property regulations, with a general rule that would apply based on all of the facts and circumstances.

The Treasury Department and the IRS received written comments on the proposed regulations from interested parties. The Treasury Department and the IRS, having now thoroughly considered those comments, have decided to withdraw the proposed regulations. The Treasury Department and the IRS will continue to study this area and may issue guidance in the future. Until new guidance is issued, any determination of whether transfers between a partner or partners and a partnership is a transfer of a partnership interest will be based on the statutory language, guidance provided in legislative history, and case law.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Withdrawal of Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking (REG–149519–03) that was published in the **Federal Register** on November 26, 2004 (69 FR 68838) is withdrawn.

L.E. Stiff,

Deputy Commissioner for Services and Enforcement.

[FR Doc. E9–1101 Filed 1–16–09; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–143686–07]

RIN 1545–BH35

The Allocation of Consideration and Allocation and Recovery of Basis in Transactions Involving Corporate Stock or Securities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under sections 301, 302, 304, 351, 354, 356, 358, 368, 861, 1001, and 1016 of the Internal Revenue Code (Code). The proposed regulations provide guidance regarding the recovery of stock basis in distributions under section 301 and transactions that are treated as dividends to which section 301 applies, as well as guidance regarding the determination of gain and the basis of stock or securities received in exchange for, or with respect to, stock or securities in certain transactions. The proposed regulations affect shareholders and security holders of corporations. These proposed regulations are necessary to provide such shareholders and security holders with guidance regarding the allocation and recovery of basis on distributions of property.

DATES: Written or electronic comments, and a request for a public hearing, must be received by April 21, 2009.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–143686–07), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–143686–07), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the Federal eRulemaking Portal at *www.regulations.gov* (IRS#REG–143686–07).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations under sections 301, 302, and 304, Theresa M. Kolish, (202) 622–7530; concerning the proposed regulations under sections 351, 354, 356, 358, 368, 1001, and 1016, Rebecca O. Burch, (202) 622–7550; concerning the proposed regulations under section 861, Jeffrey L. Parry, (202) 622–4476; concerning submission of comments or to request a hearing, Richard Hurst (202) 622–7180 (not toll free numbers).

Background

The primary objective of these proposed regulations is to provide a single model for stock basis recovery by a shareholder that receives a constructive or actual distribution to which section 301 applies and a single model for sale and exchange transactions to which section 302(a) applies, including certain elements of a reorganization exchange. Further to this objective, these proposed regulations define the scope of the exchange that must be analyzed under particular Code provisions, and provide a methodology for determining gain realized under section 356 and stock basis under section 358.

In addition, these proposed regulations respond to comments received by the IRS and Treasury Department regarding the current section 358 regulations, such as suggestions to expand the tracing rules to stock transfers that are subject to section 351 but do not qualify as reorganizations, questions regarding whether (and, if so, to what extent) shareholder elections constitute terms of an exchange, and whether the terms of an exchange control for purposes of qualifying a transaction as a reorganization under section 368. Finally, these proposed regulations include amendments to the section 304 regulations that import the statutory amendments to that section. See section 226 of the Tax Equity and Fiscal Responsibility Act of 1982, Public Law 97–248 (96 Stat. 325, 490) (September 3, 1982), section 712(l) of the Deficit Reduction Act of 1984, Public Law 98–369 (98 Stat. 494, 953–55) (July 18, 1984), section 1875(b) of the Tax Reform Act of 1986, Public Law 99–514 (100

Stat. 2085, 2894) (October 22, 1986), and section 1013 of the Taxpayer Relief Act of 1997, Public Law 105–34 (111 Stat. 788, 918) (August 5, 1997).

Explanation of Provisions

I. Introduction—Exchanges and Distributions to Which Sections 301 and 302 Apply

Section 301 provides rules for the treatment of a distribution with respect to stock but does not specify how to identify the shares upon which a distribution is made. Furthermore, the tax law does not provide rules concerning whether a shareholder recovers its stock basis in the aggregate, or alternatively, whether a shareholder is required to recover stock basis share-by-share. Finally, the tax law does not provide specifically that transactions treated as section 301 distributions (i.e., redemptions under section 302(d), certain section 304 transactions, and certain reorganizations) should be subject to the same rules as actual section 301 distributions. In the reorganization context, the Code provides consequences resulting from different types of exchanges, but does not specify whether the exchange is based on a shareholder's aggregate stock holdings, or alternatively, based on particular elements of the overall exchange.

Rules related to stock basis recovery and stock basis determinations have evolved independently over many years on a transactional basis. Ad hoc development of these authorities has lead to the possibility of variant treatment of economically similar transactions to which section 301 or 302(a) applies either directly or through the operation of other Code provisions. Moreover, because there has not been a comprehensive review of these issues, many questions lack definitive answers. Prior guidance attempted to address particular areas of uncertainty within the subject matter of basis recovery and basis identification. Without the benefit of addressing all related issues, however, certain of this prior guidance was needed reconsidered. See REG–150313–01. Other guidance built the framework for basis identification that has encouraged the development of these proposed regulations.

Building on themes developed in § 1.358–2 and comments received from the tax community, this proposal is intended to be a comprehensive approach to stock basis recovery and stock basis identification to produce consistent results among economically similar transactions, regardless of the transaction type or the specific Code provision that results in the application of section 301 or 302(a).

The cornerstone of this proposal is that a share of stock is the basic unit of property that can be disposed of and, accordingly, the results of a transaction should generally derive from the consideration received in respect of that share. This guiding principle has section 1012 as its underpinning and has become fundamental to the tax treatment of shareholders, regardless of the specific nature of a shareholder's exchange. See § 1.358–2 and § 1.367(b)–13. A corollary to this basic premise is that a reorganization exchange is not an event that justifies alteration of a shareholder's tax position beyond what is necessary to reflect the results of the reorganization.

To harmonize the tax treatment of economically similar transactions, these proposed regulations adopt a single model for section 301 distributions (dividend equivalent transactions) and a single model for sale or exchange transactions to which section 302(a) applies (non-dividend equivalent transactions), regardless of whether section 301 or section 302(a) applies directly or by reason of section 302(d), 304 or 356.

II. Distributions With Respect to Stock and Dividend Equivalent Transactions

A. Section 301 Distributions

Consistent with the fundamental notion that a share of stock is the basic unit of property, the results of a section 301 distribution should derive from the consideration received in respect of each share of stock, notwithstanding designations otherwise. *Johnson* v. *United States,* 435 F.2d 1257 (4th Cir. 1971). Accordingly, these proposed regulations treat a section 301 distribution as received on a pro rata, share-by-share basis with respect to the class of stock upon which the distribution is made. Thus, a distribution that is not a dividend within the meaning of section 301(c)(1) can result in gain with respect to some shares of a class while other shares have unrecovered basis.

B. Dividend Equivalent Redemptions

To promote consistency among transactions treated as section 301 distributions under the Code, these proposed regulations apply the same basis recovery rules described above to both dividend equivalent redemptions and certain section 304 transactions. Accordingly, under these proposed regulations, a dividend equivalent redemption results in a pro rata, share-by-share distribution to all shares of the ''redeemed class'' held by the redeemed shareholder immediately before the redemption. The proposed regulations define the term ''redeemed class'' to mean all of the shares of that class held by the redeemed shareholder. Similar to an actual section 301 distribution, the proportional approach to basis recovery in dividend equivalent redemptions can produce gain with respect to some shares while other shares have unrecovered basis.

The constructive section 301 distribution is limited to the shares of the redeemed class (instead of constructing a pro rata distribution among all shares of various classes held by the redeemed shareholder) because different classes of stock have distinct legal entitlements that are respected for federal income tax purposes. *H.K. Porter Co.,* 87 T.C. 689 (1986); *Comm'r* v. *Spaulding Bakeries,* 252 F.2d 693 (2d Cir. 1958). Accordingly, a constructive section 301 distribution is conformed to an actual section 301 distribution by identifying those shares with respect to which an actual section 301 distribution would have been received, and by reducing the basis of only those shares.

i. Basis Adjustments in Dividend Equivalent Redemptions if Less Than All of the Shares of a Single Class Held by the Taxpayer Are Redeemed

If less than all of the shares of a class of stock held by the taxpayer are redeemed, the proposed regulations provide that in a hypothetical recapitalization described in section 368(a)(1)(E), the redeemed shareholder is deemed to exchange all its shares in the class, including the redeemed shares, for the actual number of shares held after the redemption transaction. The tracing rules of the section 358 regulations apply to preserve the basis of the shares exchanged in the recapitalization in the remaining shares of the redeemed class held by the shareholder. Thus, under these proposed regulations, a dividend equivalent redemption is generally treated in the same manner, and its results are the same as, a section 301 distribution in which no shares were cancelled.

ii. Basis Recovery in Dividend Equivalent Redemptions in Which the Taxpayer Surrenders All of Its Shares in a Single Class

Under current law, if all of the shares of a single class held by a shareholder are redeemed in a dividend equivalent redemption, any unrecovered basis in the redeemed shares is permitted to shift to other shares in certain circumstances. See § 1.302–2(c). The

IRS and Treasury Department believe that the shifting of stock basis is inconsistent with the fundamental principle that each share is a separate unit of property, and can lead to inappropriate results. Accordingly, these proposed regulations do not permit the shifting of basis to other shares held (directly or by attribution) by the redeemed shareholder. Instead, the proposed regulations preserve the tax consequences of the unrecovered basis for the redeemed shareholder by treating the amount of the unrecovered basis as a deferred loss of the redeemed shareholder that can be accessed when the conditions of sections 302(b)(1), (2), or (3) are satisfied, or alternatively, when all the shares of the issuing corporation (or its successor) become worthless within the meaning of section 165(g).

C. Dividend Equivalent Reorganization Exchanges

If, pursuant to a reorganization, a shareholder receives qualifying property and boot in exchange for its target corporation stock, the tax consequences of the receipt of the boot under these proposed regulations will depend upon whether the reorganization exchange is dividend equivalent or not. See section III. of this Preamble for a description of the proposed rules that would apply if the reorganization is not dividend equivalent.

In general, the determination of whether an exchange has the effect of the distribution of a dividend for purposes of section 356(a)(2) is determined by examining the effect of the shareholder's ''overall exchange.'' *Commissioner* v. *Clark*, 489 U.S. 726, 738 (1989). Thus, the key to this determination is the scope of the exchange. For example, if the shareholder exchanges shares of preferred stock solely for boot and shares of common stock solely for qualifying property pursuant to a plan of reorganization, is the determination of whether the exchange of the preferred stock for boot is dividend equivalent based solely on that particular exchange or on the overall exchange of the preferred and common stock for the qualifying property and the boot? The same question would arise with respect to each particular exchange if the shareholder exchanged the preferred and common stock for a combination of qualifying property and boot. The *Clark* decision examined a reorganization exchange involving a single class of stock, and does not provide guidance in the context of multiple classes of stock.

In the case of a section 302 redemption, the exchanging shareholder determines dividend equivalency based on all the facts and circumstances. See *Zenz* v. *Quinlivan*, 213 F.2d 914 (C.A.6 1954). To promote consistency between sale or exchange transactions, these proposed regulations provide that the overall reorganization exchange shall be taken into account in determining whether a particular exchange is dividend equivalent. Thus, a shareholder that exchanges a class of stock solely for boot and another class of stock solely for nonqualifying property shall consider the overall exchange (the exchange of the two classes of stock for boot and qualifying property) in determining whether each particular exchange is dividend equivalent.

If it is determined that a reorganization exchange is dividend equivalent, because different classes of stock have distinct legal entitlements that are respected for federal income tax purposes, the proposed regulations provide that an exchange of a class of stock solely of boot is an exchange to which section 302(d) (and not section 356(a)(2)) applies.

To ensure similar tax treatment of dividend equivalent reorganization exchanges and dividend equivalent redemptions, if the reorganization exchange is dividend equivalent the proposed regulations limit the ability of the exchanging shareholder to specify the terms of the exchange. Specifically, if the shareholder receives more than one class of stock or surrenders one class of stock and securities, the shareholder may specify the terms of the exchange between the classes of stock surrendered (or between one or more classes of stock and securities surrendered), provided the designation is economically reasonable, but not between particular shares of the same class of stock.

As with the redemption of shares of a redeemed class in a dividend equivalent redemption, a shareholder's receipt solely of boot with respect to a class of stock in a reorganization exchange is treated as received pro rata, on a share-by-share basis, with respect to each share in the class—under the principles of *Johnson,* the shareholder cannot specify that the boot is received with respect to particular shares within the class. Consequently, such an exchange could result in gain recognition with respect to some shares while other shares in the class could have recovered basis.

In formulating the proposed regulations, the IRS and Treasury Department considered different alternatives. For example, in a dividend equivalent reorganization exchange pursuant to section 356(a)(2), the IRS and Treasury Department considered whether gain realized with respect to a class should be determined in the aggregate (for example, with respect to all shares within a class). Under this approach, no gain would be realized with respect to a class that has a block of built-in gain stock and block of built-in loss stock where the built-in loss is at least equal to the built-in gain. The IRS and Treasury Department rejected such an approach because it would contradict the fundamental principle that a share is a discrete unit of property, and also would compromise the principle that a reorganization exchange is not an event that justifies stock basis averaging. The IRS and Treasury Department also considered eliminating a shareholder's ability to specify the terms of a dividend equivalent reorganization exchange based on the premise that under *Johnson*, all consideration received in such an exchange should be considered received pro rata among all shares, regardless of whether more than one class is surrendered. The IRS and Treasury Department rejected this approach in favor of the approach of the proposed regulations that is analogous to the proposed treatment of dividend equivalent redemptions, under which each share of the redeemed class is treated as receiving a pro rata share of the proceeds, and shares outside of the redeemed class are not treated as receiving any part of the distribution.

D. Special Rules Related to Apportionment of Interest and Other Expenses

Under section 864(e), taxpayers apportion interest expense between statutory and residual groupings on the basis of the relative values of their assets in each grouping. For this purpose, taxpayers may choose to value their assets using either fair market value or tax book value (adjusted basis). The proposed regulations provide that for purposes of apportioning expenses on the basis of the tax book value of assets, the adjusted basis in any remaining shares of the redeemed class owned by the redeemed shareholder, any shares that are not in the redeemed class, or any shares owned by certain affiliated corporations shall be increased by the amount of the unrecovered basis of redeemed shares. Thus, under the proposed regulations, the interest expense allocation and apportionment consequences of a dividend equivalent redemption are the same as an actual section 301 distribution.

E. Section 1059

Section 1059(a) provides that if a corporation receives an extraordinary dividend with respect to any share of stock and such corporation has not held such stock for more than two years before the dividend announcement date, then the corporation's basis in such stock shall be reduced (but not below zero) by the non-taxed portion of such dividends.

Except as provided in regulations, in the case of any redemption of stock which would not have been treated (in whole or in part) as a dividend if any options had not been taken into account under section 318(a)(4), or section 304(a) had not applied, any amount treated as a dividend is treated as an extraordinary dividend, without regard to the taxpayer's holding period in the stock. Section 1059(e)(1)(A)(iii). In the case of these types of redemptions, section 1059(e)(1)(A) (flush language) provides that only the basis of the stock redeemed shall be taken into account under section 1059(a). These proposed regulations do not affect the basis reduction provided for in section 1059(e)(1)(A) if section 1059(e)(1)(A)(iii) otherwise applies. Accordingly, to the extent of an extraordinary dividend described in section 1059(e)(1)(A)(iii), a redeeming shareholder would first reduce basis as prescribed by section 1059(e)(1)(A). These proposed regulations would then apply to the extent the distribution is not a dividend within the meaning of section 301(c)(1).

F. Redemptions of Stock Held by Partnerships, Trusts, and S Corporations

The treatment of unrecovered basis as a deferred loss raises special issues where the redeemed shareholder is an S corporation, a partnership, or a trust (each a flow-through entity). These proposed regulations reserve with respect to the issues relating to redeemed shareholders that are flow-through entities pending further study and comment. The primary issue under study is whether an ''outside'' basis adjustment that reflects the deferred loss should occur at the time of the dividend equivalent redemption, or alternatively, when there is an inclusion date with respect to the deduction.

In general, a deferred loss is reflected in the outside basis of an interest in a flow-through entity when the deduction can be accessed by the entity. Accordingly, as a general matter, disconformity can exist between inside attributes and outside basis where an inside attribute is a deferred loss. Conversely, a net operating loss of a flow-through entity reduces the outside basis of an interest in the entity in the year that the net operating loss arises.

Although disconformity generally can exist where a flow-through entity has a deferred loss, the IRS and Treasury Department are concerned that deferred losses arising from unrecovered basis presents an opportunity to separate the deferred loss from the dividend income resulting from the redemption. The IRS and Treasury Department question whether such a separation would be appropriate, and believe that treating the deferred loss as a net operating loss in the year of the redemption for basis adjustment purposes may be the better approach. However, the IRS and Treasury Department acknowledge that it may be inappropriate to require the owners of a flow-through entity to reduce outside basis before the deferred loss can be accessed, simply because the owners of the flow-through entity cannot access the deferred loss. The IRS and Treasury Department request comments on this issue.

Flow-through entities also present the question of when it is appropriate to treat an owner of the flow-through entity as the redeemed shareholder, and when it is appropriate to treat the flow-through entity itself as the redeemed shareholder. For example, where the owner completely divests of its interest in the flow-through entity, it may be appropriate to treat the owner as the redeemed shareholder for determining whether the sale of the flow-through entity interest is an inclusion date with respect to that owner. This treatment may be more appropriate if the deferred loss is treated as a net operating loss that already has reduced the outside basis of the entity's owner. Conversely, if the deferred loss is not treated as a net operating loss, it may be more appropriate to treat the flow-through entity as the redeemed shareholder in all cases. The IRS and Treasury Department request comments on this issue.

G. Consolidated Groups and Basis Recovery in Dividend Equivalent Redemptions

The IRS and Treasury Department continue to study the issues raised when a redeemed shareholder with a deferred loss files a consolidated return. The IRS and Treasury Department believe that certain of the concerns raised by REG–150313–01 are addressed in these proposed regulations by the deemed recapitalization mechanic described in section II.B.i. of this Preamble.

III. Redemptions Treated as a Sale or Exchange Pursuant to Section 302(a)

A. In General

Under current law for redemptions characterized under section 302(a), a shareholder that owns shares of stock with different bases can decide whether to surrender for redemption high basis shares, low basis shares or any combination thereof. See § 1.1012–1(c). Consistent with treating a share as a discrete unit of property, the proposed regulations do not limit this electivity. Additionally, as further discussed below, these proposed regulations affirm the ability of a shareholder to specify the terms of a reorganization exchange where the receipt of boot results in sale or exchange treatment.

B. Reorganization Exchanges That Result in Sale or Exchange Treatment

If it is determined that the reorganization exchange is not dividend equivalent (as described in section II.C. of this Preamble), section 302(a) will apply to the extent shares are exchanged solely for boot. Just as a shareholder can elect to surrender high basis shares, low basis shares or any combination thereof in a non-dividend equivalent redemption, a shareholder engaging in a reorganization exchange that is not dividend equivalent can specify the receipt solely of boot for a share, provided that the terms of the exchange are economically reasonable. In such case, the shareholder will recognize gain or loss with respect to that share pursuant to section 302(a), and section 356(a)(1) will not apply.

IV. Extension of Tracing Principles To Determine Basis in Certain Stock Transfers That Are Not Reorganizations, and Other Proposals in Response to Specific Comments

A. Application of Tracing Principles to Certain Section 351 Exchanges and Capital

The current section 358 regulations apply tracing principles to determine the basis of stock received in a section 351 exchange only where the section 351 exchange also qualifies as a reorganization and no liabilities was assumed in the exchange. The principal reason for this limitation is the interaction of the basis tracing rules with the aggregate approach to gain determination under section 357(c). The IRS and Treasury Department continue to study this issue, but have concluded that the resolution of this issue is not necessary to broaden the application of the tracing rules to transfers of stock in section 351 exchanges in which no

liabilities are assumed. Thus, for example, in an exchange to which section 351 applies where the transferor transfers two blocks of stock with disparate basis and other property, the separate bases will be preserved under section 358, provided that liabilities are not assumed in the exchange.

In addition, these proposed regulations incorporate the deemed issuance and recapitalization approach of the current section 358 regulations to section 351 exchanges to preserve basis if insufficient shares, or no shares at all, are actually issued in the exchange. These proposed regulations also extend the deemed issuance and recapitalization approach to shareholder capital contributions to which section 118 applies.

B. Miscellaneous

The IRS and Treasury Department have received a number of comments on the current section 358 regulations. These proposed regulations make a number of clarifying, but nonsubstantive, modifications to the current section 358 regulations. Specifically, the proposed regulations add headings throughout the existing final §§ 1.358–1 and 1.358–2 regulations without substantive change. In addition, the proposed regulations address the following comments received with respect to the current section 358 regulations.

Commentators questioned how shareholder elections factor into the terms of the exchange. These proposed regulations include two new examples illustrating the effect of such elections.

Commentators questioned the effect of the terms of an exchange on the determination of whether a transaction qualifies as a reorganization, and therefore is not subject to the general rule of section 1001. These proposed regulations include cross-references in the regulations under sections 368 and 1001 to clarify that, to the extent the terms of the exchange specify that a particular property is received in exchange for a particular property, such terms shall control for purposes of determining whether a transaction qualifies as a reorganization provided such terms are economically reasonable.

Finally, in addition to provisions relating to the determination of basis, these proposed regulations add a rule that addresses certain issues considered in Rev. Rul. 68–55 (1968–1 CB 140). Specifically, consistent with Rev. Rul. 68–55, these regulations provide that, for purposes of determining gain under section 351(b), the fair market value of each category of consideration received in a section 351 exchange is allocated between the transferred assets in based on relative fair market values.

V. Specifically Requested Comments

In addition to the comments requested throughout this Preamble, the IRS and Treasury request comments on the following areas.

The proposed regulations under section 302 do not apply to a redemption of stock described in section 306(c). Pursuant to section 306(a)(2), a redemption of stock described in section 306(c) is treated as a distribution of property to which section 301 applies. *Example 2* of § 1.306–1 suggests that the unrecovered basis of redeemed section 306 stock is added to the basis of the stock with respect to which the section 306 stock was distributed. The IRS and Treasury Department request comments on whether such treatment is appropriate or whether an alternative regime should apply when such a section 306(c) redemption is treated as a section 301 distribution.

Comments are also requested regarding whether, after a section 355 pro rata split-up, the controlled corporations are the same as or different from the distributing corporation for purposes of determining whether the date of distribution would be an inclusion date for a deferred loss attributable to unrecovered basis.

Finally, the IRS and Treasury Department recognize that the proposed regulations may not address all related issues arising in all cash ''D'' reorganizations. Specifically, these proposed regulations may heighten the importance of whether the nominal share deemed issued in such a reorganization is received in respect of particular shares surrendered by the exchanging shareholder. The IRS and Treasury Department request comments with respect to this issue.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. Further, it is hereby certified that these proposed regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations provide clarifying guidance of existing law and do not create additional obligations for, or impose an economic impact on small entities. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. All comments will be available for public inspection and copying. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these regulations are Theresa M. Kolish and Rebecca O. Burch of the Office of Associate Chief Counsel (Corporate). Other personnel from offices of the IRS and Treasury Department participated in their development.

Availability of IRS Documents

IRS revenue rulings, procedures, and notices cited in this preamble are made available by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.301–2 is added to read as follows:

§ 1.301–2 Application to basis.

(a) *Application to basis.* That portion of a distribution which is not a dividend shall be applied pro rata, on a share-by-share basis, to reduce the adjusted basis of each share of stock held by the shareholder within the class of stock upon which the distribution is made. The following example illustrates this paragraph (a):

Example. (i) *Facts.* Corporation X, a calendar year taxpayer, has only common stock outstanding. A, an individual, owns all 100 shares; 25 were acquired on Date 1 for $25 (Block 1) and 75 were acquired on Date

2 for $175 (Block 2). On December 31, when Corporation X had earnings and profits of $100, it made a $3 distribution on each share of common stock.

(ii) *Analysis.* A is treated as receiving $75 of the distribution on block 1 and $225 on block 2. On Block 1, A will have a $25 dividend under section 301(c)(1), a $25 return of capital under section 301(c)(2) and a $25 gain under section 301(c)(3). On Block 2, A will have a $75 dividend under section 301(c)(1), a $150 return of capital under section 301(c)(2) and will have a remaining basis of $25 in the shares of block 2.

(b) *Effective/applicability date.* This section applies to transactions that occur after the date these regulations are published as final regulations in the **Federal Register**.

§ 1.302–2 [Amended]

Par. 3. In § 1.302–2, paragraph (c) is removed and reserved.

Par. 4. Section 1.302–5 is added to read as follows:

§ 1.302–5 Redemptions under section 302(d).

(a) *In general*—(1) *Share-by-share basis reduction.* In any case in which an amount received in redemption of stock (as defined in section 317(b)) is treated as a distribution to which section 301 applies, that portion of a distribution that is not a dividend shall be applied to reduce the adjusted basis of each share held by the redeemed shareholder (as defined in paragraph (b) of this section) in the redeemed class (as defined in paragraph (b) of this section). Such reduction shall be applied pro rata, on a share-by-share basis, to all shares of the redeemed class held by the redeemed shareholder. Gain, if any, on a share shall be determined under section 301(c)(3).

(2) *Deemed recapitalization.* Except as provided in paragraph (a)(3) of this section, immediately following the reduction of basis as provided in section 301(c)(2) and paragraph (a)(1) of this section, all shares of the redeemed class, including the redeemed shares, held by the redeemed shareholder will be treated as surrendered in a reorganization described in section 368(a)(1)(E) in exchange for the number of shares of the redeemed class directly held by the redeemed shareholder after the redemption. The basis of the shares deemed received in the reorganization described in section 368(a)(1)(E) will be determined under the rules of section 358 and § 1.358–2.

(3) *Redemption of all shares of redeemed class*—(i) *Remaining basis treated as loss.* If all the shares of the redeemed class held by the redeemed shareholder are redeemed, an amount equal to the basis of the redeemed stock, after adjusting such basis to reflect the application of section 301(c)(2) as provided in paragraph (a)(1) of this section, will be treated as a loss on a disposition of the redeemed stock on the date of the redemption. Such loss is taken into account on the inclusion date as defined in paragraph (b) of this section.

(ii) *Attributes of loss.* Notwithstanding that a loss described in paragraph (a)(3)(i) of this section may be deferred and taken into account on a date later than the date of the redemption, the attributes (for example, character and source) of such loss are determined on the date of the redemption that gave rise to such loss.

(b) *Definitions*—(1) *Redeemed shareholder.* Except as provided in paragraph (c) of this section, the term *redeemed shareholder* means the person whose stock is redeemed in a transaction. If the redeemed shareholder is a corporation, and the assets of the redeemed shareholder are acquired in a transaction described in section 381(a) (other than transactions described in paragraph (b)(4)(ii) of this section), the acquiring corporation (within the meaning of section 381) thereafter is treated as the redeemed shareholder.

(2) *Redeemed class.* With respect to a shareholder whose stock has been redeemed, the term *redeemed class* means all of the shares of that class held by the redeemed shareholder. For this purpose, a class is defined with respect to economic rights to distributions rather than the labels attached to shares or rights with respect to corporate governance.

(3) *Redeeming corporation.* The term *redeeming corporation* means the corporation that issued the stock that is redeemed.

(4) *Inclusion date*—(i) *Definition.* The term *inclusion date* means the earlier of—

(A) The first date on which the redeemed shareholder would satisfy the criteria of section 302(b)(1), (2), or (3), if the facts and circumstances that exist at the end of such day had existed immediately after the redemption; or

(B) The first date on which all classes of stock of the redeeming corporation become worthless within the meaning of section 165(g). Solely for purposes of this paragraph, if the assets of the redeeming corporation (or its successor) are acquired by another corporation in a transaction described in section 381(a), the inclusion date for the redeemed shareholder is determined by treating all of the facts and circumstances that exist at the end of the day that includes the section 381 transaction (including the acquisition of the assets of the redeeming corporation or its successor) as existing immediately after the redemption. A successor for this purpose means a corporation that acquires the assets of the redeeming corporation in a transaction to which section 381(a) applies.

(ii) *Special rules for corporate shareholders.* If the redeemed shareholder is a corporation, the inclusion date includes the date such corporation has disposed of all of its assets in a transaction in which all gain and loss with respect to its assets is recognized in whole, and the corporation ceases to exist for tax purposes. If the redeemed shareholder is a foreign corporation, the inclusion date includes the date such corporation transfers its assets to a domestic corporation in either a liquidation described in section 332 or a reorganization described in section 368(a)(1) to which section 381 applies. If the redeemed shareholder is a foreign corporation that is not a controlled foreign corporation within the meaning of section 957(a) on the date of the redemption, the inclusion date includes the date such corporation transfers its assets to a controlled foreign corporation in a liquidation described in section 332 or a reorganization described in section 368(a)(1) to which section 381 applies.

(c) *Rules for special shareholders*—(1) *Redeemed shareholder is a partnership.* [Reserved]

(2) *Redeemed shareholder is an S corporation.* [Reserved]

(3) *Redeemed shareholder is an estate or trust.* [Reserved]

(d) *Operating rules for treatment of loss attributable to basis of redeemed stock*—

(1) *Treatment as a deferred loss.* Any loss attributable to the basis of redeemed stock under paragraph (a) of this section that has not been permitted to be taken into account under such section shall be treated as a deferred loss. The character of the deferred loss as ordinary or capital is determined at the time of the redemption.

(2) *Effect of loss attributable to basis of redeemed stock on earnings and profits.* If the redeemed shareholder is a corporation, any deferred loss attributable to the basis of redeemed stock is not reflected in such corporation's earnings and profits before it is taken into account pursuant to the rules of paragraph (a)(3) of this section. See, for example, §§ 1.312–6(a) and 1.312–7.

(e) *Examples.* For the purposes of the examples in this section, Corporations X, Y and Z are domestic corporations

that file U.S. tax returns on a calendar-year basis. The examples are as follows:

Example 1. (i) *Facts.* A and B, husband and wife, each own 100 shares (50 percent) of the common stock of Corporation X which they hold as a capital asset. On Date 1, A acquired 50 shares for $100 (block 1) and 50 shares on Date 2 for $200 (block 2). On December 31, Corporation X, which has no current or accumulated earnings and profits, redeems all of A's block 2 shares for $300. Under section 302(d), the redemption proceeds are treated under section 301 as a recovery of basis.

(ii) *Analysis.* Under this section, immediately before the redemption, the distribution of property is applied on a pro rata, share-by-share basis with respect to each of the shares in the redeemed class held directly by A, the redeemed shareholder. Accordingly, A will have a $50 capital gain on block 1 ($150–100) under section 301(c)(3) and $50 of basis remaining on block 2 ($150–200). To reflect the actual number of shares held by A after the redemption, A's shares in the redeemed class, including the shares actually surrendered, will be treated as exchanged in a recapitalization under section 368(a)(1)(E). The basis in A's recapitalized shares will be determined under § 1.358–2. Accordingly, A will have 25 shares with a zero basis (attributable to block 1) and 25 shares with a basis of $50 (attributable to block 2).

Example 2. (i) *Facts.* The facts are the same as in *Example 1,* except that, Corporation X, on the following December 31, when it has no current or accumulated earnings and profits, redeems all of A's remaining 50 shares for $40. A does not file an agreement described in section 302(c)(2)(A)(iii) waiving family attribution under section 318.

(ii) *Analysis.* Since A is treated under section 318(a)(1) as owning B's shares, the redemption is described in section 302(d) and is treated as a distribution to which section 301 applies. As in *Example 1,* immediately before the redemption, the distribution is applied on a pro rata, share-by-share basis with respect to each of the shares in the redeemed class held by A. Accordingly, A recognizes a $20 gain and a $30 loss. The $30 deferred loss under § 1.302–5(a)(3) may be taken into account by A on the inclusion date (see § 1.302–5(a)(3)(ii)).

Example 3. (i) *Facts.* Corporation X has both common and preferred stock outstanding. A, an individual, has 100 shares of common stock with a basis of $100 and 100 shares of preferred stock with a basis of $200. The 100 shares of common stock represent voting control of Corporation X. Corporation X, when it has no current or accumulated earnings and profits, redeems all of A's preferred stock for $150. Section 302(d) applies to the redemption, and therefore the distribution is treated as a distribution of property to which section 301 applies.

(ii) *Analysis.* If Corporation X had declared a distribution under section 301 with respect to the redeemed preferred stock, the distribution would have been limited to the shares of common stock. Therefore, the only basis recovered under section 301(c)(2) is the basis of A's preferred stock. A has $50 in excess basis after the redemption of all its preferred stock which will not shift to the common stock held by A. Under § 1.302–5(a)(3), the excess basis will be treated as a deferred loss until the inclusion date.

Example 4. (i) *Facts.* Corporation Z has 100 shares of stock outstanding, 50 shares of which are owned by each of A and his son, B. A's basis in each of his shares of Corporation Z stock is $1. In Year 1, Corporation Z redeems all of A's shares of Corporation Z stock for $200. A does not file an agreement described in section 302(c)(2)(A)(iii) waiving family attribution under section 318. At the end of Year 1, Corporation Z has current and accumulated earnings and profits in excess of $200. Section 302(d) applies to the redemption, and therefore the distribution is treated as a distribution to which section 301 applies. A recognizes dividend income of $200. In Year 6, Corporation Y, a publicly traded corporation acquires all of Corporation Z's assets in exchange solely for voting stock in a reorganization described in section 368(a)(1)(C). In the reorganization, B surrenders his shares of Corporation Z stock which, at the time of the reorganization have an aggregate fair market value of $200, and receives in exchange 5,000 shares of common stock of Corporation Y representing less than one percent of the fair market value of all the stock of Y.

(ii) *Analysis.* Under this section, an amount equal to A's basis in the redeemed stock after the Year 1 redemption, $50, is treated as a deferred loss on a disposition of the redeemed stock on the date of the redemption. Under paragraph (b)(3) of this section, solely for purposes of determining whether a particular date on or after the date of the reorganization is the inclusion date, Corporation Y, the acquiring corporation, is treated as the redeeming corporation. If the facts and circumstances that exist at the end of the day of the reorganization had existed on the date of the redemption, the redemption would have been treated as a distribution in part or full payment in exchange for the redeemed stock pursuant to section 302(a). Therefore, the date of the reorganization is the inclusion date and A is permitted to take into account the deferred loss of $50 attributable to his basis in the redeemed stock in Year 6.

(f) *Effective/applicability date.* This section applies to transactions that occur after the date these regulations are published as final regulations in the **Federal Register**.

Par. 5. Section 1.304–1 is revised to read as follows:

§ 1.304–1 In general.

(a) *In general.* Section 304 is applicable where a shareholder sells stock of one corporation to a related corporation as defined in section 304. Sales to which section 304 is applicable shall be treated as redemptions subject to sections 302 and 303.

(b) *Effective/applicability date.* This section applies to transactions that occur after the date these regulations are published as final regulations in the **Federal Register**.

Par. 6. Section 1.304–2 is amended by revising paragraphs (a) and (c), and adding paragraph (d) to read as follows:

§ 1.304–2 Acquisition by related corporation (other than a subsidiary).

(a) *In general* (1) If a corporation (the acquiring corporation), in return for property, acquires the stock of another corporation (the issuing corporation) from one or more persons, and such person or persons from whom the stock was acquired were in control of both such corporations, then such property shall be treated as received in redemption of the common stock of the acquiring corporation. As to each person transferring stock, the amount received shall be treated as a distribution to which section 301 applies, if section 302(a) or 303 does not apply. For the amount constituting a dividend in such cases, see § 1.304–6.

(2) *Section 302(b).* In applying section 302(b), reference shall be made to the ownership of stock in the issuing corporation and not to the ownership of the acquiring corporation (except for the purposes of applying section 318(a)). Section 318(a) shall be applied without regard to the 50 percent limitation contained in section 318(a)(2)(C) and (3)(C).

(3) *Section 302(d).* If, pursuant to section 302(d), section 301 applies to the property received in redemption of the common stock of the acquiring corporation pursuant to paragraph (a)(1) of this section, the transferor and the acquiring corporation shall be treated, for all Federal income tax purposes, in the same manner as if the transferor had transferred the stock of the issuing corporation to the acquiring corporation in exchange for the common stock of the acquiring corporation in a transaction to which section 351 applies, and then the acquiring corporation had redeemed the common stock it was treated as issuing in an exchange for property. Accordingly, the acquiring corporation's basis in the stock of the issuing corporation is determined under section 362, and, under section 358, the transferor's basis in the common stock of the acquiring corporation deemed issued to the transferor in the deemed section 351 transaction is equal to the transferors basis in the stock of the issuing corporation it surrendered.

(4) *Basis of redeemed shares.* To the extent that section 301(c)(2) applies to the redemption of the common stock of the acquiring corporation issued in the deemed section 351 exchange, the amount distributed in such redemption

shall be applied to reduce the adjusted basis of each share of common stock directly held or deemed held by the transferor on a pro rata, share-by-share basis. See § 1.302–5(a).

(5) *Sale or exchange treatment.* If section 301 does not apply to the property treated as received in redemption of the common stock of the acquiring corporation pursuant to paragraph (a)(1) of this section, the property received by the transferor shall be treated as received in a distribution in full payment in exchange for such common stock of the acquiring corporation under section 302(a). The basis and the holding period of the common stock of the acquiring corporation that is treated as redeemed will be the same as the basis and holding period of the stock of the issuing corporation actually surrendered. The acquiring corporation shall take a cost basis in the stock of the issuing corporation that it acquires under section 1012.

* * * * *

(c) *Examples.* For purposes of the examples in this section, each of corporation is a domestic corporation that files a U.S. tax return on a calendar-year basis and in each instance the fair market value of the issuing corporation stock is in excess of its adjusted basis. The principles of this section are illustrated by the following examples:

Example 1. (i) *Facts.* Corporation X and Corporation Y each has 100 shares of common stock outstanding. A, an individual, owns one-half of the stock of each corporation, B owns one-half of the stock of Corporation X, and C owns one-half of the stock of Corporation Y. A, B, and C are unrelated. A sells 30 shares of the stock of Corporation X, which have an adjusted basis of $10, to Corporation Y for $50.

(ii) *Analysis.* Section 304(a)(1) applies to A's sale of 30 shares of Corporation X stock to Corporation Y because A controls both Corporation X and Corporation Y within the meaning of section 304(c), and Corporation Y acquires the 30 shares of Corporation X stock from A in exchange for property ($50 of cash). Pursuant to section 304(a)(1), the cash received by A is treated as a redemption of the stock of Corporation Y. Because before the sale A owns 50 percent of the stock of Corporation X and after the sale A owns only 35 percent of such stock (20 shares directly and 15 constructively because one-half of the 30 shares owned by Corporation Y are attributed to A), the redemption is substantially disproportionate as to A pursuant to the provisions of section 302(b)(2). A, therefore, recognizes a gain of $40 ($50 minus $10). If the stock surrendered is a capital asset, such gain is long-term or short-term capital gain depending on the period of time that A held such stock. A's basis in the stock of Corporation Y is not changed as a result of the sale. Under section 1012, the basis that Corporation Y takes in the acquired stock of Corporation X is its cost of $50.

Example 2. (i) *Facts.* Corporation X and Corporation Y each has 200 shares of common stock outstanding, all of which are owned by H, an individual. H has a basis $100 in his Corporation X stock and $30 in his Corporation Y stock. Corporation X has $40 and Corporation Y has $20 of current and accumulated earnings and profits. H sells his 200 shares of Corporation X stock to Corporation Y for $150 at a time when Corporation Y stock also has a fair market value of $150.

(ii) *Analysis.* Section 304(a)(1) applies to H's sale of his 200 shares of Corporation X stock to Corporation Y because H controls both Corporation X and Corporation Y within the meaning of section 304(c), and Corporation Y acquires the 200 shares of Corporation X stock from H in exchange for property. Pursuant to section 304(a)(1), the cash received by H is treated as a redemption of the stock of Corporation Y. Because before the sale H directly owns 100 percent of Corporation X and after the sale H is treated as owning 100 percent of Corporation X, section 302(a) does not apply to the deemed redemption distribution. Under section 302(d), the proceeds of the deemed redemption are treated as a distribution to which section 301 applies. Therefore, H is treated as transferring the Corporation X stock to Corporation Y in exchange for Corporation Y common stock in a transaction to which section 351(a) applies. Corporation Y's basis in the Corporation X stock acquired is $100 under section 362(a), the same basis that H had in the Corporation X stock surrendered. H takes a basis of $100 in the Corporation Y common stock H is treated as receiving in the deemed section 351 exchange. Corporation Y is then treated as redeeming such Corporation Y common stock from H for $150 in a transaction to which section 301 applies. H is treated as receiving a dividend of $60 ($20 from the current and accumulated earnings and profits of Corporation Y and then $40 from the current and accumulated earnings and profits of Corporation X) (see section 304(b)). Under § 1.302–5, the remaining $90 of the distribution will be applied to and reduce the basis of each share of Corporation Y stock held by H. Accordingly, H will have no gain on the shares deemed received in the section 351 exchange which have a $100 basis, but will have a $15 gain on the Corporation Y shares with a $30 basis. After the redemption transaction, all of H's shares in Corporation Y, including the deemed shares that are redeemed, are treated as exchanged in a recapitalization described in section 368(a)(1)(E). The basis of the redeemed shares and the shares actually outstanding in Corporation Y are allocated pursuant to § 1.358–2(a). Accordingly, of H's 200 shares in Corporation Y common stock, 100 will have a basis of $55, and 100 will have a zero basis.

Example 3. (i) *Facts.* Corporation W acquired all of the outstanding stock of Corporation X stock for $75 (100 shares of common) and then acquired all of the outstanding stock of Corporation Y (50 shares of common stock for $75 and 50 shares of common stock for $100). Only corporation Y has current or accumulated earnings and profits ($100). Corporation W sells all the shares in Corporation X to Corporation Y for $300. At the time of the transaction, the Corporation X and Corporation Y stock have the same fair market value.

(ii) *Analysis.* Section 304(a)(1) applies to Corporation W's sale of Corporation X to Corporation Y because Corporation W is in control of both Corporation X and Corporation Y within the meaning of section 304(c), and Corporation Y acquires the Corporation X stock in exchange for property. Because before the sale Corporation W owns 100 percent of Corporation X, and after the sale is treated as owning 100 percent of Corporation X, section 302(a) does not apply to the deemed redemption distribution. Under section 302(d), the proceeds of the deemed redemption are treated as a distribution to which section 301 applies. Section 1059(e)(1)(A)(iii) also applies. Corporation W is treated as transferring the Corporation X stock to Corporation Y in exchange for Corporation Y common stock in a transaction to which section 351(a) applies. Corporation Y's basis in the Corporation X stock is $75 under section 362(a), the same basis that Corporation W had in the stock it surrendered. Corporation W takes a $75 basis in the Corporation Y common stock it is deemed to receive in the deemed section 351 transaction. Corporation Y is then treated as redeeming such Corporation Y common stock from Corporation W for $300. In a redemption to which section 301 applies, Corporation W is treated as receiving a dividend of $100 (from the current and accumulated earnings and profits of Corporation Y) (see section 304(b)). Under section 1059, the $100 dividend is treated as an extraordinary dividend which, under the flush language of section 1059(e)(1)(A)(iii), reduces only the basis of the stock deemed redeemed, which has a basis of $75. Accordingly, Corporation W recognizes a $25 gain. Under § 1.302–5, the remaining $200 of the distribution is applied to reduce the basis of the Corporation Y stock held by Corporation W on a pro rata, share-by-share basis, including the basis in the shares deemed redeemed. Accordingly, $100 is allocated to the Corporation Y stock that Corporation W deemed received in the section 351 transaction that now has a zero basis after the application of section 1059 and the remaining $100 is allocated to Corporation W's other two blocks of Corporation Y stock. Corporation W has a total gain of $125 on the Corporation Y stock deemed received and redeemed; and $25 and $50, respectively, of remaining basis in the other 2 blocks of corporation Y shares. After the redemption transaction, all of Corporation W's shares in corporation Y, including the deemed shares that are redeemed, are treated as exchanged in a recapitalization described in section 368(a)(1)(E). As a result, corporation W will have 100 shares in corporation Y, 50 shares will have a zero basis, 25 shares will have a $25 basis, and 25 shares will have a $50 basis.

(d) *Effective/applicability date.* This section applies to transactions that

occur after the date these regulations are published as final regulations in the **Federal Register**.

Par. 7. Section 1.304–3 is amended by revising paragraph (a) and adding paragraph (c) to read as follows:

§ 1.304–3 Acquisition by a subsidiary.

(a) *In general.* If a subsidiary, in return for property, acquires stock of its parent corporation from a shareholder of the parent corporation, the acquisition of such stock will be treated as if the parent corporation had redeemed its own stock in exchange for the property. For the purposes of this section, a corporation is a parent corporation if it meets the 50 percent ownership requirements of section 304(c). The determination of whether the amount received shall be treated as received in payment in exchange for the stock will be made by applying section 302(b) with reference to the stock of the issuing parent corporation, or by applying section 303.

* * * * *

(c) *Effective/applicability date.* This section applies to transactions that occur after the date these regulations are published as final regulations in the **Federal Register**.

Par. 8. Section 1.304–5 is amended by adding a sentence at the end of paragraph (a) and revising paragraph (c) to read as follows:

§ 1.304–5 Control.

(a) * * * Specifically, section 318(a) will be applied by substituting ''5 percent'' for ''50 percent'' in section 318(a)(2)(C) and by substituting ''5 percent'' for ''50 percent'' in section 318(a)(3)(C), except that if section 318(a)(3)(C) would not have applied but for this substitution, by considering a corporation as owning the stock (other than stock in such corporation) owned by or for any shareholder of such corporation in that proportion which the value of the stock which such shareholder owned in such corporation bears to the value of all stock in such corporation.

* * * * *

(c) *Effective/applicability date.* This section applies to transactions that occur after the date these regulations are published as final regulations in the **Federal Register**.

Par. 9. Section 1.351–2 is amended by redesignating paragraphs (b), (c), (d) and (e) as paragraphs (c), (d), (e) and (f), respectively and adding new paragraphs (b) and (g) to read as follows:

§ 1.351–2 Receipt of property.

* * * * *

(b) To determine the amount of gain recognized under section 351(b), the fair market value of each category of consideration received by each transferor is allocated to the properties transferred in proportion to each property's relative fair market value. The application of this paragraph (b) is illustrated by the following example:

Example. C transfers $2,000 in exchange for 200 shares of stock. D transfers Asset I, Asset II, and Asset III in exchange for $100 cash and 100 shares of stock. The exchange is subject to section 351. At the time of the exchange, Asset I has a fair market value of $220 and a basis of $400, Asset II has a fair market value of $330 and a basis of $200, and Asset III has a fair market value of $550 and a basis of $250. No gain or loss is recognized to C. Gain, but not loss, is recognized by D. To determine the gain recognized by D under section 351(b), the fair market value of each category of consideration received is allocated to the properties transferred in proportion to the relative fair market values of the properties transferred. Asset I represents 20 percent of the total fair market value of assets transferred (220/1100), Asset II represents 30 percent (330/1100), and Asset III represents 50 percent (550/1100). Under paragraph (b) of this section, the amount of gain recognized by D is determined by allocating a pro rata portion of each class of consideration received to each property transferred as follows: (A) $20 cash and 20 shares of stock to Asset I (20 percent of 100 shares of stock and 20 percent of $100 (B) $30 cash and 30 shares of stock to Asset II (30 percent of 100 shares of stock and 30 percent of $100); and (C) $50 cash and 50 shares of stock to Asset III (50 percent of 100 shares of stock and 50 percent of $100). D realizes a loss of $180 on Asset I, none of which is recognized, a gain of $130 on Asset II, $30 of which is recognized, and a gain of $300 on Asset III, $50 of which is recognized.

* * * * *

(g) This section applies to exchanges that occur after the date these regulations are published as final regulations in the **Federal Register**, except for exchanges which occur pursuant to a written agreement that is binding on or before the date these regulations are published as final in the **Federal Register**. For exchanges that occur on or before the date that these regulations are published as final regulations in the **Federal Register**, see this section as contained in 26 CFR part 1 revised April 1, for the year before these regulations are published as final regulations in the **Federal Register**.

Par. 10. Section 1.354–1 is amended by:

1. Revising the section heading.
2. Redesignating paragraphs (d), (e) and (f) as paragraphs (e), (f) and (g), respectively.
3. Adding new paragraphs (d) and (h).
4. Adding *Example 5* to the end of newly designated paragraph (e).

The additions and revisions read as follows:

§ 1.354–1 Exchanges of stock, securities and other property in certain reorganizations.

* * * * *

(d) *Exchanges solely or partly for money or other property*—(1) *Determination of consideration for a share of stock or a security.* In determining the consideration received for a share of stock or a security, except as otherwise provided in this paragraph (d)(1), a pro rata portion of any 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. However, 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 the terms are economically reasonable, unless the shareholder's exchange has the effect of a distribution of a dividend. If the exchange has the effect of a distribution of a dividend and the terms of an exchange specify the other property or money that is received with respect to a particular share of stock and such specification would otherwise be economically reasonable, such other property or money shall be treated as received pro rata in exchange for each share of stock within that class (as defined in section 1.302–5(b)(2)) held by the exchanging shareholder. Notwithstanding the preceding sentence, economically reasonable designations between classes of stock or securities (as opposed to within a class) shall generally control. All exchanges made by an exchanging shareholder, whether governed by section 354, 356, or 302, are taken into account to determine whether the shareholder's exchange has the effect of a distribution of a dividend.

(2) *Treatment of exchanges of stock solely for money or other property.* Neither section 354 nor so much of section 356 as relates to section 354 applies to a shareholder's surrender of a share of stock in exchange solely for money or other property that is not permitted to be received without the recognition of gain, even though such exchange is pursuant to a plan of reorganization described in section 368(a), and even though section 354, section 356 or both sections 354 and 356 apply to the exchange of other shares by that shareholder or other shareholders. See section 302 and the regulations

under that section for the treatment of such an exchange.

(e) * * *

Example 5. D owns shares of Class A common stock, Series 1 preferred stock, and Series 2 preferred stock in Corporation T. The Series 1 preferred stock and the Series 2 preferred stock are different classes of stock. Pursuant to a reorganization described in section 368(a) to which corporations T and V are parties, D surrenders all of D's Class A common stock in Corporation T in exchange for common stock in Corporation V, all of D's Series 1 preferred stock in Corporation T in exchange for both cash and common stock in Corporation V, and all of D's Series 2 preferred stock in Corporation T in exchange solely for cash. Section 354 applies to the exchange of the Class A common stock in Corporation T for Corporation V common stock. Section 356 applies to the exchange of Series 1 preferred stock for Corporation V common stock and cash. Neither section 354 (nor so much of section 356 as relates to section 354) applies to the exchange of Series 2 preferred stock in Corporation T solely for cash (see section 302 and regulations thereunder).

* * * * *

(h) This section applies to exchanges that occur after the date these regulations are published as final regulations in the **Federal Register**, except for exchanges which occur pursuant to a written agreement that is binding on or before the date these regulations are published as final in the **Federal Register**. For exchanges that occur on or before the date these regulations are published as final regulations in the **Federal Register**, see this section as contained in 26 CFR part 1 revised April 1, for the year before these regulations are published as final regulations in the **Federal Register**.

Par. 11. Section 1.355–1 is amended by adding new paragraph (e) to read as follows:

§ 1.355–1 Distribution of stock and securities of a controlled corporation.

* * * * *

(e) *Exchanges solely or partly for money and other property*—(1) *Determination of consideration for a share of stock or a security.* In determining the consideration received for a share of stock or a security, except as otherwise provided in this paragraph (e)(1), a pro rata portion of any 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. However, 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 the terms are economically reasonable, unless the shareholder's exchange has the effect of a distribution of a dividend. If the exchange has the effect of a distribution of a dividend and the terms of an exchange specify the other property or money that is received with respect to a particular share of stock and such specification would otherwise be economically reasonable, such other property or money shall be treated as received pro rata in exchange for each share of stock within that class (as defined in § 1.302–5(b)(2)) held by the exchanging shareholder. Notwithstanding the preceding sentence, economically reasonable designations among classes of stock (as opposed to within a class) shall generally control. All exchanges made by an exchanging shareholder, whether governed by section 355, 356, or 302, are taken into account to determine whether the shareholder's exchange has the effect of a distribution of a dividend.

(2) *Treatment of exchanges of stock solely for money or other property.* Neither section 355 nor so much of section 356 as relates to section 355 applies to a shareholder's surrender of a share of stock in exchange solely for money or other property that is not permitted to be received without the recognition of gain, even though such exchange is pursuant to a plan of reorganization described in section 368(a), or even though section 355, section 356 or both sections 355 and 356 apply to the exchange of other shares by that shareholder or other shareholders. See section 302 and the regulations under that section for the treatment of such an exchange. Any such exchange is treated as occurring immediately before any distribution of or exchange for the stock of the controlled corporation to which section 355 (or so much of section 356 as relates to section 355) applies.

(3) *Effective/applicability date.* This paragraph (e) applies to transactions that occur after the date these regulations are published as final regulations in the **Federal Register**, except for exchanges which occur pursuant to a written agreement that is binding on or before the date these regulations are published as final in the **Federal Register**.

Par. 12. Section 1.356–1 is amended by revising paragraph (b), Examples 3 and 4 to paragraph (d), and paragraph (g) to read as follows:

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

* * * * *

(b) The rules of § 1.354–1(d)(1) or § 1.355–1(e)(1), as the case may be, apply for purposes of computing the gain, if any, recognized pursuant to section 356(a) and paragraph (a)(1) of this section.

* * * * *

(d) * * *

Example 3. (i) *Facts.* J, an individual, acquired 10 shares of stock of Corporation X on Date 1 for $3 each (Block 1) and 10 shares of stock of Corporation X on Date 2 for $9 each (Block 2). 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 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 stock of Corporation X. In addition, the distribution of the $100 of cash does not have the effect of a distribution of a dividend.

(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 particular shares of stock of Corporation X, a pro rata portion of the cash received is treated as received in exchange for each share of 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 $100 and $100 of cash in exchange for each block of J's stock of Corporation X. J realizes a gain of $70 on the exchange of the Block 1 shares of Corporation X 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 the Block 2 shares of Corporation X stock, all of which is recognized under section 356 and paragraph (a) of this section. Because 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 Block 1 shares of stock of Corporation X and $100 of cash in exchange for J's Block 2 shares of 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 Block 1 shares of stock of Corporation X and $100 of cash in exchange for J's Block 2 shares of stock of Corporation X and such terms are economically reasonable, such terms control. J realizes a gain of $70 on the exchange of the Block 1 shares of stock, none of which is recognized under section 354. J realizes a gain of $10 on the exchange of the Block 2 shares of stock of Corporation X, all of which is recognized under section 302(a).

* * * * *

(g) This section applies to exchanges and distributions that occur after the date these regulations are published as final regulations in the **Federal Register**, except for exchanges which occur pursuant to a written agreement that is binding on or before the date these regulations are published as final in the **Federal Register**. For exchanges and distributions that occur on or before the date these regulations are published as final regulations in the **Federal Register**, see this section as contained in 26 CFR part 1 revised April 1, for the year before these regulations are published as final regulations in the **Federal Register**.

Par. 13. Section 1.358–1 is revised to read as follows:

§ 1.358–1 Basis to distributees.

(a) *Certain exchanges or distributions in which only nonrecognition property is received*—(1) *Exchanges to which section 354 or 355 applies.* In the case of an exchange to which section 354 or 355 applies in which only nonrecognition property is received, 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 of the stock and securities in such corporation surrendered in the transaction, allocated in the manner described in § 1.358–2.

(2) *Distributions to which section 355 applies.* In the case of a distribution to which section 355 applies in which only nonrecognition property is received, 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 of the 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.

(3) *Exchanges to which section 351 or 361 applies.* In the case of an exchange to which section 351 or 361 applies in which only nonrecognition property is received, the basis of all of the stock and securities received in the exchange shall be the same as the basis of all of the property exchanged for such stock and securities.

(b) *Certain exchanges or distributions in which both nonrecognition property and ''other property'' or money are received*—(1) *Exchanges or distributions to which section 351, 356, or 361 applies.* If in an exchange or distribution to which section 351, 356, or 361 applies both nonrecognition property and ''other property'' or money are received, the basis of the nonrecognition property held after the transaction shall be determined as described in paragraph (a) of this section, decreased by the sum of the money and the fair market value of the ''other property'' (as of the date of the transaction) received and increased by the sum of the amount treated as a dividend (if any) and the amount of the gain recognized on the exchange (other than gain treated as a dividend).

(2) *Cases in which loss is recognized.* 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.

(3) *Basis of ''other property'' received.* The basis of the ''other property'' is its fair market value as of the date of the transaction.

(c) *Other rules.* 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.

(d) The application of this section may be illustrated by the following example:

Example. A purchased a share of stock in Corporation X on Date 1 for $150. Since that date, A has received distributions under section 301(c)(2) 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, with a value of $100, cash 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 was $5. A realized a gain of $50 on the exchange ($140 − $90), but the amount of gain 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 of 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.

(e) *Effective/applicability date.* This section applies to exchanges and distributions of stock and securities that occur after the date these regulations are published as final regulations in the **Federal Register**, except for exchanges which occur pursuant to a written agreement that is binding on or before the date these regulations are published as final in the **Federal Register**. For exchanges and distributions that occur on or before the date these regulations are published as final regulations in the **Federal Register**, see this section as contained in 26 CFR part 1 revised April 1, for the year before these regulations are published as final regulations in the **Federal Register**.

Par. 14. Section 1.358–2 is revised to read as follows:

§ 1.358–2 Allocation of basis among nonrecognition property in certain exchanges or distributions.

(a) *Introduction*—(1) *Scope.* This section prescribes rules for allocating basis in the case of an exchange or distribution to which section 354, 355 or 356 applies. For rules that apply to transfers of stock and other property where the transfer of stock is described in section 351 but does not qualify as a reorganization, see § 1.358–2(g). For transfers of stock described in section 361, see § 1.358–2(h).

(2) *Definitions.* As used in this section the term *stock* means stock which is not ''other property'' under sections 351, 356, or 361, as applicable. The term *securities* means securities (including, where appropriate, fractional parts of securities) which are not ''other property'' under sections 356 or 361, as applicable. 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.

(b) *Exchanges to which section 354, 355, or 356 applies.* If a shareholder or security holder surrenders one or more shares of stock or one or more securities in an exchange under the terms of section 354, 355 or 356, the following rules apply:

(1) *In general.* Except as otherwise provided in this section, 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).

(2) *More shares of stock or securities received than surrendered.* 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 proportion to the fair market value of the shares of stock or securities received.

(3) *Fewer shares of stock or securities received than surrendered*—(i) *In general.* 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) *Surrendered shares of stock or securities acquired on different dates or at different prices.* If a share of stock or a security is received in exchange for more than one share of stock or security and such shares of stock 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. Each segment shall have a basis determined under the rules of this section and a corresponding holding period.

(4) *''Other property,'' money, or more than one class of stock or securities received.* 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 shares of stock or securities, the rules of §§ 1.354–1(d)(1) and 1.355–1(e)(1) apply for purposes of applying the rules of this section.

(5) *Pro rata exchanges to which section 355 or section 356(b) applies.* If a shareholder or security holder surrenders stock in distributing (as defined in § 1.355–1(b)) for only stock in controlled and the receipt of the controlled stock would be treated, within the meaning of section 302(d), as a distribution of property to which section 301 applies if the controlled stock received were money or other property, then the basis of the shares received shall be determined under the rules of paragraph (c) of this section and not the rules of this paragraph (b). The rules of paragraph (c) and not the rules of this paragraph (b) also apply to distributions subject to section 356(b).

(c) *Distributions to which section 355 applies.* If a shareholder or security holder receives one or more shares of stock or one or more securities in a distribution under section 355 (or so much of section 356 as relates to section 355), the following rules apply:

(1) *In general.* Except as otherwise provided in this section, 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 in proportion to their fair market values.

(2) *Fewer shares of stock or securities received than with respect to which distributed*—(i) *In general.* 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.

(ii) *Distribution upon shares of stock or securities acquired on different dates or at different prices.* If a share of stock or a security is received 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 with respect to which the share of stock or security is received. Each segment shall have a basis determined under the rules of this section and a corresponding holding period.

(3) *''Other property,'' money, or more than one class of stock or securities received.* 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, the rules of § 1.355–1(e)(1) apply for purposes of applying the rules of this section as though the distribution were an exchange.

(d) *Reorganizations in which stock is deemed received.* 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 receives 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 provided in paragraphs (1) and (2) of this paragraph (d).

(1) *Step one: Deemed issuance.* 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.

(2) *Step two: Deemed section 368(a)(1)(E) exchange.* 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 paragraph (d)(1) of this section, 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.

(e) *Designating which stock or securities were received for, or with respect to, the stock or securities surrendered or distributed upon*—(1) *In general.* 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 subject to the limitations of this section, 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 (d) of this section), and the other rules of this section. 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.

(2) *Timing for designation*—(i) *In exchanges under section 354 or 356.* 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 (d) 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 (d) of this section applies) 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.

(ii) *In exchanges or distributions under section 355.* 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.

(3) *Failure to designate.* 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.

(f) *Applicability of section to certain overlap situations*—(1) *Exchanges described in both section 1036 and section 354 or 356.* The rules of paragraphs (a) through (e) of this section 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 356.

(2) *Exchanges described in both section 351 and section 354 or 356.* The rules of paragraphs (a) through (e) of this section 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 351 and section 354 or 356, unless liabilities of the shareholder or security holder are assumed in connection with the exchange.

(g) *Section 351 exchanges*—(1) *In general.* Except as provided in paragraph (g)(2) of this section, if in an exchange to which section 351 applies property is transferred to a corporation and the transferor receives more than one share of stock, then the aggregate basis of the property transferred (as adjusted under § 1.358–1) shall be allocated among all of the shares of stock received in proportion to the fair market values of each share of stock.

(2) *Stock and property transferred in an exchange without a liability assumption.* If in an exchange to which section 351 applies stock or stock and property is transferred to a corporation and no liability is assumed by the transferee in the exchange, then the basis of the stock transferred (as adjusted under § 1.358–1) shall be allocated pursuant to paragraphs (b)(1) through (b)(3) of this section. Such rules also apply to other property, money or more than one class of stock or securities received.

(3) *Transactions in which stock is deemed received.* For purposes of this paragraph (g), if a shareholder transfers property to a corporation in a transaction to which section 351 applies, and such shareholder receives no property or property (including property permitted by section 351 to be received without the recognition of gain or ''other property'' or money) in such corporation with a fair market value less than that of the property transferred in the transaction, such shareholder shall be treated as provided in paragraphs (3)(i) and (ii) of this paragraph (g).

(i) *Step one: Deemed issuance.* First, the shareholder shall be treated as receiving the stock, other property, and money actually received by the shareholder in the transaction and an amount of stock of the transferee corporation that has a value equal to the excess of the value of the property the shareholder transferred in the transaction over the value of the stock, other property, and money the shareholder actually received in the transaction. If the shareholder owns only one class of stock of the transferee corporation the receipt of which would be consistent with the economic rights associated with each class of stock of the transferee 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 transferee corporation the receipt of which would be consistent with the economic rights associated with each class of stock of the transferee 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.

(ii) *Step two: Deemed section 368(a)(1)(E) exchange.* Second, the shareholder shall then be treated as surrendering all of its shares of stock in the transferee corporation, including those shares of stock held immediately

prior to the transaction, those shares of stock actually received in the transaction, and those shares of stock deemed received pursuant to paragraph (3)(i) of this paragraph (g), in a reorganization under section 368(a)(1)(E) in exchange for the shares of stock of the transferee corporation that the shareholder actually holds immediately after the transaction. The basis of each share of stock deemed received in the reorganization under section 368(a)(1)(E) shall be determined under the rules of this section.

(h) *Section 361 exchanges.* If in an exchange to which section 361 applies property is transferred to a corporation and the transferor receives stock or securities of more than one class or receives both stock and securities, then the basis of the property transferred (as adjusted under § 1.358–1) shall be allocated among all of the stock and securities received in proportion to the fair market values of the stock of each class and the securities of each class.

(i) *Examples.* The application of this section is illustrated by the following examples:

Example 1. More shares of stock received than surrendered. (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 (b)(2) 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 (e) 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. More shares of stock received than surrendered. (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 (b)(2) 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 (e) 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. More than one class of stock received. (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 (b)(4) 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 (b)(2) 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 (e) 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. Money received in addition to stock. (i) *Facts.* J, an individual, acquired 10 shares of stock of Corporation X on Date 1 for $2 each (Block 1), 10 shares of stock of Corporation X on Date 2 for $4 each (Block 2), and 20 shares of stock of Corporation X on Date 3 for $6 each (Block 3). 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. The distribution of $200 of cash does not have the effect of a distribution of a dividend. On the date of the exchange, the fair market value of each share of 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 stock of Corporation X.

(ii) *Analysis.* Under paragraph (b)(4) of this section and under § 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 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 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 stock of Corporation X. J realizes a gain of $80 on the exchange of Block 1, $50 of which is recognized under § 1.356–1(a). J realizes a gain of $60 of the exchange of Block 2, $50 of which is recognized under § 1.356–1(a). J realizes a gain of $80 on the exchange of the Block 3 shares of stock of Corporation X, all of which is recognized under § 1.356–1(a). Under paragraph (b)(1) 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 (e) 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. Money received in addition to stock. (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 Block 1 and Block 2 shares of stock of Corporation X and $200 of cash in exchange for J's Block 3 shares of stock of Corporation X.

(ii) *Analysis.* Under paragraph (b)(4) of this section and under § 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 Block 1 and Block 2 shares of stock of Corporation X and $200 of cash in exchange for J's Block 3 shares of stock of Corporation X and such terms are economically reasonable and the distribution is not dividend equivalent, such terms control. J realizes a gain of $80 on the exchange of Block 1, none of which is recognized under section 354. J realizes a

gain of $60 on the exchange of Block 2, none of which is recognized under section 354. J realizes a gain of $80 on the exchange of the Block 3 shares of stock of Corporation X, all of which is recognized under section 302(a). Under paragraph (b)(2) 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 (e) 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. Stock and securities received as nonrecognition property. (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. The distribution of neither the Y stock nor the Y security has the effect of a distribution of a dividend. 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 (b)(4) of this section and under § 1.354–1(d), 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 (b)(1) 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. Fewer shares of stock received than surrendered. (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 (b)(3) 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 (e) 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. Exchange described in sections 351 and 354. (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 (f)(2) 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 (g) this section apply to determine J's basis in the Corporation Y stock received in the transaction.

Example 9. Reorganization in which stock is deemed received. (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 (d) 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 (b)(1) 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 (b)(3) of this section, 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 (e) 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 10. Reorganization in which stock is deemed received. (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 (d) 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 the 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 (b)(1) 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 (b)(3) of this section, 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 (e) 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 11. Distribution to which section 355 applies. (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 $1,800. 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. 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 (c)(1) 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 (e) 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 12. Designation of stock surrendered and received. (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. In addition, the receipt of Y stock is not dividend equivalent.

(ii) *Analysis.* Under paragraph (b)(1) 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 (e) 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 13. Surrendered shares of stock or securities acquired on different dates or at different prices. (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 ¾ share of Corporation Y stock in exchange for each share of Corporation X stock. Therefore, J receives 30 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 (or portions of shares) of Corporation X stock.

(ii) *Analysis.* Under paragraph (b)(3) 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 (b)(3) 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 (e) of this section, 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.

Example 14. Shareholder election and terms of the exchange. (i) *Facts.* J, an individual, acquired 10 shares of stock of widely-held Corporation X on Date 1 for $2 each, 10 shares of stock of Corporation X on Date 2 for $4 each, and 10 shares of stock of Corporation X on Date 3 for $6. On Date 5, Corporation X and Corporation Y sign a binding contract pursuant to which, in a reorganization under section 368(a)(1)(A), Corporation X will be merged with and into Corporation Y on Date 6. The fair market value of each share of Corporation X stock is $10 and the fair market value of each share of Corporation Y stock is $5. In exchange for each share of stock of Corporation X, the shareholders of Corporation X may elect to receive 2 shares of stock of Corporation Y or $10 cash. If, however, the elected consideration is oversubscribed, by default a pro-rata mix of consideration will be received for the corresponding shares of stock of Corporation X (the default pro-rata term). J elects to receive 2 shares of stock of Corporation Y in exchange for each of the 10 shares of stock of Corporation X acquired on Date 1, and $10 cash for each of the remaining 20 shares of stock of Corporation X. Neither of the elections is oversubscribed by the shareholders of Corporation X. The distribution of cash does not have the effect of a distribution of a dividend.

(ii) *Analysis.* Under paragraph (b)(4) of this section and under § 1.356–1(b), because the receipt does not have the effect of dividend, and the terms of the exchange specify that J receives 2 shares of stock of Corporation Y in exchange for each of the 10 shares of stock of Corporation X acquired on Date 1, and $10 cash for each of the remaining 20 shares of stock of Corporation X, and such terms are economically reasonable, such terms control. J realizes a gain of $80 on the exchange of the 10 shares of stock of Corporation X acquired on Date 1, none of which is recognized under § 1.356–1(a). J realizes a gain of $60 on the exchange of the 10 shares of stock of Corporation X acquired on Date 2 and realizes $40 on the exchange of the 10 shares of stock of Corporation X acquired on Date 3, all of which is recognized under § 1.356–1(a). Under paragraph (b)(2) of this section, J has 20 shares of stock of Corporation Y, each of which has a basis of $1 and is treated as having been acquired on Date 1.

Example 15. Shareholder election and terms of the exchange. (i) *Facts.* The facts are the same as in Example 14, except that the cash election is oversubscribed and, pursuant to the default pro-rata term, for each of the shares of stock of Corporation X that J acquired on Date 2 and Date 3, J receives 1 share of stock of Corporation Y and $5 cash.

(ii) *Analysis.* Under paragraph (b)(4) of this section and under § 1.356–1(b), because the terms of the exchange specify that J receives 2 shares of stock of Corporation Y in exchange for each of the 10 shares of stock

of Corporation X acquired on Date 1, and 1 share of stock of Corporation Y and $5 cash for each of the remaining 20 shares of stock of Corporation X, and such terms are economically reasonable, such terms control. J realizes a gain of $80 on the exchange of the 10 shares of stock of Corporation X acquired on Date 1, none of which is recognized under § 1.356–1(a). J realizes a gain of $60 on the exchange of the 10 shares of stock of Corporation X acquired on Date 2, $50 of which is recognized under § 1.356–1(a), and $40 on the exchange of the 10 shares of stock of Corporation X acquired on Date 3, all of which is recognized under § 1.356–1(a). Of the 40 shares of stock of Corporation Y received by J, 20 of the shares each has a basis of $1 and is treated as having been acquired on Date 1 under paragraph (b)(2) of this section, and 10 of the shares each has a basis of $4 and is treated as having been acquired on Date 2 and 10 of the shares each has a basis of $6 and is treated as having been acquired on Date 3 under paragraph (b)(1) of this section.

Example 16. Exchange described in section 351 in which only stock is received. (i) *Facts.* J transfers Asset I, Asset II, and 50 shares of Corporation X stock in exchange for 110 shares of Corporation Y in an exchange to which section 351 applies. At the time of the exchange, Asset I has a fair market value of $220 and a basis of $400, Asset II has a fair market value of $330 and a basis of $200, and the 50 shares of Corporation X stock each have a fair market value of $22 ($550 total) and a basis of $10 ($250 total). The fair market value of each share of Corporation Y stock is $10.

(ii) *Analysis.* Pursuant to section 351(a), J recognizes no gain or loss on the exchange. Under paragraph (g)(2) of this section, J has 55 shares of Corporation Y stock each of which has a basis of $10.91 ($600 total, the aggregate basis of Asset I and Asset II). Under paragraph (g)(2) of this section, J has 55 shares of Corporation Y stock each of which has a basis of $4.55 ($250 total).

Example 17. Exchange described in section 351 in which ''other property'' is received. (i) *Facts.* The facts are the same as Example 1, except J receives 100 shares of Corporation Y stock and $100 in the exchange.

(ii) *Analysis.* Pursuant to section 351(b), J recognizes gain, but no loss, on the exchange, but not in excess of the amount of money received. Under § 1.351–2, J realizes a loss of $180 on Asset I, none of which is recognized, a gain of $130 on Asset II, $30 of which is recognized, and a gain of $300 on shares of Corporation X stock, $50 of which is recognized. Under paragraph (g)(2) of this section, J has 50 shares of Corporation Y stock each of which has a basis of $11.60 ($580 total), and 50 shares of Corporation Y stock each of which has a basis of $5.00 ($250 total).

(j) *Effective/applicability date.* This section applies to exchanges and distributions of stock and securities that occur after the date these regulations are published as final regulations in the **Federal Register**, except for exchanges which occur pursuant to a written agreement that is binding on or before the date these regulations are published as final in the **Federal Register**. For exchanges and distributions of stock and securities that occur on or before the date these regulations are published as final regulations in the **Federal Register**, see this section as contained in 26 CFR part 1 revised April 1, for the year before these regulations were published as final regulations in the **Federal Register**.

Par. 15. Section 1.358–6 is amended by revising paragraphs (c)(1)(i)(B), (c)(3)(ii), and (f)(3) to read as follows:

§ 1.358–6 Stock basis in certain triangular reorganizations.

* * * * *

(c) * * *

(1) * * *

(i) * * *

(B) P transferred the T assets (and liabilities which S assumed or to which the T assets acquired by S were subject) to S in a transaction in which P received no property and P 's basis in S stock was determined under section 358. See § 1.358–2(g)(3) (allocation of basis in a section 351 transaction in which stock is deemed received).

* * * * *

(3) * * *

(ii) P transferred the T stock to S in a transaction in which P received no property and P's basis in its S stock was determined under section 358. See § 1.358–2(g)(3) (allocation of basis in a section 351 transaction in which stock is deemed received).

* * * * *

(f) * * *

(3) This section applies to exchanges that occur after the date these regulations are published as final regulations in the **Federal Register**, except for exchanges which occur pursuant to a written agreement that is binding on or before the date these regulations are published as final in the **Federal Register**. For exchanges that occur on or before the date these regulations are published as final regulations in the **Federal Register**, see this section as contained in 26 CFR part 1 revised April 1, 2008, for the year before the date these regulations are published as final regulations in the **Federal Register**.

Par. 16. Section 1.368–1 is amended by adding a sentence to the end of paragraph (a) and by revising paragraph (e)(9) to read as follows:

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

(a) * * * For purposes of determining whether a transaction qualifies as a reorganization under section 368(a), to the extent the terms of the exchange specify that a particular property is received in exchange for a particular property, such terms shall control provided such terms are economically reasonable.

* * * * *

(e) * * *

(9) This section applies to exchanges that occur after the date these regulations are published as final regulations in the **Federal Register**, except for exchanges which occur pursuant to a written agreement that is binding on or before the date these regulations are published as final in the **Federal Register**. For effective dates for transactions that occur on or before the date these regulations are published as final regulations in the **Federal Register**, see paragraph (e) of this section, as contained in 26 CFR part 1 revised April 1, for the year before these regulations are published as final regulations in the **Federal Register**.

* * * * *

Par. 17. Section 1.861–12 is added to read as follows:

§ 1.861–12 Characterization rules and adjustments for certain assets.

(a) through (c)(2)(v) [Reserved]. For further guidance, see § 1.861–12T(a) through (c)(2)(v).

(c)(2)(vi) Adjustments in respect of redeemed stock for taxpayers using the tax book value method. Solely for purposes of apportioning expenses on the basis of the tax book value of assets, the adjusted basis of any other class of stock in a 10 percent owned corporation owned directly by a taxpayer that is a redeemed shareholder (as defined in § 1.302–5(b)(1)) with respect to such corporation shall be increased by the amount of any loss that has not been taken into account under § 1.302–5(a)(3) as of the close of the redeemed shareholder's taxable year (unrecovered loss). If the redeemed shareholder does not own directly any shares in the 10 percent owned corporation as of the end of the taxable year, but is treated for purposes of section 302(b) as owning shares actually owned by another member of the redeemed shareholder's affiliated group, as defined in section § 1.861–11(d)(1) and § 1.861–11T(d)(6) with respect to the redeemed shareholder, then, solely for purposes of this paragraph (c)(2)(vi), the adjusted basis of the shares in the 10 percent owned corporation, if any, that are owned by such other corporation or corporations shall be increased by the amount of the redeemed shareholder's unrecovered loss (and allocated among such corporations, if applicable, in proportion to their relative adjusted bases (as adjusted pursuant to this

paragraph and § 1.861–12T(c)(2)) in the stock of the redeeming corporation). These adjustments are to be made annually and are noncumulative.

(vii) *Examples.* Certain of the rules of this paragraph (c)(2) may be illustrated by the following examples:

Examples 1 and *2.* [Reserved]. For further guidance, see § 1.861–12T(c)(2)(vii), *Examples 1* and *2.*

Example 3. X, an unaffiliated domestic corporation that was organized on January 1, 2000, owns all of the stock of Y, a foreign corporation with a functional currency other than the U.S. dollar since January 1, 2000. The Y stock held by X includes Class A and Class B common stock. X's adjusted basis in the Class A and Class B common stock is $25,000 and $50,000, respectively. Y has earnings and profits for the 2008 taxable year of $40,000. During the 2008 taxable year, Y redeems all of the Class A common stock held by X for $40,000. Because X still owns all of the outstanding stock of Y, the redemption is treated as a distribution with respect to the stock of Y under section 301. Under § 1.302–5(a)(3), X's $ 25,000 adjusted basis in the redeemed shares of Class A common stock is treated as a loss recognized on the date of the redemption, none of which is taken into account in 2008. Under paragraph (c)(2)(vi) of this section, solely for purposes of apportioning expenses on the basis of the tax book value of assets, X's adjusted basis in its remaining Class B common stock of Y is considered to be $75,000 ($50,000 adjusted basis in the Class B common stock plus $ 25,000 unrecovered basis in the redeemed Class A common stock).

(c)(2)(viii) *Effective/applicability date.* Paragraph (c)(2)(vi) and *Example 3* apply to transactions that occur after the date these regulations are published as final regulations in the **Federal Register**.

(c)(3) through (j) [Reserved]. For further guidance, see § 1.861–12T(c)(3) through (j).

§ 1.1002–1 [Redesignated as § 1.1001–6]

Par. 18. Section 1.1002–1 is redesignated as 1.1001–6 and amended by revising paragraph (c) and adding a new paragraph (e) to read as follows:

§ 1.1001–6 Sales or exchanges.

* * * * *

(c) *Certain exceptions to general rule.* Exceptions to the general rule are made, for example, by sections 351(a), 354, 361(a), 721, 1031, 1035, and 1036. These sections describe certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the Internal Revenue Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure and the new property are substantially continuations of the old still unliquidated. Solely for purposes of determining whether the exceptions to the general rule under sections 354 and 361 apply to an exchange, to the extent the terms of the exchange specify that a particular property is received in exchange for a particular property, such terms shall control provided such terms are economically reasonable.

* * * * *

(e) *Effective/applicability date.* This section applies to exchanges that occur after the date these regulations are published as final regulations in the **Federal Register**. For exchanges that occur on or before the date these regulations are published as final regulations in the **Federal Register**, see this section as contained in 26 CFR part 1 revised April 1, for the year before these regulations are published as final regulations in the **Federal Register**.

Par. 19. Section 1.1016–2 is amended by adding paragraphs (e) and (f) to read as follows:

§ 1.1016–2 Items properly chargeable to capital account.

* * * * *

(e) Solely for purposes of determining basis in stock, in the case of a shareholder capital contribution to which section 118 applies, the principles of § 1.358–2(g)(3) (allocation of basis in a section 351 transaction in which stock is deemed received) shall apply.

(f) This section applies to transactions that occur after the date these regulations are published as final regulations in the **Federal Register**. For exchanges that occur on or before the date these regulations are published as final regulations in the **Federal Register**, see this section as contained in 26 CFR part 1 revised April 1, for the year before these regulations are published as final regulations in the **Federal Register**.

Par. 20. Section 1.1374–10, the first sentence of paragraph (a) is revised to read as follows:

§ 1.1374–10 Effective date and additional rules.

(a) *In general.* For transactions to which § 1.302–5 applies [Reserved]. Sections 1.1374–1 through 1.1374–9, other than § 1.1374–3(b) and (c) *Examples 2* through *4,* apply for taxable years ending on or after December 27, 1994, but only in cases where the S corporation's return for the taxable year is filed pursuant to an S election or a section 1374(d)(8) transaction occurring on or after December 27, 1994. * * *

* * * * *

Linda M. Kroening,

(Acting) Deputy Commissioner for Services and Enforcement.

[FR Doc. E9–1100 Filed 1–16–09; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF LABOR

Occupational Safety and Health Administration

29 CFR Part 1910

[Docket No. OSHA–2007–0007]

RIN 1218–AC39

Additional Quantitative Fit-Testing Protocols for the Respiratory Protection Standard

AGENCY: Occupational Safety and Health Administration (OSHA); Labor.

ACTION: Notice of proposed rulemaking; request for comments.

SUMMARY: OSHA is proposing to add two PortaCount® quantitative fit-testing protocols to its Respiratory Protection Standard (29 CFR 1910.134); the proposed protocols would apply to employers in general industry, shipyard employment, and the construction industry. The first of the two proposed protocols consists of the eight fit-testing exercises described in Part I.A.14 of Appendix A of the Respiratory Protection Standard, except each exercise would last 30 seconds instead of the currently required 60 seconds.[1] The second proposed protocol would eliminate two of the eight fit-testing exercises, and each of the remaining six exercises would last 40 seconds; in addition, this proposed protocol would increase the current minimum pass-fail fit-testing criterion from a fit factor of 100 to 200 for half masks, and from 500 to 1,000 for full facepieces.

DATES: Submit comments to this proposal, including comments to the information collection (paperwork) determination described under the section this preamble titled **SUPPLEMENTARY INFORMATION**, as well as

[1] Except for the grimace exercise, which currently lasts 15 seconds and would remain at 15 seconds in both of the proposed protocols. However, neither the current nor proposed protocols include the fit factor obtained from this exercise in determining the overall fit factor for a respirator tested using a quantitative fit test.