Internal Revenue
bulletin

Bulletin No. 2001–3
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HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2001–3, page 319.

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for January 2001.

Rev. Rul. 2001–4, page 295.

Aircraft maintenance costs. Costs incurred by a taxpayer to perform work on its aircraft airframe as part of a heavy maintenance visit generally are deductible as ordinary and necessary business expenses under section 162 of the Code. However, costs incurred in conjunction with a heavy maintenance visit must be capitalized to the extent they materially add to the value of, substantially prolong the useful life of, or adapt the airframe to a new or different use. In addition, costs incurred as part of a plan of rehabilitation, modernization, or improvement must be capitalized. Rev. Proc. 99–49 modified and amplified.

T.D. 8911, page 321.

Final regulations under sections 7508 and 7508A of the Code authorize the Service to postpone certain tax-related deadlines due either to service in a combat zone or a Presidentially declared disaster. The regulations list the types of taxpayers who are affected and the acts for which the deadlines may be postponed. The regulations also provide that the Service may specify additional acts that may be postponed in other guidance, such as revenue rulings, revenue procedures, notices, announcements, or news releases.

T.D. 8913, page 300.

Final regulations under section 355(d) of the Code relate to recognition of gain on certain distributions of stock or securities of a controlled corporation.

REG–107566–00, page 346.

Proposed regulations under section 355(e) of the Code generally require corporations to recognize gain on certain distributions of stock or securities of a subsidiary corporation if the distribution is part of a plan that also involves the acquisition by one or more persons of a 50 percent or greater interest in the corporation making the distribution or the corporation being distributed. A public hearing is scheduled for May 15, 2001.

Notice 2001–5, page 327.

This notice provides guidance to partnerships regarding the need for both the terminated partnership and the new partnership to file a final short-year partnership tax return following a partnership termination under section 708(b)(1)(B) of the Code.

Notice 2001–12, page 328.

Cost-of-living adjustments for 2001. This notice clarifies Rev. Proc. 2001–13, on page 337 of this Bulletin, to provide that the inflation-adjustment amounts set forth in Part I of section 3 of that revenue procedure are the applicable amounts for 2001 in accordance with the recently enacted legislation. Rev. Proc. 2001–13 clarified.

Rev. Proc. 2001–12, page 335.

This procedure details safe harbor conditions under which the transfer of a REMIC noneconomic residual interest or FASIT ownership interest is presumed to be accomplished without an intention to impede the assessment or collection of tax. Taxpayers may rely on the safe harbors from February 4, 2000 (the date proposed regulations were filed with the Federal Register), until the date specified in future published guidance.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

Rev. Proc. 2001–13, page 337.
Cost-of-living adjustments for 2001. This procedure provides cost-of-living adjustments for the tax rate tables for individuals, estates, and trusts, the standard deduction amounts, the personal exemption, and several other items that use the adjustment method provided for the tax rate tables. The Service also provides the adjustment for eligible long-term care premiums and another item that uses the adjustment method provided for eligible long-term care premiums. Also, see Notice 2001–12, page 328 of this Bulletin, for a determination of the applicable inflation-adjustment amounts for 2001.

Rev. Proc. 2001–14, page 343.
This procedure sets forth the maximum face amount of qualified zone academy bonds that may be issued by each State, the District of Columbia, and the possessions of the United States during 2001.

EMPLOYMENT TAX

Rev. Proc. 2001–9, page 328.
Electronic filing, Form 940. This procedure provides taxpayers, reporting agents, transmitters, and software developers with the reqiurements for electronically filing Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*, as part of the Form 940 *e-file* Program. Rev. Proc. 96–17 modified.

Announcement 2001–7, page 357.
This document contains a correction to Announcement 2000–97, 2000–48 I.R.B. 557. Employers are advised that the use of Code V (Income from the exercise of nonstatutory stock options) in box 12 of Form W-2 is optional for the 2001 Form W-2.

EXCISE TAX

Notice 2001–6, page 327.
Mileage awards. This notice provides guidance on the application of the excise tax on the amount paid for air transportation to amounts paid for frequent flyer miles. Under the notice, amounts paid for mileage awards that cannot be redeemed for taxable transportation are not subject to tax.

ADMINISTRATIVE

Rev. Proc. 2001–9, page 328.
Electronic filing, Form 940. This procedure provides taxpayers, reporting agents, transmitters, and software developers with the requirements for electronically filing Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*, as part of the Form 940 *e-file* Program. Rev. Proc. 96–17 modified.

Announcement 2001–6, page 357.
An updated edition of Publication 547, *Casualties, Disasters, and Thefts* (*Business and Nonbusiness*) (revised December 2000), will be available soon.

Announcement 2001–7, page 357.
This document contains a correction to Announcement 2000-97, 2000–48 I.R.B. 557. Employers are advised that the use of Code V (Income from the exercise of nonstatutory stock options) in box 12 of Form W-2 is optional for the 2001 Form W-2.

Announcement 2001–8, page 357.
An updated edition of Publication 583, *Starting a Business and Keeping Records* (revised December 2000), is now available.

Announcement 2001–9, page 357.
Test of mediation procedure for appeals. This announcement extends the test of the mediation procedure set forth in Announcement 98–99, 1998–2 C.B. 650, for an additional one-year period beginning on January 16, 2001, the date this announcement is published in the Internal Revenue Bulletin.

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 1.—Tax Imposed

The Service provides inflation adjustments to the tax rate tables for individuals, trusts, and estates for taxable years beginning in 2001. In addition, the amounts of certain reductions allowed against the unearned income of minor children in computing the "kiddie tax" are adjusted. Also adjusted are the amounts used to determine whether a parent may elect to report the "kiddie tax" on the parent's return. See Rev. Proc. 2001–13, page 337.

Section 32.—Earned Income

The Service provides inflation adjustments to the limitations on the earned income tax credit for taxable years beginning in 2001. See Rev. Proc. 2001–13, page 337.

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, midterm, and long-term rates are set forth for the month of January 2001. See Rev. Rul. 2001–3, page 319.

Section 59.—Other Definitions and Special Rules for the Alternative Minimum Tax

The Service provides an inflation adjustment to the exemption amount used in computing the alternative minimum tax for a minor child subject to the "kiddie tax" for taxable years beginning in 2001. See Rev. Proc. 2001–13, page 337.

Section 63.—Taxable Income Defined

The Service provides inflation adjustments to the standard deduction amounts (including the limitation in the case of certain dependents, and the additional standard deduction for the aged or blind) for taxable years beginning in 2001. See Rev. Proc. 2001–13, page 337.

Section 68.—Overall Limitation on Itemized Deductions

The Service provides inflation adjustments to the overall limitation on itemized deductions for taxable years beginning in 2001. See Rev. Proc. 2001–13, page 337.

Section 132.—Certain Fringe Benefits

The Service provides inflation adjustments to the limitations on the exclusion of income for a qualified transportation fringe for taxable years beginning in 2001. See Rev. Proc. 2001–13, page 337.

Section 135.—Income From United States Savings Bonds Used to Pay Higher Education Tuition and Fees

The Service provides inflation adjustments to the limitation on the exclusion of income from United States savings bonds for taxpayers who pay qualified higher education expenses for taxable years beginning in 2001. See Rev. Proc. 2001–13, page 337.

Section 151.—Allowance of Deductions for Personal Exemptions

The Service provides inflation adjustments to the personal exemption and to the threshold amounts of adjusted gross income above which the exemption amount phases out for taxable years beginning in 2001. See Rev. Proc. 2001–13, page 337.

Section 162.—Trade or Business Expenses

26 CFR 1.162–1: Business expenses.
(Also sections 263; 263A; sections 1.162–4, 1.263(a)–1, 1.263A–1)

Aircraft maintenance costs. Costs incurred by a taxpayer to perform work on its aircraft airframe as part of a heavy maintenance visit generally are deductible as ordinary and necessary business expenses under section 162 of the Code. However, costs incurred in conjuction with a heavy maintenance visit must be capitalized to the extent they materially add to the value of, substantially prolong the useful life of, or adapt the airframe to a new or different use. In addition, costs incurred as part of a plan of rehabilitation, modernization, or improvement must be capitalized.

Rev. Rul. 2001–4

ISSUE

Are costs incurred by a taxpayer to perform work on its aircraft airframe, including the costs of a "heavy maintenance visit," deductible as ordinary and necessary business expenses under § 162 of the Internal Revenue Code, or must they be capitalized under §§ 263 and 263A?

FACTS

X is a commercial airline engaged in the business of transporting passengers and freight throughout the United States and abroad. To conduct its business, *X* owns or leases various types of aircraft. As a condition of maintaining its operating license and airworthiness certification for these aircraft, *X* is required by the Federal Aviation Administration "FAA" to establish and adhere to a continuous maintenance program for each aircraft within its fleet. These programs, which are designed by *X* and the aircraft's manufacturer and approved by the FAA, are incorporated into each aircraft's maintenance manual. The maintenance manuals require a variety of periodic maintenance visits at various intervals during the operating lives of each aircraft. The most extensive of these for *X* is termed a "heavy maintenance visit" (also known in the industry as a "D check," "heavy C check," or "overhaul"), which is required to be performed by *X* approximately every eight years of aircraft operation. The purpose of a heavy maintenance visit, according to *X*'s maintenance manual, is to prevent deterioration of the inherent safety and reliability levels of the aircraft equipment and, if such deterioration occurs, to restore the equipment to their inherent levels.

In each of the following three situations, *X* reasonably anticipated at the time the aircraft was placed in service that the aircraft would be useful in its trade or business for up to 25 years, taking into account the repairs and maintenance necessary to keep the aircraft in an ordinarily efficient operating condition. In addition, each of the aircraft in the following three situations is fully depreciated for federal income tax purposes at the time of the heavy maintenance visit.

Situation 1

In 2000, *X* incurred $2 million for the labor and materials necessary to perform a heavy maintenance visit on the airframe of Aircraft 1, which *X* acquired in 1984 for $15 million (excluding the cost of engines). To perform the heavy maintenance visit, *X* extensively disassembled the airframe, removing items such as its engines, landing gear, cabin and passenger compartment seats, side and ceiling panels, baggage stowage bins, galleys, lavatories, floor boards, cargo loading systems, and flight control surfaces. As specified by *X*'s maintenance manual for Aircraft 1, *X* then performed certain tasks on the disassembled airframe for the purpose of preventing deterioration of the inherent safety and reliability levels of the airframe. These tasks included lubrication and service; operational and visual checks; inspection and functional checks; restoration of minor parts and components; and removal, discard, and replacement of certain life-limited single cell parts, such as cartridges, canisters, cylinders, and disks.

Whenever the execution of a task revealed cracks, corrosion, excessive wear, or dysfunctional operation, *X* was required by the maintenance manual to restore the airframe to an acceptable condition. This restoration involved burnishing corrosion; repairing cracks, dents, gouges, punctures, or scratches by burnishing, blending, stop-drilling, or applying skin patches or doublers over the affected area; tightening or replacing loose or missing fasteners, rivets, screws, bolts, nuts, or clamps; repairing or replacing torn or damaged seals, gaskets, or valves; repairing or replacing damaged or missing placards, decals, labels, or stencils; additional cleaning, lubricating, or painting; further inspecting or testing, including the use of sophisticated non-destructive inspection methods; repairing fiberglass or laminated parts; replacing bushings, bearings, hinges, handles, switches, gauges, or indicators; repairing chaffed or damaged wiring; repairing or adjusting various landing gear or flight surface control cables; replacing light bulbs, window panes, lenses, or shields; replacing anti-skid materials and stops on floors, pedals, and stairways; replacing floor boards; and performing minor repairs on ribs, spars, frames, longerons, stringers, beams, and supports.

In addition to the tasks described above, *X* also performed additional work as part of the heavy maintenance visit for Aircraft 1. This work included applying corrosion prevention and control compounds; stripping and repainting the aircraft exterior; and cleaning, repairing, and painting airframe interior items such as seats, carpets, baggage stowage bins, ceiling and sidewall panels, lavatories, galleys, and passenger service units. Other additional work included implementing certain outstanding service bulletins ("SBs") issued by the aircraft manufacturer and airworthiness directives ("ADs") issued by the FAA. Implementing these SBs and ADs involved inspecting specific skin locations and applying doublers over the areas where cracks were found; inspecting bolts or fasteners at specific locations, and replacing those found to be broken, worn, or missing; and installing structural reinforcements between body frames in a small area in the lower aft fuselage to reduce skin wrinkling and replacing a small number of the wrinkled skin panels in this area with stronger skin panels.

None of the work performed by *X* as part of the heavy maintenance visit (including the execution of SBs and ADs) for Aircraft 1 resulted in a material upgrade or addition to its airframe or involved the replacement of any (or a significant portion of any) major component or substantial structural part of the airframe. This work maintained the relative value of the aircraft. The value of the aircraft declines as it ages even if the heavy maintenance work is performed.

After 45 days, the heavy maintenance visit was completed, and Aircraft 1 was reassembled, tested, and returned to *X*'s fleet. *X* then continued to use Aircraft 1 for the same purposes and in the same manner that it did prior to the performance of the heavy maintenance visit. The performance of the heavy maintenance visit did not extend the useful life of the airframe beyond the 25-year useful life that *X* anticipated when it acquired the airframe.

Situation 2

Also in 2000, *X* incurred costs to perform work in conjunction with a heavy maintenance visit on the airframe of Aircraft 2. The heavy maintenance visit on Aircraft 2 involved all of the same work described in *Situation 1*. In addition, *X* found significant wear and corrosion of fuselage skins of Aircraft 2 that necessitated more extensive work than was performed on Aircraft 1. Namely, *X* decided to remove all of the skin panels on the belly of Aircraft 2's fuselage and replace them with new skin panels. The replaced skin panels represented a significant portion of all of the skin panels of Aircraft 2, and the work performed materially added to the value of the airframe.

Because Aircraft 2 was already out of service and its airframe disassembled for the heavy maintenance visit, *X* also performed certain modifications to the airframe. These modifications involved installing a cabin smoke and fire detection and suppression system, a ground proximity warning system, and an air phone system to enable passengers to send and receive voice calls, faxes, and other electronic data while in flight.

Situation 3

Also in 2000, *X* decided to make substantial improvements to Aircraft 3, which was 22 years old and nearing the end of its anticipated useful life, for the purpose of increasing its reliability and extending its useful life. *X*'s improvement of Aircraft 3 involved many modifications to the structure, exterior, and interior of the airframe. The modifications included removing all the belly skin panels on the aircraft's fuselage and replacing them with new skin panels; replacing the metal supports under the lavatories and galleys; removing the wiring in the leading edges of both wings and replacing it with new wiring; removing the fuel tank bladders, harnesses, wiring systems, and connectors and replacing them with new components; opening every lap joint on the airframe and replacing the epoxy and rivets used to seal the lap joints with a non-corrosive sealant and larger rivets; reconfiguring and upgrading the avionics and the equipment in the cockpit; replacing all the seats, overhead bins, sidewall panels, partitions, carpeting, windows, galleys, lavatories, and ceiling panels with new items; installing a cabin smoke and fire detection system, and a ground proximity warning system; and painting the exterior of the aircraft. The work performed on Aircraft 3 also included modifications necessary to terminate every aging aircraft AD applicable to Aircraft 3.

In order to upgrade the airframe to the desired level, X performed much of the same work that would be performed during a heavy maintenance visit (as described in *Situation* 1). The result of the work performed on Aircraft 3 was to materially increase the value of the airframe and substantially prolong its useful life.

LAW

Section 162 and § 1.162–1(a) of the Income Tax Regulations allow a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including "incidental repairs."

Section 1.162–4 allows a deduction for the cost of incidental repairs that neither materially add to the value of the property nor appreciably prolong its useful life, but keep it in an ordinarily efficient operating condition. However, § 1.162–4 also provides that the cost of repairs in the nature of replacements that arrest deterioration and appreciably prolong the life of the property must be capitalized and depreciated in accordance with § 167.

Section 263(a) provides that no deduction is allowed for (1) any amount paid out for new buildings or permanent improvements or betterments made to increase the value of any property or estate or (2) any amount expended in restoring property or in making good the exhaustion thereof for which an allowance has been made. *See also* § 1.263(a)–1(a).

Section 1.263(a)–1(b) provides that capital expenditures include amounts paid or incurred to (1) add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or (2) adapt property to a new or different use. However, that regulation also provides that amounts paid or incurred for incidental repairs and maintenance of property within the meaning of § 162 and § 1.162–4 are not capital expenditures under § 1.263(a)–1.

Section 263A provides that the direct and indirect costs properly allocable to real or tangible personal property produced by the taxpayer must be capitalized. Section 263A(g)(1) provides that, for purposes of § 263A, the term "produce" includes construct, build, install, manufacture, develop, or improve.

The United States Supreme Court has specifically recognized that the "decisive distinctions [between capital and ordinary expenditures] are those of degree and not of kind," and a careful examination of the particular facts of each case is required. *Deputy v. du Pont*, 308 U.S. 488, 496 (1940), quoting *Welch v. Helvering*, 290 U.S. 111, 114 (1933). To determine whether certain costs should be classified as capital expenditures or as repair and maintenance expenses, "it is appropriate to consider the purpose, the physical nature, and the effect of the work for which the expenditures were made." *American Bemberg Corp. v. Commissioner*, 10 T.C. 361, 376 (1948), *aff'd*, 177 F.2d 200 (6th Cir. 1949).

Any properly performed repair, no matter how routine, could be considered to prolong the useful life and increase the value of the property if it is compared with the situation existing immediately prior to that repair. Consequently, courts have articulated a number of ways to distinguish between deductible repairs and non-deductible capital improvements. For example, in *Illinois Merchants Trust Co. v. Commissioner*, 4 B.T.A. 103, 106 (1926), *acq.*, V-2 C.B. 2, the court explained that repair and maintenance expenses are incurred for the purpose of keeping the property in an ordinarily efficient operating condition over its probable useful life for the uses for which the property was acquired. Capital expenditures, in contrast, are for replacements, alterations, improvements, or additions that appreciably prolong the life of the property, materially increase its value, or make it adaptable to a different use. In *Estate of Walling v. Commissioner*, 373 F.2d 190, 192–193 (3rd Cir. 1966), the court explained that the relevant distinction between capital improvements and repairs is whether the expenditures were made to "put" or "keep" property in ordinary efficient operating condition. In *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333, 338 (1962), *nonacq. on other grounds*, 1964–2 C.B. 8., the court stated that if the expenditure merely restores the property to the state it was in before the situation prompting the expenditure arose and does not make the property more valuable, more useful, or longer-lived, then such an expenditure is usually considered a deductible repair. In contrast, a capital expenditure is generally considered to be a more permanent increment in the longevity, utility, or worth of the property. The Supreme Court's decision in *INDOPCO Inc. v. Commissioner*, 503 U.S. 79 (1992) does not affect these general principles. *See* Rev. Rul. 94–12, 1994–1 C.B. 36; *Ingram Industries, Inc. v. Commissioner*, T.C.M. 2000–323.

Even if the expenditures include the replacement of numerous parts of an asset, if the replacements are a relatively minor portion of the physical structure of the asset, or of any of its major parts, such that the asset as whole has not gained materially in value or useful life, then the costs incurred may be deducted as incidental repairs or maintenance expenses. *See Buckland v. United States*, 66 F.Supp. 681, 683 (D. Conn. 1946) (costs to replace all window sills in factory building were deductible repairs). *See also*, *e.g.*, *Libby & Blouin Ltd. v. Commissioner*, 4 B.T.A. 910 (1926) (costs to replace all the tubing in sugar evaporator, which were small parts in a large machine, were deductible repairs). The same conclusion is true even if such minor portion of the asset is replaced with new and improved materials. *See*, *e.g.*, *Badger Pipeline v. Commissioner*, T.C.M. 1997–457 (costs to replace 1,000 feet of pipeline in a 25-mile section of pipeline were deductible repairs, regardless of whether the new pipe was of better quality or has a longer life).

If, however, a major component or a substantial structural part of the asset is replaced and, as a result, the asset as a whole has increased in value, life expectancy, or use then the costs of the replacement must be capitalized. *See*, *e.g.*, *Denver & Rio Grande Western R.R. Co. v. Commissioner*, 279 F.2d 368 (10th Cir. 1960) (costs to replace major portion of a viaduct - all of the floor planks and 85-90% of the stringers - were capital expenditures); *P. Dougherty Co. v. Commissioner*, 159 F.2d 269, 272 (4th Cir. 1946) (costs to replace entire stern section of barge with new materials were capital expenditures); *Vanalco Inc. v. Commissioner*, T.C.M. 1999-265 (cost to replace the cell lining, an essential and substantial component of the cell, was required to be capitalized); *Stark v. Commissioner*, T.C.M. 1999-1 (cost to replace building roof were capital expenditures); Rev. Rul. 88–57, 1988–2 C.B. 36, modified by Rev. Rul. 94–38, 1994–1

C.B. 35 (costs to perform major cyclical rehabilitations on railroad freight train cars as part of a plan of rehabilitation in which all of the structural components were either reconditioned or replaced were capital expenditures).

In addition, although the high cost of the work performed may be considered in determining whether an expenditure is capital in nature, cost alone is not dispositive. *Compare R.R. Hensler, Inc. v. Commissioner*, 73 T.C. 168, 177 (1979), *acq. in result*, 1980–2 C.B. 1 (the fact that taxpayer's expense was large does not change its character as ordinary); *Buckland* at 683 (replacements of relatively minor proportions of the entire physical asset constitute repairs even where high in cost); and *American Bemberg*, 10 T.C. 361 (1948) (deduction allowed for drilling and grouting to prevent cave-ins even though the total cost of the expenditures exceeded $1.1 million), *with Wolfsen Land & Cattle Co. v. Commissioner*, 72 T.C. 1, 17 (1979) (costs to dragline an irrigation ditch were capital expenditures, in part, because they could be as high as the cost to construct a new ditch); and *Stoeltzing v. Commissioner*, 266 F.2d 374, 376 (3d Cir. 1959) (expenditures could not be incidental repairs because they exceeded by almost 200% the cost of the building).

Similarly, the fact that a taxpayer is required by a regulatory authority to make certain repairs or to perform certain maintenance on an asset in order to continue operating the asset in its business does not mean that the work performed materially increases the value of such asset, substantially prolongs its useful life, or adapts it to a new use. *See, e.g., Midland Empire Packing Co. v. Commissioner*, 14 T.C. 635 (1950), *acq*., 1950–2 C.B. 3 (costs of applying concrete liner to basement walls and floors in order to satisfy federal meat inspectors were deductible repairs); *L&L Marine Service Inc. v. Commissioner*, T.C.M. 1987–428 (work performed on barges that was necessary to enable the barges to continue to qualify for sea duty was a deductible repair).

The characterization of any cost as a deductible repair or capital improvement depends on the context in which the cost is incurred. Specifically, where an expenditure is made as part of a general plan of rehabilitation, modernization, and improvement of the property, the expenditure must be capitalized, even though, standing alone, the item may be classified as one of repair or maintenance. *United States v. Wehrli*, 400 F.2d 686, 689 (10th Cir. 1968). Whether a general plan of rehabilitation exists, and whether a particular repair or maintenance item is part of it, are questions of fact to be determined based upon all the surrounding facts and circumstances, including, but not limited to, the purpose, nature, extent, and value of the work done. *Id*. at 690. The existence of a written plan, by itself, is not sufficient to trigger the plan of rehabilitation doctrine. *See Moss v. Commissioner*, 831 F.2d 833, 842 (9th Cir. 1987); *Vanalco v. Commissioner*, T.C.M. 1999–265.

In general, the courts have applied the plan of rehabilitation doctrine to require a taxpayer to capitalize otherwise deductible repair and maintenance costs where the taxpayer has a plan to make substantial capital improvements to property and the repairs are incidental to that plan. *See*, *e.g*., *California Casket Co. v. Commissioner*, 19 T.C. 32 (1952), *acq*., 1953–1 C.B. 3 (costs of repairing the foundation although not in the original plan became, when undertaken, incidental to and involved in the plan of completely renovating and remodeling an old warehouse building); *Stoeltzing* at 377 (costs to renovate old building by shoring up floors; constructing steps, landing and new driveway; replacing wiring and plumbing; installing new roof; plastering; insulating; performing carpentry work; patching the gutters; and removing rubbish must be capitalized as part of plan of rehabilitation); *Bank of Houston v. Commissioner*, T.C.M. 1960–110 (costs incurred for various repairs incident to the reconstruction and renovation of a bank building must be capitalized as part of a general plan of rehabilitation).

On the other hand, the courts and the Service have not applied the plan of rehabilitation doctrine to situations where the plan did not include substantial capital improvements and repairs to the same asset, the plan primarily involved repair and maintenance items, or the work was performed merely to keep the property in an ordinarily efficient operating condition. *See*, *e.g*., *Moss* at 840 (repairs incurred in conjunction with a hotel remodeling project not required to be capitalized as part of a plan of rehabilitation because the project's capital expenditures were not of the nature or scope necessary to trigger the plan of rehabilitation doctrine); *Schroeder v. Commissioner*, T.C.M. 1996–336 (costs of renovating barns were not required to be capitalized as part of a plan of rehabilitation where most of the renovation costs were repairs and maintenance to keep the barns in an efficient operating condition); Rev. Rul. 70–392, 1970–2 C.B. 33 (costs incurred to relocate existing capital assets in order to install new assets intended to increase a utility's distribution voltage were not required to be capitalized as part of a general plan of rehabilitation because the relocation merely kept the existing assets in an ordinarily efficient operating condition).

ANALYSIS

In *Situation 1*, the heavy maintenance visit on Aircraft 1 primarily involved inspecting, testing, servicing, repairing, reconditioning, cleaning, stripping, and repainting numerous airframe parts and components. The heavy maintenance visit did not involve replacements, alterations, improvements, or additions to the airframe that appreciably prolonged its useful life, materially increased its value, or adapted it to a new or different use. Rather, the heavy maintenance visit merely kept the airframe in an ordinarily efficient operating condition over its anticipated useful life for the uses for which the property was acquired. *See Illinois Merchant Trust Co*. at 106; *Estate of Walling* at 192–193; *Ingram Industries, Inc*. at 538–539. The fact that the taxpayer was required to perform the heavy maintenance visit to maintain its airworthiness certificate does not affect this determination. *See Midland Empire Packing* at 642.

Although the heavy maintenance visit did involve the replacement of numerous airframe parts with new parts, none of these replacements required the substitution of any (or a significant portion of any) major components or substantial structural parts of the airframe so that the airframe as a whole increased in value, life expectancy, or use. *Compare Buckland* at 683 with *P. Dougherty* at 272. Thus, the facts in *Situation 1* are distinguishable from those in Rev. Rul. 88–57 in which all of the structural components of a railroad freight car were either reconditioned or replaced so that the car was restored to a "like new" condition with a new, additional service life of 12 to 14 years. Moreover, the heavy maintenance visit also did not restore the airframe, or make good exhaustion for which an allowance had been made, within the meaning of § 263(a)(2). In order to have a restoration under § 263(a)(2), much more extensive work would have to be done so as to substantially prolong the useful life of the airframe. *See Denver & Rio Grande* at 373. Thus, the costs of the heavy maintenance visit constitute expenses for incidental repairs and maintenance under §1.162-4.

Finally, the costs of the heavy maintenance visit are not required to be capitalized under §§ 263 or 263A as part of a plan of rehabilitation, modernization, or improvement to the airframe. Because the heavy maintenance visit involved only repairs for the purpose of keeping the airframe in an ordinarily efficient operating condition, it did not include the type of substantial capital improvements necessary to trigger the plan of rehabilitation doctrine. *See Schroeder v. Commissioner*, T.C.M. 1996–336; *Moss* at 842. Accordingly, the costs incurred by *X* for the heavy maintenance visit in *Situation 1* may be deducted as ordinary and necessary business expenses under §162.

In *Situation 2*, in addition to performing all of the work described in Situation 1 on Aircraft 2, *X* replaced all of the skin panels on the belly of the fuselage and installed a cabin smoke and fire detection and suppression system, a ground proximity warning system and an air phone system. Because the replacement of the skin panels involved replacing a significant portion of the airframe's skin panels (which in the aggregate represented a substantial structural part of the airframe) thereby materially adding to the value of and improving the airframe, the cost of replacing the skin panels must be capitalized. See *Vanalco*, T.C.M. 1999–265; *P. Dougherty* at 272. In addition, the additions and upgrades to Aircraft 2 in the form of the fire protection, air phone, and ground proximity warning systems must be capitalized because they materially improved the airframe. *See Phillips and Easton Supply Co. v. Commissioner*, 20 T.C 455, 460 (1953). Accordingly, the costs incurred by *X* for labor and materials allocable to these capital improvements must be treated as capital expenditures under § 263. Moreover, because the improvement of property constitutes production within the meaning of § 263A(g)(1), *X* is required to capitalize under § 263A the direct costs and a proper share of the allocable indirect costs associated with these improvements.

Further, the mere fact that these capital improvements were made at the same time that the work described in *Situation 1* was performed on Aircraft 2 does not require capitalization of the cost of the heavy maintenance visit under the plan of rehabilitation doctrine. Whether a general plan of rehabilitation exists is a question of fact to be determined based on all the facts and circumstances. See *Wehrli* at 690. *X*'s plan in *Situation 2* was not to rehabilitate Aircraft 2, but merely to perform discrete capital improvements to the airframe. *See Moss* at 839; *Schroeder v. Commissioner*, T.C.M. 1996–336; Rev. Rul. 70–392. For this reason, the facts of *Situation 2* are distinguishable from Rev. Rul. 88–57, which involved a major rehabilitation that constituted a plan of rehabilitation undertaken near the end of the freight car's life for the purpose of restoring it to a "like new" condition. Accordingly, the costs of the work described in *Situation 1* are not part of a general plan of rehabilitation, modernization, or improvement to the airframe. The costs incurred by *X* for the work performed on *Aircraft 2* must be allocated between capital improvements, which must be capitalized under §§ 263 and 263A, and repairs and maintenance, which may be deducted under § 162.

In *Situation 3*, *X* is required to capitalize under § 263 the costs of all the work performed on Aircraft 3. The work in *Situation 3* involved replacements of major components and significant portions of substantial structural parts that materially increased the value and substantially prolonged the useful life of the airframe. *See P. Dougherty* at 272 and Rev. Rul. 88–57. In addition, the value of Aircraft 3 was materially increased as a result of material additions, alterations and upgrades that enabled *X* to operate Aircraft 3 in an improved way. *See Dominion Resources*, 48 F. Supp. 2d 527, 553. In contrast to *Situation 1*, the extensiveness of the work performed on Aircraft 3 constitutes a restoration within the meaning of §263(a)(2). *See*, *e.g. Denver & Rio Grande* at 373.

X performed much of the same work on Aircraft 3 that would be performed during a heavy maintenance visit (as described in *Situtation 1*) ("*Situation 1*-type work"). Although these costs, standing alone, generally are deductible expenses under § 162, in this context, they are incurred as part of a general plan of rehabilitation, modernization, and improvement to the airframe of Aircraft 3 and *X* is required to capitalize under §§ 263 and 263A the costs of that work. *See Wehrli* at 689–90. In this situation, *X* planned to perform substantial capital improvements to upgrade the airframe of Aircraft 3 for the purpose of increasing its reliability and extending its useful life. *See* Rev. Rul. 88–57. The *Situation 1*-type work was incidental to *X*'s plan to upgrade Aircraft 3. *See California Casket* at 38. The effect of all the work performed on Aircraft 3, including the inspection, repair, and maintenance items, is to materially increase the value of the airframe and substantially prolong its useful life. Thus, all the work performed by *X* on Aircraft 3 is part of a general plan of rehabilitation, modernization, and improvement to the airframe and the costs associated with this work must be capitalized under § 263. Further, because the improvement of the airframe constitutes production of property within the meaning of § 263A(g)(1), *X* is required to capitalize under § 263A the direct costs and a proper share of the allocable indirect costs associated with this improvement plan.

The conclusions in this ruling would be the same whether *X* transported only freight or only passengers.

HOLDINGS

Costs incurred by a taxpayer to perform work on its aircraft airframe as part of a heavy maintenance visit generally are deductible as ordinary and necessary business expenses under § 162. However, costs incurred in conjunction with a heavy maintenance visit must be capitalized to the extent they materially add to the value of, substantially prolong the useful life of, or adapt the airframe to a new or different use. In addition, costs incurred as part of a plan of rehabilitation, modernization, or improvement must be capitalized.

APPLICATION

Any change in a taxpayer's method of accounting to conform with this revenue ruling is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply. A taxpayer wanting to change its method of accounting to conform with the holding in this revenue ruling must follow the automatic change in accounting method provisions of Rev. Proc. 99–49, 1999–2 C.B. 725, provided the change is made for the first taxable year ending after January 16, 2001. However, the scope limitations in section 4.02 of Rev. Proc. 99–49 do not apply unless the taxpayer's method of accounting for costs incurred to perform work on its aircraft airframes is an issue pending, within the meaning of section 6.01(6) of Rev. Proc. 2000–38, 2000–40 I.R.B. 310, at the time the Form 3115 is filed with the national office. If the taxpayer is under examination, before an appeals office, or before a federal court with respect to any income tax issue, the taxpayer must provide a copy of the Form 3115, *Application for Change in Accounting Method*, to the examining agent, appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the Form 3115 with the national office. The Form 3115 must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate.

EFFECT ON OTHER DOCUMENTS

Rev. Proc. 99–49 is modified and amplified to include the prospective change in accounting method in the APPENDIX. Rev. Rul. 88–57 is distinguished.

DRAFTING INFORMATION

The principal author of this revenue ruling is Merrill D. Feldstein of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Ms. Feldstein or Beverly Katz at (202) 622-4950 (not a toll-free call).

Section 170.—Charitable, Etc., Contributions and Gifts

The Service provides inflation adjustments to the "insubstantial benefit" guidelines for calendar year 2001. Under the guidelines, a charitable contribution is fully deductible even though the contributor recieves "insubstantial benefits" from the charity. See Rev. Proc. 2001–13, page 337.

Section 213.—Medical, Dental, Etc., Expenses

The Service provides inflation adjustments to the limitation on the amount of eligible long-term care premiums includible in the term "medical care," for taxable years beginning in 2001. See Rev. Proc. 2001–13, page 337.

Section 220.—Medical Savings Accounts

The Service provides inflation adjustments to the amounts used to determine whether a health plan is a "high deductible health plan" for purposes of determining whether an individual is eligible for a deduction for cash paid to a medical savings account for taxable years beginning in 2001. See Rev. Proc. 2001–13, page 337.

Section 263.—Capital Expenditures

26 CFR 1.263 (a)–1: Capital expenditures; in general.

Costs incurred by a taxpayer in conjunction with a heavy maintenance visit on an aircraft airframe must be capitalized to the extent they materially add to the value of, substantially prolong the useful life of, or adapt the airframe to a new or different use. In addition, costs incurred as part of a plan of rehabilitation, modernization, or improvement must be capitalized. See Rev. Rul. 2001–4, page 295.

Section 263A.—Capitalization and Inclusion in Inventory Costs of Certain Expenses

26 CFR 1.263A–1: Uniform capitalization of costs.

Costs incurred by a taxpayer in conjunction with a heavy maintenance visit on an aircraft airframe must be capitalized to the extent they materially add to the value of, substantially prolong the useful life of, or adapt the airframe to a new or different use. In addition, costs incurred as part of a plan of rehabilitation, modernization, or improvement must be capitalized. See Rev. Rul. 2001–4, page 295.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of January 2001. See Rev. Rul. 2001–3, page 319.

Section 355.—Distribution of Stock and Securities of a Controlled Coporation

26 CFR 1.355–6: Recognition of gain on certain distributions of stock or securities in controlled corporation.

T.D. 8913

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

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

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

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

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

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

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

SUPPLEMENTARY INFORMATION:

Background

On May 3, 1999, the IRS and Treasury issued a notice of proposed rulemaking (REG–106004–98, 1999–1 C.B. 1072) in the **Federal Register** (64 F.R. 23554) setting forth rules under section 355(d) of the Internal Revenue Code relating to the recognition of gain on certain distributions of stock or securities of a controlled corporation. Generally, section 355(d) requires recognition of gain on a distribution of stock or securities of a controlled corporation (Controlled) (as though the Controlled stock or securities were sold to the distributee at its fair market value) if, immediately after the distribution, any person holds disqualified stock of the distributing corporation (Distributing) or of any distributed Controlled that constitutes a 50 percent or greater interest. Disqualified stock is stock in Distributing acquired by purchase after October 9, 1990, and during the five-year period (taking into account section 355(d)(6)) ending on the date of distribution (the five-year period), or Controlled stock either (1) acquired by purchase during the five-year period or (2) distributed with respect to either disqualified Distributing stock or on Distributing securities acquired by purchase during the five-year period. No public hearing regarding these proposed regulations was held. Written comments to the notice were received. After consideration of all the comments, the proposed regulations are adopted as revised by this Treasury decision. The principal revisions are discussed below.

Explanation of Revisions and Summary of Comments

1. *Purposes of Section 355(d) Not Violated*

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

a. *Technical clarification of disqualified person*

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

b. *Related transactions*

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

c. *Fractional shares*

Some commentators requested that *de minimis* increases in interest in the stock of Distributing or Controlled should be disregarded in determining whether the purpose rule applies. The final regulations provide that an issuance of cash in lieu of fractional shares is disregarded in applying the purpose exception.

2. *Disqualified Stock*

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

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

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

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

The modified definition of disqualified stock eliminates the need for the "purchased interest no longer held" rule of §1.355–6(b)(3)(iv) of the proposed regulations, since transactions that result in the purchased interest no longer being held also will result in an elimination of basis. Accordingly, that paragraph has been deleted. Examples have been added illustrating the effect of the changes discussed.

3. *Purchase*

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

a. *Section 338*

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

b. *Partnerships*

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

c. *Transfers of cash, cash items, marketable stock and debt of the transferor*

i. Transferred With Respect to an Active Trade or Business

Under section 355(d)(5)(B), a purchase includes any acquisition of property in an exchange to which section 351 applies to the extent the property is acquired in exchange for any cash or cash item, any marketable stock or security, or any debt of the transferor. The proposed regulations provide certain exceptions to purchase treatment under section

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

ii. Transfers Between Members of the Same Affiliated Group

Under the proposed regulations, an acquisition of stock in exchange for any cash or cash item, marketable stock or security, or debt of the transferor in a section 351 transaction is generally not a purchase if the transferor corporation or corporations, the transferee corporation (whether formed in the transaction or already existing), and any distributed controlled corporation of the transferee corporation are members of the same affiliated group as defined in section 1504(a) before the section 351 transaction (if the transferee corporation is in existence before the transaction). See §1.355–6(d)(3)(v) for additional requirements. The final regulations clarify that the cash or cash item, marketable stock or security, or debt of the transferor that is transferred must not have been acquired from a nonmember in a related transaction in which section 362(a) or (b) applies to determine the basis in the acquired assets. Examples in the final regulations have been modified to reflect this clarification. See §1.355–6(d)(4)(iii) and (d)(5)(iii) illustrating the effects of a forward and reverse triangular merger, respectively. The final regulations also eliminate the requirement that distributed controlled corporations be a member of the group before the section 351 transaction.

iii. Certain Section 355 and Section 305 Distributions

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

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

a. *Exchanged basis rule and plan or arrangement*

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

b. *Options*

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

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

5. *Statistical Sampling*

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

6. *Administrative Remedies*

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

Special Analyses

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

Drafting Information

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

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

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

§1.355–0 Table of Contents.

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

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

i. In general.
ii. Understanding.
iii. Examples.
iv. Exception.
(A) Subsequent disposition.
(B) Example.
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Par. 3. Section 1.355–6 is revised to read as follows:

§1.355–6 Recognition of gain on certain distributions of stock or securities in controlled corporation—(a) *Conventions*— (1) *Examples*. For purposes of the examples in this section, unless otherwise stated, assume that P, S, T, X, Y, N, HC, D, D1, D2, D3, and C are corporations, A and B are individuals, shareholders are not treated as one person under section 355(d)(7), stock has been owned for more than five years and section 355(d)(6) and paragraph (e)(4) of this section do not apply, no election under section 338 (if available) is made, and all transactions described are respected under general tax principles, including the step transaction doctrine. No inference should be drawn from any example as to whether any requirements of section 355 other than those of section 355(d), as specified, are satisfied.

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

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

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

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

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

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

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

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

(B) Any stock in any controlled corporation—

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

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

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

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

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

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

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

(*3*) *Special rule for Split-offs and Split-ups*. Under section 355(d)(3)(B)(ii) and paragraph (b)(2)(i)(B)(*2*) of this section, disqualified stock includes controlled corporation stock received in exchange for distributing corporation stock acquired by purchase. Solely for purposes of determining whether controlled corporation stock received in a distribution in exchange for distributing corporation stock is disqualified stock described in that section and paragraph immediately after the distribution, paragraph (b)(2)(iii)(C)(2) of this section does not apply to the exchange to eliminate basis resulting from a purchase of that distributing corporation stock (notwithstanding that paragraph (e)(3) of this section applies to the exchange).

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

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

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

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

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

(A) The person—

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

(*2*) Received in the distribution to the extent attributable to distributions on any stock in the distributing corporation acquired by purchase under section 355(d)(5) or (8) and paragraphs (d) and (e) of this section by that person during the five-year period; and

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

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

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

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

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

Example 1. *Stock distributed in spin-off; no purchased basis*. D owns all of the stock of D1, and D1 owns all the stock of C. A purchases 60 percent of the D stock for cash. Within five years of A's purchase, D1 distributes the C stock to D. A is treated as having purchased 60 percent of the stock of both D1 and C on the date A purchases 60 percent of the D stock under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. The C stock received by D is attributable to a distribution on purchased D1 stock under section 355(d)(3)(B)(ii). Accordingly, the D1 and C stock each is disqualified stock under section 355(d)(3) and paragraph (b)(2) of this section, and A is a disqualified person under paragraph (b)(3)(ii) of this section. However, the purposes of section 355(d) under paragraph (b)(3)(i) of this section are not violated. A did not increase direct or indirect ownership in D1 or C. In addition, D's basis in the C stock is not a purchased basis under paragraph (b)(3)(iii) of this section because both the D1 and the C stock are treated as acquired by purchase solely under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. Accordingly, D1's distribution of the C stock to D is not a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

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

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

Example 4. *Stock distributed in spin-off; purchased basis*. D1 owns all the stock of C. D purchases all of the stock of D1 for cash. Within five years of D's purchase of D1, P acquires all of the stock of D1 from D in a section 368(a)(1)(B) reorganization that is not a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E), and D1 distributes all of its C stock to P. P is treated as having acquired the D1 stock by purchase on the date D acquired it under the transferred basis rule of section 355(d)(5)(C) and paragraph (e)(2) of this section. P is treated as having purchased all of the C stock on the date D purchased the D1 stock under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section, and the C stock received by P is attributable to a distribution on purchased D1 stock under section 355(d)(3)(B)(ii). Accordingly, the D1 and C stock each is disqualified stock under section 355(d)(3) and paragraph (b)(2) of this section, and P is a disqualified person under paragraph (b)(3)(ii) of this section. The purposes of section 355(d) under paragraph (b)(3)(i) of this section are violated. P did not increase direct or indirect ownership in D1 or C. However, P's basis in the C stock is a purchased basis under paragraph (b)(3)(iii) of this section because the D1 stock is not treated as acquired by purchase solely under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. Accordingly, D1's distribution of the C stock to P is a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

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

Example 6. *Stock distributed in split-off with no ownership increase; no purchased basis*. A purchases all of the stock of T. T later merges into D in a section 368(a)(1)(A) reorganization and A exchanges its purchased T stock for 60 percent of the stock of D. D owns all of the stock of D1 and D2, D1 and D2 each owns 50 percent of the stock of D3, and D3 owns all of the stock of C. Within five years of A's purchase of the T stock, D3 distributes the C stock to D1 in exchange for all of D1's D3 stock. A is treated as having acquired 60 percent of the D stock by purchase on the date A purchases the T stock under paragraph (e)(3) of this section. A is treated as having purchased 60 percent of the stock of D1, D2, D3, and C on the date A purchases the T stock under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. The C stock received by D1 is attributable to a distribution on purchased D3 stock under section 355(d)(3)(B)(ii). Accordingly, the D3 stock and the C stock each is disqualified stock under section 355(d)(3) and paragraph (b)(2) of this section, and A is a disqualified person under paragraph (b)(3)(ii) of this section. However, the purposes of section 355(d) under paragraph (b)(3)(i) of this section are not violated. A did not increase direct or indirect ownership in D3 or C, and D1's basis in the C stock is not a purchased basis under paragraph (b)(3)(iii) of this section because the D3 stock is treated as acquired by purchase solely under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. Accordingly, D3's distribution of the C stock to D1 is not a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

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

Example 8. Purchased basis eliminated by upstream merger; stock distributed in spin-off. D owns all of the stock of D1, and D1 owns all of the stock of C. P purchases 60 percent of the D stock for cash. Within five years of P's purchase, D merges into P in a section 368(a)(1)(A) reorganization, with the D shareholders other than P receiving solely P stock in exchange for their D stock, and D1 then distributes the stock of C to P. Prior to the merger, P is treated as having purchased 60 percent of the stock of D1 and C on the date P purchases the D stock under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. After the merger, however, under paragraph (b)(2)(iii) of this section, P is not treated as having acquired by purchase the D1 or the C stock under section 355(d)(8)(B) and paragraph (e)(1) of this section because P's basis in the D stock is eliminated in the merger. Under section 362(b), P's basis in the D1 stock is determined by reference to D's basis in the D1 stock and not by reference to P's basis in D. Paragraph (d)(2)(i)(B) of this section does not treat the D1 stock as newly purchased in P's hands because no gain or loss was recognized by D in the merger. Accordingly, neither the D1 stock nor the C stock is disqualified stock under section 355(d)(3) and paragraph (b)(2) of this section in P's hands, and the distribution is not a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

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

Example 10. Allocation of purchased basis analyzed separately. (i) P owns all the stock of D. D purchases all the stock of D1 for cash on Date 1. D1 owns all the stock of C (which owns all the stock of C1) and S. Within five years of Date 1, D1 distributes all the stock of C to D. The D1 and C stock each is disqualified stock under section 355(d)(3) and paragraph (b)(2) of this section, and D is a disqualified person under paragraph (b)(3)(ii) of this section. The purposes of section 355(d) under paragraph (b)(3)(i) of this section are violated. D did not increase direct or indirect ownership in D1 or C. However, D's basis in the C stock is a purchased basis under paragraph (b)(3)(iii) of this section because the D1 stock is not treated as acquired by purchase solely under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section. Accordingly, the distribution is a disqualified distribution under section 355(d) and paragraph (b)(1) of this section. D's basis in the D1 stock is allocated pursuant to §1.358–2 between the D1 stock and the C stock. Therefore, under paragraph (e)(4) of this section, the C stock is deemed to be acquired by purchase on Date 1, the date D purchased all the stock of D1. If thereafter, and within five years of Date 1, C were to distribute all the stock of C1 to D, that distribution would also be a disqualified distribution because of D's deemed purchase of the stock of C.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Example 1. D owns all of the stock of C. A purchases 40 percent of D's only class of stock and an option to purchase D stock from D, that if deemed exercised, would result in A owning a total of 60 percent of the stock of D. Assume that no control premium or minority or blockage discount applies to the D stock underlying the option. The option permits A to acquire the D stock at $30 per share, and D's stock has a fair market value of $27 per share on the date the option is issued. The option is subject to no contingencies or restrictive covenants, may be exercised within five years after its issuance, and is not described in paragraph (c)(3)(vi) of this section (regarding instruments generally not treated as options). Within five years of A's purchase of the D stock and option, D distributes the stock of its subsidiary C pro rata and A receives 40 percent of the C stock in the distribution. Immediately after the distribution, D's stock has a fair market value of $30 per share and C's stock has a fair market value of $15 per share. At the time of the distribution, A exchanges A's option for an option to purchase 20 percent of the D stock at $20 per share and an option to purchase 20 percent of the C stock at $10 per share. The exchange of the options in D for options in D and C did not materially increase the likelihood that the options would be exercised. Nonetheless, based on all the facts and circumstances, it is reasonably certain, immediately after the distribution, that A will exercise its options. Under paragraph (c)(3)(iii)(C) of this section, the substituted options are treated as issued on the date the original option was issued. Accordingly, the options are treated as exercised by A on the date that A purchased the original option. A is treated as owning 60 percent of the D stock and 60 percent of the C stock that is disqualified stock, and the distribution is a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

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

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

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

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

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

Example 2. D has 1,000 shares of outstanding stock owned by unrelated individuals. D's management is concerned that D may become subject to a takeover bid. In separate meetings, D's management meets with potential investors who own no stock and are friendly to management to convince them to acquire D's stock based on an understanding that D will assemble a group that in the aggregate will acquire more than 50 percent of D's stock. Subsequently, 15 of these investors each purchases four percent of D's outstanding stock. Under paragraph (c)(4)(ii) of this section, the 15 investors have a formal or informal understanding among themselves to make a coordinated acquisition of stock. Their interests are therefore aggregated under section 355(d)(7)(B), and they are treated as one person that purchased 600 shares of D stock for purposes of section 355(d).

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

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

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

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

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

Example. In an initial public offering of D stock on Date 1, 100 investors independently purchase one percent each of the D stock. Two years later, D merges into P (in a reorganization described in section 368(a)(1)(A)) and, pursuant to the plan of reorganization, the D shareholders exchange their D stock for 50 percent of the stock of P. The D shareholders approve the plan by a two-thirds vote, as required by state law. Under section 358(a), each shareholder's basis in its P stock is determined by reference to the basis of the D stock it purchased. Under paragraph (e)(3) of this section, the former D shareholders are treated as purchasing their P stock on Date 1. The investors do not become a single person under paragraph (c)(4) of this section with respect to the deemed purchase of the P stock on Date 1 by virtue of their acquisition of the P stock pursuant to the merger on Date 2.

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

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

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

(*2*) Under section 1014(a); and

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

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

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

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

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

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

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

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

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

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

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

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

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

(ii) The facts are the same as in paragraph (i) of this *Example 1*, except that rather than D stock and $100 cash, A receives D stock and stock in C, a corporation not a party to the reorganization, with a fair market value of $100. Under section 358(a)(2), A's basis in the C stock is its fair market value, or $100. Under paragraph (d)(2)(i)(A)(*2*) of this section, A is treated as having purchased the C stock, but not the D stock, for purposes of section 355(d)(5).

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

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

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

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

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

Example. T owns all of the stock of S and no other assets. X acquires all of the T stock from the T shareholders for cash and makes an election under section 338. Under section 338(a) and (b), T, as Old T, is treated as having sold all of its assets at fair market value and purchased the assets as a new corporation, New T, as of the beginning of the day after the acquisition date. Under paragraph (d)(2)(iv)(A) of this section, X is not treated as having purchased the T stock. Absent a section 338 election or a section 338(h)(10) election with respect to S, New T is treated as having purchased all of the S stock under section 355(d)(5)(A).

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

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

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

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

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

(iii) *Exception for certain acquisitions*—(A) *In general*. Except to the extent provided in paragraph (e)(3) of this section (interest received in exchange for purchased interest in exchanged basis transaction treated as purchased), an acquisition of stock in a corporation in a section 351 transaction by one or more persons in exchange for an amount of stock in another corporation (the transferred corporation) that meets the requirements of section 1504(a)(2) is not a purchase by the transferor or transferors, regardless of whether the stock of the transferred corporation is marketable stock under section 355(d)(5)(B)(ii) and paragraph (d)(3)(ii) of this section.

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

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

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

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

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

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

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

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

(*1*) Conduct is tested before the transfer (with respect to the transferor) and after the transfer (with respect to the transferee) rather than immediately after a distribution; and

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

(C) *Reasonable needs of the trade or business*. For purposes of this paragraph (d)(3)(iv), the reasonable needs of the trade or business include only the amount of cash or cash items, marketable stock, or debt of the transferor that a prudent business person apprised of all relevant facts would consider necessary for the present and reasonably anticipated future needs of the business. Transferred items may be considered necessary for reasonably anticipated future needs only if the transferor and transferee have specific, definite, and feasible plans for their use. Those plans must require that items intended for anticipated future needs rather than present needs be used as expeditiously as possible consistent with the business purpose for retention of the items. Future needs are not reasonably anticipated if they are uncertain or vague or where the execution of the plan for their use is substantially postponed. The reasonable needs of a trade or business are generally its needs at the time of the transfer of the business including the items. However, for purposes of applying section 355(d) to a distribution, events and conditions after the transfer and through the date immediately after the distribution (including whether plans for the use of transferred items have been consummated or substantially postponed) may be considered to determine whether at the time of the transfer the items were necessary for the present and reasonably anticipated future needs of the business.

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

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

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

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

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

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

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

Example 1. Publicly traded P has wholly owned S since 1990. S is engaged in the telecommunications business and the business of computer software development. S is developing new software for use in the managed health care industry. Over a period of four years beginning on January 31, 2000, P contributes a substantial amount of cash to S solely for the purpose of funding the software development. On completion of the software in January of 2004, 60 percent of the value of the S stock is attributable to the cash contributions made within the last four years. The P group's primary lender requires that S separately incorporate the software and related assets and distribute the new subsidiary to P as a condition of providing required funding to market the software. Accordingly, on February 1, 2004, S forms N, contributes the software and related assets to N, and distributes all of the N stock to P in a transaction intended to qualify under section 355(a). P, S, and N will not leave the affiliated group in any transaction related to the cash contributions. Under paragraph (d)(3)(v)(A) of this section, P's cash contributions to S are not treated as purchases of additional S stock, and the distribution of N from S to P is not a disqualified distribution under section 355(d)(2) and paragraph (b)(1) of this section.

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

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

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

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

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

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

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

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

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

Example. *Forward triangular reorganization*. P forms S with $25 of cash and T merges into S in a reorganization qualifying under section 368(a)(1)(A) by reason of section 368(a)(2)(D) in which the T shareholders receive $70 of P stock and $15 of cash in exchange for their T stock. T is not a common parent of a consolidated group of corporations. The remaining $10 of cash with which P formed S will not be used in the acquired business. T's assets consist only of assets part of and used in its business with a value of $80, and $5 of cash that is not part of or used in T's business. T has no liabilities. S will use T's business assets in T's business (which will become S's business), but will invest the $5 of cash in an unrelated passive investment. Under paragraph (d)(4)(ii) of this section, P is treated as acquiring the T assets in a transaction in which P's basis in the T assets was determined under section 362(b) and contributing them to S in a section 351 transfer. Under paragraph (d)(3)(v) of this section, $10 (of the total $25) of cash contributed by P to S upon S's formation is not treated as a purchase of S stock. The $15 (of the total $25) of cash contributed by P to S upon S's formation that is paid to T's shareholders is not treated as a purchase of S stock. The exception in paragraph (d)(3)(v) of this section does not apply to the $5 of cash from T's business because P is treated as having acquired T's assets in a related transaction in which section 362(b) applies to determine P's basis in such assets. Accordingly, P is treated under section 355(d)(5)(B) and paragraph (d)(3)(iv) of this section as having purchased $5 of the S stock, but is not deemed to have purchased the remaining $80 of the S stock.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(2) *Transferred basis rule*. If any person acquires property from another person who acquired the property by purchase (determined with regard to section 355(d)(5) and paragraphs (d) and (e)(2), (3) and (4) of this section, but without regard to section 355(d)(8) and paragraph (e)(1) of this section), and the adjusted basis of the property in the hands of the acquirer is determined in whole or in part

by reference to the adjusted basis of the property in the hands of the other person, the acquirer is treated as having acquired the property by purchase on the date it was so acquired by the other person. The rule in this paragraph (e)(2) applies, for example, where stock of a corporation acquired by purchase is subsequently acquired in a section 351 transfer or a reorganization qualifying under section 368(a)(1)(B), but does not apply if the stock of a former common parent is acquired in a group structure change to which §1.1502–31 applies. But see paragraph (d)(2)(i)(B)(*2*) of this section for situations where the stock is treated as purchased on the date of a transfer.

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

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

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

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

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

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

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

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

(iv) *Special class of stock*. For purposes of section 355(d)(6) and paragraph (e)(5)(ii) of this section, the term special class of stock includes a class of stock that grants particular rights to, or bears particular risks for, the holder or the issuer with respect to the earnings, assets, or attributes of less than all the assets or activities of a corporation or any of its subsidiaries. The term includes, for example, tracking stock and stock (or any related instruments or arrangements) the terms of which provide for the distribution (whether or not at the option of any party or in the event of any contingency) of any controlled corporation or other specified assets to the holder or to one or more persons other than the holder.

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

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

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

(4) *Presumption as to less-than-five-percent shareholders*. Absent actual knowledge (or deemed knowledge under paragraph (f)(2) of this section) immedi-

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

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

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

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

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

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

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

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

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

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

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved December 11, 2000.

Jonathan Talisman,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 19, 2000, 8:45 a.m., and published in the issue of the Federal Register for December 20, 2000, 65 F.R. 79719)

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted applicable federal long-term rate is set forth for the month of January 2001. See Rev. Rul. 2001–3, page 319.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2001. See Rev. Rul. 2001–3, page 319.

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2001. See Rev. Rul. 2001–3, page 319.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2001. See Rev. Rul. 2001–3, page 319.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of January 2001. See Rev. Rul. 2001–3, page 319.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2001. See Rev. Rul. 2001–3, page 319.

Section 512.—Unrelated Business Taxable Income

The Service provides an inflation adjustment to the maximum amount of annual dues that can be paid to certain agricultural or horticultural organizations without any portion being treated as unrelated trade or business income by reason of any benefits or privileges available to members for taxable years beginning in 2001. See Rev. Proc. 2001–13, page 337.

Section 513.—Unrelated Trade or Business

The Service provides inflation adjustments to the maximum amount of a "low cost article" for taxable years beginning in 2001. Funds raised through a charity's distribution of "low cost articles" will not be treated as unrelated business income to the charity. See Rev. Proc. 2001–13, page 337.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of January 2001. See Rev. Rul. 2001–3, page 319.

Section 685.—Treatment of Funeral Trusts

The Service provides an inflation adjustment to the maximum amount of contributions that may be made to a qualified funeral trust for contracts entered in calendar year 2001. See Rev. Proc. 2001–13, page 337.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2001. See Rev. Rul. 2001–3, page 319.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2001. See Rev. Rul. 2001–3, page 319.

Section 860E.—Treatment of Income in Excess of Daily Accruals on Residual Interests

26 CFR 1.860E–1: Treatment of taxable income of a residual interest holder in excess of daily accruals.

This procedure details safe harbor conditions under which the transfer of a REMIC noneconomic residual interest or FASIT ownership interest is presumed to be accomplished without an intention to impede the assessment or collection of tax. Taxpayers may rely on the safe harbors from February 4, 2000 (the date proposed regulations were filed with the Federal Register) until the date specified in future published guidance. See Rev. Proc. 2001–12, page 335.

Section 860H.—Taxation of a FASIT; Other General Rules

This procedure details safe harbor conditions under which the transfer of a REMIC noneconomic residual interest or FASIT ownership interest is presumed to be accomplished without an intention to impede the assessment or collection of tax. Taxpayers may rely on the safe harbors from February 4, 2000 (the date proposed regulations were filed with the Federal Register) until the date specified in future published guidance. See Rev. Proc. 2001–12, page 335.

Section 877.—Expatriation to Avoid Tax

The Service provides inflation adjustments to amounts used to determine whether an individual's loss of United States citizenship had the avoidance of the United States tax as one of its principal purposes for calendar year 2001. See Rev. Proc. 2001–13, page 337.

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also Sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for January 2001.

Rev. Rul. 2001–3

This revenue ruling provides various prescribed rates for federal income tax purposes for January 2001 (the current) month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520. Finally, Table 6 contains the deemed rate of return for transfers made during calendar year 2001 to pooled income funds described in § 642(c)(5) that have been in existence for less than 3 taxable years immediately preceding the taxable year in which the transfer is made.

REV. RUL. 2001–3 TABLE 1

Applicable Federal Rates (AFR) for January 2001

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	5.90%	5.82%	5.78%	5.75%
110% AFR	6.50%	6.40%	6.35%	6.32%
120% AFR	7.10%	6.98%	6.92%	6.88%
130% AFR	7.71%	7.57%	7.50%	7.45%
Mid-Term				
AFR	5.61%	5.53%	5.49%	5.47%
110% AFR	6.17%	6.08%	6.03%	6.00%
120% AFR	6.75%	6.64%	6.59%	6.55%
130% AFR	7.32%	7.19%	7.13%	7.08%
150% AFR	8.47%	8.30%	8.22%	8.16%
175% AFR	9.91%	9.68%	9.57%	9.49%
Long-Term				
AFR	5.78%	5.70%	5.66%	5.63%
110% AFR	6.37%	6.27%	6.22%	6.19%
120% AFR	6.96%	6.84%	6.78%	6.74%
130%AFR	7.55%	7.41%	7.34%	7.30%

REV. RUL. 2001–3 TABLE 2

Applicable Federal Rates (AFR) for January 2001

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term adjusted AFR	4.18%	4.14%	4.12%	4.10%
Mid-Term adjusted AFR	4.52%	4.47%	4.45%	4.43%
Long-Term adjusted AFR	5.24%	5.17%	5.14%	5.12%

REV. RUL. 2001-3 TABLE 3	
Rates Under Section 382 for January 2001	
Adjusted federal long-term rate for the current month	5.24%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	5.39%

REV. RUL. 2001-3 TABLE 4	
Appropriate Percentages Under Section 42(b)(2) for January 2001	
Appropriate percentage for the 70% present value low-income housing credit	8.33%
Appropriate percentage for the 30% present value low-income housing credit	3.57%

REV. RUL. 2001-3 TABLE 5	
Rate Under Section 7520 for January 2001	
Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	6.8%

REV. RUL. 2001-3 TABLE 6	
Deemed Rate for Transfers to New Pooled Income Funds During 2001	
Deemed rate of return for transfers during 2001 to pooled income funds that have been in existence for less than 3 taxable years	6.6%

Section 1288.—Treatment of Original Issue Discounts on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2001. See Rev. Rul. 2001–3 page 319.

Section 2032A.—Valuation of Certain Farm, Etc., Real Property

The Service provides an inflation adjustment to the maximum amount by which the value of certain farm and other qualified real property included in a decedent's gross estate may be decreased for purposes of valuing the estate of a decedent dying in calendar year 2001. See Rev. Proc. 2001–13, page 337.

Section 2503.—Taxable Gifts

The Service provides an inflation adjustment to the amount of gifts that may be made to a person in a calendar year without including the amount in taxable gifts for calendar year 2001. See Rev. Proc. 2001–13, page 337.

Section 2523.—Gift to Spouse

The Service provides an inflation adjustment to the amount of gifts that may be made in a calendar year to a spouse who is not a citizen of the United States without including the amount in taxable gifts for calendar year 2001. See Rev. Proc. 2001–13, page 337.

Section 2631.—GST Exemption

The Service provides an inflation adjustment to the amount of the generation-skipping transfer tax exemption for calendar year 2001. See Rev. Proc. 2001–13, page 337.

Section 4001.—Passenger Vehicles

The Service provides inflation adjustments to the price above which a passenger vehicle becomes subject to an excise tax for transactions occurring in calendar year 2001. See Rev. Proc. 2001–13, page 337.

Section 4003.—Special Rules

The Service provides inflation adjustments to the price above which a passenger vehicle becomes subject to an excise tax for transactions occurring in calendar year 2001. (Price includes the price of installation of parts or accessories on a passenger vehicle within six months of the date after the vehicle was first placed in service.) See Rev. Proc. 2001–13, page 337.

Section 4261.—Imposition of Tax; In General.

This notice provides rules relating to the air transportation tax imposed by § 4261(a) of the Internal Revenue Code on amounts paid for the right to provide mileage awards. The notice reflects changes made by § 1031(c)(2) of the Taxpayer Relief Act of 1997, 1997–4 (Vol. 1) C.B. 2, 144, which added § 4261(e)(3) to the Code. See Notice 2001–6, page 327.

Section 4261(c).—Use of International Travel Facilities

The Service provides an inflation adjustment to the amount of the excise tax on passenger air transportation beginning or ending in the United States for calendar year 2001. See Rev. Proc. 2001–13, page 337.

Section 6011.—General Requirement of Return, Statement, or List

26 CFR 31.6011(a)–3: Returns under Federal Unemployment Tax Act.

What are the requirements of the Form 940 *e-file* Program, which allows taxpayers, reporting agents, transmitters, and software developers to electronically file a Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return?* See Rev. Proc. 2001–9, page 328.

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26 CFR 31.6011(a)–7: Execution of returns.

What are the requirements of the Form 940 *e-file* Program, which allows taxpayers, reporting agents, transmitters, and software developers to electronically file a Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return?* See Rev. Proc. 2001–9, page 328.

Section 6033.—Returns by Exempt Organizations

The Service provides an inflation adjustment to the amount of dues certain exempt organizations with nondeductible lobbying expenditures can charge and still be excepted from reporting requirements for taxable years beginning in 2001. See Rev. Proc. 2001–13, page 337.

Section 6039F.—Notice of Large Gifts Received From Foreign Persons

The Service provides an inflation adjustment to the amount of gifts in a taxable year from foreign person(s) that triggers a reporting requirement for a United States person for taxable years beginning in 2001. See Rev. Proc. 2001–13, page 337.

Section 6061.—Signing of Returns and Other Documents

26 CFR 301.6061–1: Signing of returns and other documents.

What are the requirements of the Form 940 *e-file* Program, which allows taxpayers, reporting agents, transmitters, and software developers to electronically file a Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return?* See Rev. Proc. 2001–9, page 328.

Section 6071.—Time for Filing Returns and Other Documents

26 CFR 31.6071(a)–1: Time for filing returns and other documents.

What are the requirements of the Form 940 *e-file* Program, which allows taxpayers, reporting agents, transmitters, and software developers to electronically file a Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return?* See Rev. Proc. 2001–9, page 328.

Section 6323.—Validity and Priority Against Certain Persons

The Service provides inflation adjustments for calendar year 2001 to (1) the maximum amount of a casual sale of personal property below which a federal tax lien will not be valid against a purchaser of the property, and (2) the maximum amount of a contract for the repair or improvement of certain residential property at or below which a federal tax lien will not be valid against a mechanic's lienor. See Rev. Proc. 2001–13, page 337.

Section 6334.—Property Exempt From Levy

The Service provides inflation adjustments to the value of certain property exempt from levy (fuel, provisions, furniture, household personal effects, arms for personal use, livestock, poultry, and books and tools of a trade, business, or profession) for calendar year 2001. See Rev. Proc. 2001–13, page 337.

Section 6601.—Interest on Underpayment, Nonpayment, or Extension of Time for Payment, of Tax

The Service provides an inflation adjustment to the amount used to determine the amount of interest charged on a certain portion of the estate tax payable in installments for the estate of a decedent dying in calendar year 2001. See Rev. Proc. 2001–13, page 337.

Section 6651.—Failure to File Tax Return or to Pay Tax

26 CFR 301.6651–1: Failure to file tax return or to pay tax.

What are the requirements of the Form 940 *e-file* Program, which allows taxpayers, reporting agents, transmitters, and software developers to electronically file a Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return?* See Rev. Proc. 2001–9, page 328.

Section 7430.—Awarding of Costs and Certain Fees

The Service provides an inflation adjustment to the hourly limit on attorney fees that may be awarded in a judgement or settlement of an administrative or judicial proceeding concerning the determination, collection, or refund of tax, interest, or penalty for calendar year 2001. See Rev. Proc. 2001–13, page 337.

Section 7508.—Time for Performing Certain Acts Postponed by Reason of Service in Combat Zone

26 CFR 301.7508–1: Time for performing certain acts postponed by reason of service in a combat zone.

26 CFR 301.7508A–1: Postponement of certain tax-related deadlines by reason of Presidentially declared disaster.

T.D. 8911

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 301

Relief for Service in Combat Zone and for Presidentially Declared Disaster

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the postponement of certain tax-related deadlines due either to service in a combat zone or a Presidentially declared disaster. The regulations reflect changes to the law made by the Taxpayer Relief Act of 1997. The regulations affect taxpayers serving in a combat zone and taxpayers affected by a Presidentially declared disaster.

DATES: *Effective Date*: These regulations are effective December 30, 1999. *Applicability Date*: For dates of applicability, see §§301.7508–1(b) and 301.7508A–1(h).

FOR FURTHER INFORMATION CONTACT: Bridget E. Finkenaur, (202) 622-4940 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Regulations on Procedure and Administration (26 CFR part 301) under section 7508 of the Internal Revenue Code (Code), relating to postponement of certain acts by reason of service in a combat zone, and section 7508A, relating to postponement of certain tax-related deadlines by reason of a Presidentially declared disaster. Section 7508A was added to the Code by section 911 of the Taxpayer Relief Act of 1997, Public Law 105–34 (111 Stat. 788), effective for any period for performing an act that has not expired before August 5, 1997.

A notice of proposed rulemaking (REG–101492–98, 2000–3 I.R.B. 326) was published in the **Federal Register** (64 F.R. 73444) on December 30, 1999. No public hearing was requested or held. One comment letter was received. After consideration of the comments, the proposed regulations are adopted as modified by this Treasury decision. The comments are discussed below.

Summary of Comments

1. IRA and Pension Contribution Deadlines

Section 301.7508A–1(c)(1) of the proposed regulations lists various tax-related deadlines that may be postponed. The commentator recommends that deadlines for contributions to an individual retirement account (IRA) or a pension plan be added to the list. The final regulations adopt this recommendation and also add the deadline for rollover contributions.

2. Notification of IRS When Taxpayer Moves Out of Disaster Area

The commentator suggests that the IRS develop a simple procedure for taxpayers to notify the IRS when they move out of a Presidentially declared disaster area. The commentator believes that the notification would ensure that relief under section 7508A will automatically apply to a taxpayer who has moved out of a Presidentially declared disaster area. Such taxpayers could also be advised of any further relevant filing guidance regarding the disaster.

The final regulations do not adopt this suggestion because it is not necessary for taxpayers moving out of a disaster area to notify the IRS to obtain relief under section 7508A. When a Presidentially declared disaster occurs, the IRS makes a decision whether to grant relief to taxpayers affected by the disaster. If a decision is made to grant relief, the IRS identifies most affected taxpayers located in the disaster area and places a marker on the affected tax accounts. A subsequent change of address will not remove the marker from the tax account. Thus, an affected taxpayer who relocates outside a disaster area will still automatically receive disaster relief.

Because the IRS may not be able to identify all taxpayers potentially affected by a Presidentially declared disaster, some taxpayers may have to identify themselves to the IRS to receive relief. To ensure that they receive the relief for which they are eligible, the IRS typically issues public guidance, such as a news release, that describes how to claim relief. The guidance instructs taxpayers how to note on their tax return that they are affected taxpayers, and what, if any, additional information should be attached. When the IRS processes these tax returns, it manually places the disaster relief marker on the tax account. Subsequent changes of address will not affect the grant of relief.

3. Definition of Affected Taxpayer

The regulations list seven types of affected taxpayers, including "any business whose principal place of business is located in a covered disaster area." The commentator recommends that this definition be expanded to include all owners of a business.

The final regulations do not adopt this recommendation. The IRS and Treasury Department believe that the definition of *affected taxpayer* in the proposed regulations is sufficiently broad to cover all taxpayers within the intended scope of section 7508A. Although the final regulations do not provide a specific rule for business owners (other than sole proprietors), the IRS may nonetheless make a determination based on the facts and circumstances in a particular case that a business owner is an affected taxpayer under either §301.7508A–1(d)(1)(iv), which applies to an individual whose principal residence is not located in a disaster area, but whose records necessary to meet the deadline for a specified act are maintained in a covered disaster area, or under §301.7508A–1(d)(1)(vii), which applies to any other person determined by the IRS to be affected by a Presidentially declared disaster. For example, in the case of a partnership, it is expected that partners whose ability to meet a deadline is significantly affected by a Presidentially declared disaster will be granted relief.

4. Deadline for Tax Deposits

The commentator also recommends that the deadline for tax deposits under section 6302 be added to the list. The commentator states that no distinction should be drawn between tax payments and tax deposits and that allowing a postponement of deposits would be less cumbersome than waiving the section 6656 deposit penalties for reasonable cause. To the contrary, due to the frequency with which tax deposits are due, the IRS believes it would be more administratively cumbersome to defer those deadlines. However, in cases where taxpayers are unable to make timely tax deposits under section 6302 because of a Presidentially declared disaster, the IRS will consider a reasonable cause waiver of the section 6656 failure to deposit penalty on a case by case basis. The IRS believes such a system is more administrable. Thus, this comment has not been adopted by the final regulations.

Explanation of Other Revisions

Section 301.7508A–1(c)(1) of the final regulations expands the acts for which disaster relief is available to include: the filing of generation-skipping transfer tax returns; the payment of generation-skipping transfer tax; and the filing of any petition with the Tax Court.

Sections 301.7508A–1(d)(1)(ii) and (iv) of the final regulations have been revised to clarify that *affected taxpayer* includes any business entity or sole proprietor whose principal place of business is located in a covered disaster area.

Example 5 of the final regulations clarifies the application of section 7508A to the lookback period in section 6511(b)(2)(A). This period limits the amount that may be refunded to the taxpayer when a timely claim is filed under section 6511(a). In *Example 5*, H and W timely file their 2001 income tax return on April 15, 2002. *Example 5* states that an amended return for 2001 will be timely if it is filed on or before July 14, 2005. As clarified by the final regulations, *Example 5* further states that the section 6511(b)(2)(A) lookback period runs from July 14, 2005, back to April 15, 2002. Thus, the taxpayers are allowed a refund of estimated tax and tax withheld from wages for 2001, deemed paid on April 15, 2002, under section 6513(b).

The final regulations also clarify *Examples 6* and *7*. Under §301.7508A–1(f) of the final regulations, if there is an extension of time to file income tax returns under section 6081 and to pay income tax with respect to such returns under section 6161, and a postponement of tax-related deadlines under section 7508A, interest on an underpayment that arises during such period is abated under section 6404(h) for the period of time disregarded under section 7508A. This is illustrated by *Example 8*. By contrast, in *Examples 6* and *7*, extensions were not granted under sections 6081 and 6161 and interest was not abated under section 6404(h). Therefore, in *Examples 6* and *7*, no interest abatement would be permitted regardless of whether the underpayment arose before or during the extension period. Therefore, *Examples 6* and *7* are amended by removing the statement that interest is not abated "because the underpayment arose prior to the extension period" and clarifying that because no extensions under sections 6081 and 6161 were granted, interest was not abated under section 6404(h).

Special Analyses

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

Drafting Information

The principal author of these regulations is Bridget E. Finkenaur, Office of Associate Chief Counsel, Procedure and Administration (Administrative Provisions and Judicial Practice Division). However, other personnel from the IRS and Treasury Department participated in their development.

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Amendments to the Regulations

Accordingly, 26 CFR part 301 is amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 is amended by adding entries in numerical order to read in part as follows:

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

Section 301.7508–1 also issued under 26 U.S.C. 7508(a)(1)(K);

Section 301.7508A–1 also issued under 26 U.S.C. 7508(a)(1)(K) and 7508A(a); * * *

Par. 2. Section 301.7508–1 is added to read as follows:

§ 301.7508–1 Time for performing certain acts postponed by reason of service in a combat zone.

(a) *General rule*. The period of time that may be disregarded for performing certain acts under section 7508 applies to acts described in section 7508(a)(1) and to other acts specified in a revenue ruling, revenue procedure, notice, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(b) *Effective date*. This section applies to any period for performing an act that has not expired before December 30, 1999.

Par. 3. Section 301.7508A–1 is added to read as follows:

§301.7508A–1 Postponement of certain tax-related deadlines by reason of Presidentially declared disaster.

(a) *Scope*. This section provides rules by which the Internal Revenue Service (IRS) may postpone deadlines for performing certain acts with respect to taxes other than taxes not administered by the IRS such as firearms tax (chapter 32, section 4181); harbor maintenance tax (chapter 36, section 4461); and alcohol and tobacco taxes (subtitle E).

(b) *Postponed deadlines*. For any tax, penalty, additional amount, or addition to the tax of an affected taxpayer (as defined in paragraph (d)(1) of this section), the IRS may disregard a period of up to 90 days in determining, under the internal revenue laws—

(1) Whether any or all of the acts described in paragraph (c) of this section were performed within the time prescribed; and

(2) The amount of any credit or refund.

(c) *Acts for which a period may be disregarded*—(1) *Acts performed by taxpayers*. Paragraph (b) of this section applies to the following acts performed by affected taxpayers (as defined in paragraph (d)(1) of this section)—

(i) Filing any return of income tax, estate tax, gift tax, generation-skipping transfer tax, excise tax (other than firearms tax (chapter 32, section 4181); harbor maintenance tax (chapter 36, section 4461); and alcohol and tobacco taxes (subtitle E)), or employment tax (including income tax withheld at source and income tax imposed by subtitle C or any law superseded thereby);

(ii) Paying any income tax, estate tax, gift tax, generation-skipping transfer tax, excise tax (other than firearms tax (chapter 32, section 4181); harbor maintenance tax (chapter 36, section 4461); and alcohol and tobacco taxes (subtitle E)), employment tax (including income tax withheld at source and income tax imposed by subtitle C or any law superseded thereby), any installment of those taxes (including payment under section 6159 relating to installment agreements), or of any other liability to the United States in respect thereof, but not including deposits of taxes pursuant to section 6302 and the regulations under section 6302;

(iii) Making contributions to a qualified retirement plan (within the meaning of section 4974(c)) under section 219(f)(3), 404(a)(6), 404(h)(1)(B), or 404(m)(2); making distributions under section 408(d)(4); recharacterizing contributions under section 408A(d)(6); or making a rollover under section 402(c), 403(a)(4), 403(b)(8), or 408(d)(3);

(iv) Filing a petition with the Tax Court, or for review of a decision rendered by the Tax Court;

(v) Filing a claim for credit or refund of any tax;

(vi) Bringing suit upon a claim for credit or refund of any tax; and

(vii) Any other act specified in a revenue ruling, revenue procedure, notice, announcement, news release, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(2) *Acts performed by the government*. Paragraph (b) of this section applies to the following acts performed by the government—

(i) Assessing any tax;

(ii) Giving or making any notice or demand for the payment of any tax, or with respect to any liability to the United States in respect of any tax;

(iii) Collecting by the Secretary, by levy or otherwise, of the amount of any liability in respect of any tax;

(iv) Bringing suit by the United States, or any officer on its behalf, in respect of any liability in respect of any tax;

(v) Allowing a credit or refund of any tax; and

(vi) Any other act specified in a revenue ruling, revenue procedure, notice, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(d) *Definitions*—(1) *Affected taxpayer* means–-

(i) Any individual whose principal residence (for purposes of section 1033(h)(4)) is located in a covered disaster area;

(ii) Any business entity or sole proprietor whose principal place of business is located in a covered disaster area;

(iii) Any individual who is a relief worker affiliated with a recognized government or philanthropic organization and who is assisting in a covered disaster area;

(iv) Any individual whose principal residence (for purposes of section 1033(h)(4)), or any business entity or sole proprietor whose principal place of business is not located in a covered disaster area, but whose records necessary to meet a deadline for an act specified in paragraph (c) of this section are maintained in a covered disaster area;

(v) Any estate or trust that has tax records necessary to meet a deadline for an act specified in paragraph (c) of this section and that are maintained in a covered disaster area;

(vi) The spouse of an affected taxpayer, solely with regard to a joint return of the husband and wife; or

(vii) Any other person determined by the IRS to be affected by a Presidentially declared disaster (within the meaning of section 1033(h)(3)).

(2) *Covered disaster area* means an area of a Presidentially declared disaster (within the meaning of section 1033(h)(3)) to which the IRS has determined paragraph (b) of this section applies.

(e) *Notice of postponement of certain acts*. If any tax-related deadline is postponed under section 7508A and this section, the IRS will publish a revenue ruling, revenue procedure, notice, announcement, news release, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter) describing the acts postponed, the number of days disregarded with respect to each act, the time period to which the postponement applies, and the location of the covered disaster area. Guidance under this paragraph (e) will be published as soon as practicable after the declaration of a Presidentially declared disaster.

(f) *Abatement of interest under section 6404(h)*. In the case of a Presidentially declared disaster, if there is an extension of time to file income tax returns under section 6081 and to pay income tax with respect to such returns under section 6161, and, in addition, a postponement of tax-related deadlines under section 7508A, interest on an underpayment of income tax that arises during such period will be abated under section 6404(h) for the period of time disregarded under section 7508A in addition to the period of time covered by the extension of time to file and the extension of time to pay.

(g) *Examples*. The rules of this section are illustrated by the following examples:

Example 1. (i) Corporation M, a calendar year taxpayer, has its principal place of business in County A in State X. Pursuant to a timely filed request for extension of time to file, Corporation M's 1999 Form 1120, "U.S. Corporation Income Tax Return," is due on September 15, 2000. Also due on September 15, 2000, is Corporation M's third quarter estimated tax payment for 2000. Corporation M's 2000 third quarter Form 720, "Quarterly Federal Excise Tax Return," and third quarter Form 941, "Employer's Quarterly Federal Tax Return," are due on October 31, 2000. In addition, Corporation M has an employment tax deposit due on September 15, 2000.

(ii) On September 1, 2000, a hurricane strikes County A. On September 6, 2000, the President declares a disaster within the meaning of section 1033(h)(3). The IRS determines that County A in State X is a covered disaster area and publishes guidance informing taxpayers that for acts described in paragraph (c) of this section that are required to be performed within the period beginning on September 1, 2000, and ending on November 6, 2000, 90 days will be disregarded in determining whether the acts are performed timely.

(iii) Because Corporation M's principal place of business is in County A, Corporation M is an affected taxpayer. Accordingly, Corporation M's 1999 Form 1120 will be filed timely if filed on or before December 14, 2000. Corporation M's 2000 third quarter estimated tax payment will be made timely if paid on or before December 14, 2000. In addition, because excise and employment tax returns are described in paragraph (c) of this section, Corporation M's 2000 third quarter Form 720 and third quarter Form 941 will be filed timely if filed on or before January 29, 2001. However, because deposits of taxes are excluded from the scope of paragraph (c) of this section, Corporation M's employment tax deposit is due on September 15, 2000. In addition, Corporation M's deposits relating to the third quarter Form 720 are due without extension.

Example 2. The facts are the same as in *Example 1*, except that during 2000, Corporation M's 1996

Form 1120 is being examined by the IRS. Pursuant to a timely filed request for extension of time to file, Corporation M timely filed its 1996 Form 1120 on September 15, 1997. Without application of this section, the statute of limitations on assessment for 1996 income tax will expire on September 15, 2000. However, pursuant to paragraph (c) of this section, assessment of tax is one of the government acts for which up to 90 days may be disregarded. The IRS determines that an extension of the statute of limitations is necessary and appropriate under these circumstances. Because the September 15, 2000, expiration date of the statute of limitations on assessment falls within the period of the disaster as described in the IRS's published guidance, the 90 day period disregarded under paragraph (b) of this section begins on September 16, 2000, and ends on December 14, 2000. Accordingly, the statute of limitations on assessment for Corporation M's 1996 income tax will expire on December 14, 2000.

Example 3. The facts are the same as in *Example 2*, except that the examination of the 1996 taxable year was completed earlier in 2000, and on July 28, 2000, the IRS mailed a statutory notice of deficiency to Corporation M. Without application of this section, Corporation M has 90 days (or until October 26, 2000) to file a petition with the Tax Court. However, pursuant to paragraph (c) of this section, filing a petition with the Tax Court is one of the taxpayer acts for which up to 90 days may be disregarded. Because Corporation M is an affected taxpayer, Corporation M's petition to the Tax Court will be filed timely if filed on or before January 24, 2001.

Example 4. (i) H and W, individual calendar year taxpayers, intend to file a joint Form 1040, "U.S. Individual Income Tax Return," for the 2001 taxable year and are required to file a Schedule H, "Household Employment Taxes." The joint return is due on April 15, 2002. H and W fully and timely paid all taxes for the 2001 taxable year, including domestic service employment taxes, through withholding and estimated tax payments. H and W's principal residence is in County B in State Y.

(ii) On April 2, 2002, a severe ice storm strikes County B. On April 5, 2002, the President declares a disaster within the meaning of section 1033(h)(3). The IRS determines that County B in State Y is a covered disaster area and publishes guidance informing taxpayers that for acts described in paragraph (c) of this section that are required to be performed within the period beginning on April 2, 2002, and ending on April 19, 2002, 90 days will be disregarded in determining whether the acts are performed timely.

(iii) Because H and W's principal residence is in County B, H and W are affected taxpayers. Because April 15, 2002, the due date of H and W's 2001 Form 1040 and Schedule H, falls within the period of the disaster as described in the IRS published guidance, the 90 day period disregarded under paragraph (b) of this section begins on April 16, 2002, and ends on July 14, 2002, a Sunday. Pursuant to section 7503, if the last day for performing an act falls on Saturday, Sunday, or a legal holiday, the performance of the act shall be considered timely if it is performed on the next succeeding day that is not a Saturday, Sunday, or legal holiday. Accordingly, H and W's 2001 Form 1040 and Schedule H will be filed timely if filed on or before July 15, 2002.

Example 5. (i) H and W, residents of County C in State Z, want to file an amended return to request a refund of 2001 taxes. H and W timely filed their 2001 income tax return on April 15, 2002. Without application of section 7508A, under section 6511(a), H and W's amended 2001 tax return must be filed on or before April 15, 2005.

(ii) On April 1, 2005, an earthquake strikes County C. On April 5, 2005, the President declares a disaster within the meaning of section 1033(h)(3). The IRS determines that County C in State Z is a covered disaster area and publishes guidance informing taxpayers that for acts described in paragraph (c) of this section that are required to be performed within the period beginning on April 1, 2005, and ending on April 19, 2005, 90 days will be disregarded in determining whether the acts are performed timely.

(iii) Under paragraph (c) of this section, filing a claim for refund of tax is one of the taxpayer acts for which up to 90 days may be disregarded. Ninety days are disregarded under paragraph (b)(1) of this section beginning on April 16, 2005, and ending on July 14, 2005. Accordingly, H's and W's claim for refund for 2001 taxes will be timely if filed on or before July 14, 2005. Moreover, in applying the lookback period in section 6511(b)(2)(A), which limits the amount of the allowable refund, the period from July 14, 2005, back to April 16, 2005, is disregarded under paragraph (b)(2) of this section. Thus, if the claim is filed on or before July 14, 2005, amounts deemed paid on April 15, 2002, under section 6513(b), such as estimated tax and tax withheld from wages, will have been paid within the lookback period of section 6511(b)(2)(A).

Example 6. (i) L is an unmarried, calendar year taxpayer whose principal residence is located in County R in State T. L does not timely file a 2001 Form 1040, "U.S. Individual Income Tax Return," which is due on April 15, 2002, and does not timely pay tax owed on that return. Absent reasonable cause, L is subject to the failure to file and failure to pay penalties under section 6651 beginning on April 16, 2002.

(ii) On May 10, 2002, a tornado strikes County R. On May 14, 2002, the President declares a disaster within the meaning of section 1033(h)(3). The IRS determines that County R in State T is a covered disaster area and publishes guidance informing taxpayers that for acts described in paragraph (c) of this section that are required to be performed within the period beginning on May 10, 2002, and ending on June 27, 2002, 90 days will be disregarded in determining whether the acts are timely.

(iii) On May 31, 2002, L files a 2001 Form 1040, "U.S. Individual Income Tax Return," and pays the tax owed for 2001.

(iv) Because L's principal residence is in County R, L is an affected taxpayer. For purposes of penalties under section 6651, 90 days are disregarded under paragraph (b) of this section beginning on May 10, 2002. Because L files the return on May 31, 2002, the penalties under section 6651 will run from April 16, 2002, until May 10, 2002. Because there is no extension of time to file returns under section 6081 and no extension of time to pay under section 6161, interest is not abated under section 6404(h), and L is liable for the underpayment interest for the entire period of April 16, 2002, through May 31, 2002.

Example 7. The facts are the same as in *Example 6*, except L does not file the 2001 Form 1040 until November 25, 2002. Ninety days are disregarded under paragraph (b) of this section beginning on May 10, 2002, and ending on August 8, 2002. Therefore, the section 6651 penalties will run from April 16, 2002, until May 10, 2002, and from August 9, 2002, until November 25, 2002. Because there is no extension of time to file returns under section 6081 and no extension of time to pay under section 6161, interest is not abated under section 6404(h), and L will remain liable for underpayment interest for the entire period of April 16, 2002, through November 25, 2002.

Example 8. (i) H and W, individual calendar year taxpayers, intend to file a joint Form 1040, "U.S. Individual Income Tax Return," for the 2001 taxable year. The joint return is due on April 15, 2002. After credits for withholding under section 31 and estimated tax payments, H and W owe tax for the 2001 taxable year. H and W's principal residence is in County D in State Q.

(ii) On March 1, 2002, severe flooding strikes County D. On March 5, 2002, the President declares a disaster within the meaning of section 1033(h)(3). The IRS determines that County D in State Q is a covered disaster area and publishes guidance informing taxpayers that for acts described in paragraph (c) of this section that are required to be performed within the period beginning on March 1, 2002, and ending on April 25, 2002, 90 days will be disregarded in determining whether the acts are performed timely. The guidance also grants affected taxpayers an additional 6-month extension of time to file returns under section 6081 and an additional 6-month extension of time to pay under section 6161.

(iii) Because H and W's principal residence is in County D, H and W are affected taxpayers. Pursuant to the published guidance, H and W have until January 13, 2003, to file their return and pay the tax. This date is computed as follows: Under sections 6081 and 6161, H and W will have an additional 6 months, until October 15, 2002, to file and pay the tax. Further, under paragraph (f) of this section, 90 days are disregarded in determining the period of the extension. Therefore, H and W's return and payment of tax will be timely if filed and paid on or before January 13, 2003. In addition, under section 6404(h), underpayment interest under section 6601 is abated for the entire period, from April 16, 2002, until January 13, 2003.

(h) *Effective date*. This section applies to disasters declared after December 30, 1999.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved November 30, 2000.

Jonathan Talisman,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 14, 2000, 8:45 a.m., and published in the issue of the Federal Register for December 15, 2000, 65 F.R. 78409)

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2001. See Rev. Rul. 2001–3 page 319.

Section 7702B.—Treatment of Qualified Long-Term Care Insurance

The Service provides an inflation adjustment to the stated dollar amount of the *per diem* limitation regarding periodic payments received under a qualified long-term care insurance contract or periodic payments received under a life insurance contract that are treated as paid by reason of the death of a chronically ill individual for calendar year 2001. See Rev. Proc. 2001–13, page 337.

Section 7872.—Treatment of Loans With Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2001. See Rev. Rul. 2001–3 page 319.

Part III. Administrative, Procedural, and Miscellaneous

Partnership Termination - Final Short-Year Tax Return

Notice 2001–5

This notice provides guidance to partnerships regarding the need to file a final short-year partnership tax return following a partnership termination under §708(b)(1)(B) of the Internal Revenue Code. Questions have arisen regarding whether a terminated partnership files a final short-year tax return given that the new partnership resulting from the termination will continue to use the employer identification number of the terminated partnership.

A partnership terminates for tax purposes under § 708(b)(1)(B) as a result of the sale or exchange of 50 percent or more of the total interest in partnership capital and profits within a 12-month period. The regulations under § 708(b) were modified in 1997 to provide that following the termination of a partnership, the terminated partnership is deemed to contribute all its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership.

Section 301.6109–1(d)(2)(iii) of the Procedure and Administration Regulations provides that the new partnership that is formed as a result of the termination of a partnership under § 708(b)(1)(B) will retain the employer identification number of the terminated partnership.

Section 1.706–1(c)(1) of the Income Tax Regulations provides that in the case of a termination, the partnership taxable year closes for all partners as of the date of termination. Thus, the taxable year of the partnership terminates with the termination of the partnership under § 708(b)(1)(B). Under § 6031(a) every partnership that is required to file a return must file a return of partnership income for each taxable year of the partnership.

Under § 443(a)(2), a return is required to be made for a period of less than 12 months if the taxpayer is in existence for only part of what would otherwise be its taxable year.

Accordingly, a partnership that terminates under § 708(b)(1)(B) is required to file a short-year final return for the taxable year ending with the date of its termination. The new partnership is required to file a return for its taxable year beginning after the date of termination of the terminated partnership.

The principal author of this notice is Stephen J. Coleman of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice contact Mr. Coleman at (202) 622-3060 (not a toll free call).

Air Transportation Excise Tax; Amount Paid for the Right to Award Miles

Notice 2001–6

This notice provides rules relating to the air transportation tax imposed by § 4261(a) of the Internal Revenue Code on amounts paid for the right to provide mileage awards. The notice reflects changes made by § 1031(c)(2) of the Taxpayer Relief Act of 1997, 1997–4 (Vol. 1) C.B. 2, 144, which added § 4261(e)(3) to the Code. Section 4261(e)(3) provides that the tax imposed by § 4261(a) applies to any amount paid (and the value of any other benefit provided) for the right to provide mileage awards for, or other reductions in the cost of, any transportation of persons by air. The Treasury Department and the Internal Revenue Service expect to issue the substance of this notice as a regulation at a later date. Until that regulation is published, persons responsible for collecting the tax and persons responsible for paying the tax may rely on the guidance provided in this notice.

Section 4261(a) imposes a 7.5 percent excise tax on amounts paid for taxable transportation. Taxable transportation includes most domestic air transportation (that is, transportation between points in the United States) and certain air transportation beginning or ending in southern Canada or northern Mexico. With the exception of these Canadian and Mexican flights, the tax does not apply to air transportation between the United States and a foreign country, which is subject to the international arrival and departure tax imposed by § 4261(c), or to entirely foreign air transportation, which is not taxed.

Section 4261(e)(3) was enacted for the purpose of "clarifying that the air transportation excise tax applies to payments to air carriers (and related parties) for the right to award air travel benefits." H.R. Conf. Rep. No. 105–220, at 555 (1997), 1997–4 (Vol. 2) C.B. 2025. Thus, because the Treasury Department and the IRS have concluded that this clarification was intended as a backstop to the 7.5 percent tax imposed by § 4261(a), the new mileage award rules should not apply with respect to mileage awards for air transportation that would not, under any circumstances, be subject to the tax imposed by § 4261(a) or with respect to mileage awards that will otherwise be fully subject to that tax.

Regulations under § 4261(e)(3) will provide the following rules concerning mileage awards:

(1) Amounts paid for mileage awards that cannot be redeemed for taxable transportation (for example, awards usable only on a foreign air carrier) are not subject to tax.

(2) Amounts paid by an air carrier to another air carrier, whether foreign or domestic, for mileage awards that can be redeemed for taxable transportation are not subject to tax to the extent those miles will be awarded in connection with the purchase of air transportation subject to the tax imposed by § 4261(a).

(3) Amounts paid by an air carrier to another air carrier, whether foreign or domestic, for mileage awards that can be redeemed for taxable transportation are subject to tax to the extent those miles will be awarded other than in connection with the purchase of air transportation subject to the tax imposed by § 4261(a).

Air carriers may use any reasonable method to allocate amounts paid (and the value of any other benefits provided) between purchased mileage that cannot be redeemed for taxable transportation or that will be awarded in connection with the purchase of air transportation that is subject to the tax imposed by § 4261(a) and purchased mileage that does not meet either of these conditions.

These rules apply to amounts paid after September 30, 1997. However, any amount paid after June 11, 1997, by one member of a controlled group for a mileage award that is furnished by another member of the controlled group after September 30, 1997, is treated as paid after September 30, 1997.

The principal author of this notice is Patrick S. Kirwan of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice contact Mr. Kirwan at (202) 622-3130 (not a toll-free call).

Inflation-Adjusted Amounts for 2001

Notice 2001–12

PURPOSE

This notice clarifies Rev. Proc. 2001–13, 2001–3 I.R.B. (Jan. 16, 2001), to provide that the inflation-adjustment amounts set forth in Part I of section 3 of that revenue procedure are the applicable amounts for 2001 in light of recently enacted legislation.

BACKGROUND

Section 3 of Rev. Proc. 2001–13, released on December 15, 2000, set forth two alternative sets of inflation adjustment figures for 2001 for certain items. Part I of section 3 provided the figures for these items that would apply if certain legislation, pending on the date of release, were to be enacted. Part II of section 3 provided alternative figures for these items that would apply if the pending legislation were not enacted. Section 2.02 of Rev. Proc. 2001–13 stated that the Service would issue subsequent notification clarifying whether the amounts set forth in Part I or Part II of section 3 are in fact the appropriate figures for 2001.

The then-pending legislation was subsequently enacted as section 308 of H.R. 5662, the Community Renewal Tax Relief Act of 2000 (the "Act"), the text of which was incorporated by reference in section 1(a)(7) of the Consolidated Appropriations Act of 2001, Public Law 106–554, 106th Cong., 2nd Sess. (Dec. 21, 2000).

APPLICATION

As a result of section 308 of the Act, the tax tables and other items adjusted for inflation for 2001 in Rev. Proc. 2001–13 are required to reflect the unpublished corrections made by the Bureau of Labor Statistics in the Consumer Price Index for All Urban Consumers for September 1999 through December 1999. Thus, the applicable inflation-adjusted amounts for 2001 are those set forth in Part I of section 3 of Rev. Proc. 2001–13. Part II of section 3 should be disregarded. The specific items that are affected are:

(1) the tax rate tables (set forth in section 3.01);

(2) certain figures relating to the earned income tax credit (section 3.03);

(3) the aggregate amount of gifts received from foreign persons for purposes of information reporting under § 6039F (section 3.22); and

(4) the amount used to determine the validity of certain tax liens under § 6323(b)(7) (section 3.23).

EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2001–13 is clarified.

DRAFTING INFORMATION

The principal author of this notice is Paul E. Tellier of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this notice contact Mr. Tellier at (202) 622-4930 (not a toll-free call).

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26 CFR. 601.602: Tax forms and instructions. (Also Part I, secs. 6011, 6061, 6071, 6651; 31.6011(a)–3, 31.6011(a)–7, 31.6061–1, 301.6061–1, 31.6071(a)–1, 301.6651–1)

Rev. Proc. 2001–9

Table of Contents

SECTION 1. PURPOSE

This revenue procedure provides the requirements for electronically filing the Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return in the "Form 940 *e-file* Program." Under "IRS *e-file* for Business," there are two options for electronically filing Form 940: 940 *e-file* Option and 940 On-Line Option, both similar to the 941 *e-file* and 941 On-Line options. There is no 940 TeleFile option at this time. The technical specifications for filing Form 940 electronically are published separately in Publication 3715, *Technical Specifications Guide for the Electronic Filing of Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return.* This revenue procedure does not address the requirements of the Form 941 *e-file* Program, which can be found in Rev. Proc. 99–39, 1999–2 C.B. 532.

SECTION 2. BACKGROUND

.01 Section 6011(a) of the Internal Revenue Code provides that any person liable for any tax imposed by this title, or for the collection thereof, must make a return or statement according to the forms and regulations prescribed by the Secretary. Every person required to make a return or statement must include therein the information required by such forms or regulations.

.02 Section 31.6011(a)–3 of the Regulations on Employment Taxes and Collection of Income Tax at Source provides in general that every person must make a return of tax under the Federal Unemployment Tax Act for each calendar year in which the person is an employer as defined in section 31.3306(a)–1. Except as otherwise provided, Form 940 is the form prescribed for making the return.

.03 Section 31.6011(a)–7 provides that each return, together with any prescribed copies or supporting data, must be filled in and disposed of in accordance with the forms, instructions, and regulations applicable thereto. The return may be made by an agent in the name of the person required to make the return if an acceptable power of attorney is filed with the Internal Revenue Service office with which such person is required to file returns and if such a return includes all taxes required to be reported by such person on such return. Form 8655, *Reporting Agent Authorization for Magnetic Tape/Electronic Filers*, is an acceptable power of attorney, if prepared in accordance with the requirements set forth in Rev. Proc. 96–17, 1996–1 C.B. 633, as modified by section 18 of this revenue procedure.

.04 Section 31.6061–1 provides that the return may be signed for the taxpayer by an agent that is fully authorized in accordance with section 31.6011(a)–7 to make such return. An agent may sign the Form 940 on behalf of a taxpayer that has a valid form on file with the Service.

.05 Section 301.6061–1 of the Regulations on Procedure and Administration provides that the Secretary may prescribe in forms, instructions, or other appropriate guidance the method for signing any return, statement, or other document required to be made under any provision of the internal revenue laws or regulations. The Service has prescribed in Publication 3715 that an electronically-filed Form 940 is signed by the entry of the Authorized Signatory's Personal Identification Number ("PIN").

.06 Section 31.6071(a)–1(c) generally provides that each return of the tax imposed by the Federal Unemployment Tax Act required to be made under section 31.6011(a)–3 must be filed on or before the last day of the first calendar month following the period for which it is made. However, that regulation also provides that a return may be filed on or before the 10th day of the second calendar month following the tax period if timely deposits under section 6302(c) of the Code and the regulations thereunder have been made in full payment of such tax due for the period.

.07 Procedures for the magnetic filing of Form 940 are in Rev. Proc. 96–18, 1996–1 C.B. 637, and the specifications are in Publication 1314. For further information, see Publication 1314, Form 940—Employer's Federal Unemployment Tax Return (FUTA): *File Specifications, Processing Criteria, and Record Layouts for Magnetic Tape Filing.*

SECTION 3. SCOPE

.01 The Form 940 *e-file* Program applies to electronically-filed Forms 940 for the year ending December 31, 2000, and thereafter that are timely filed. Late and/or amended Forms 940 must not be filed electronically. A violation of these restrictions may cause a Processing Interruption (as defined in section 4.10 of this revenue procedure). Late and/or amended Forms 940 must be filed by paper only.

.02 The Form 940 *e-file* Program applies only to the Form 940. The Form 940 *e-file* Program does **not** apply to the Form 940 (PR), *Employer's Annual Federal Unemployment (FUTA) Tax Return (Puerto Rican Version)* or the Form 940 EZ, *Employer's Annual Federal Unemployment (FUTA) Tax Return*. Do **not** file the listed forms electronically. Taxpayers who currently file a paper Form 940 EZ, however, may wish to electronically file a Form 940.

SECTION 4. DEFINITIONS

.01 *Form 940 e-file Program*. The program within "IRS *e-file* for Business" that provides two options for electronically filing Forms 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return:* 940 *e-file* Option and 940 On-Line Option.

.02 *940 e-file Option.* The option for electronically filing a Form 940 in the Form 940 *e-file* Program that allows taxpayers to use a Reporting Agent to prepare, sign and electronically file Form 940 for the taxpayer.

.03 *940 On-Line Option.* The option for electronically filing a Form 940 in the Form 940 *e-file* Program that allows taxpayers to use the World Wide Web, via a Transmitter, to electronically file Form 940.

.04 *Authorized Signatory*. An Authorized Signatory is a person who is authorized to use a PIN to sign returns filed by or through an Electronic Filer under the Form 940 *e-file* Program or during software development testing.

.05 *Electronic Filer.* An Electronic Filer may be a:

(1) *Reporting Agent*. A Reporting Agent ("Agent"), commonly called a "payroll service," is an accounting service, franchiser, bank, or other person that complies with Rev. Proc. 96–17, as modified by section 18 of this revenue procedure, and is authorized to prepare, sign, and electronically file a Form 940 for a taxpayer by using the 940 *e-file* Option of the Form 940 *e-file* Program;

(2) *Software Developer.* A Software Developer develops software for the purposes of (a) formatting returns according to the Service's electronic return specifications in Publication 3715; and/or (b) transmitting electronic returns directly to the Service. A Software Developer may also sell its software. A Software Developer may develop software for the 940 *e-file* Option and/or the 940 On-Line Option of the Form 940 *e-file* Program; or

(3) *Transmitter.* A Transmitter is a firm, organization, or individual that receives returns and Letters of Application electronically from its clients, reformats the data (if necessary), batches the data with returns or electronic Letters of Application from other clients, and then transmits the data to the Service. A Transmitter does not have signature authority for the taxpayers that it services. A Transmitter receives the data from its clients via the World Wide Web and transmits the data to the Service by using the On-Line Option of the Form 940 *e-file* Program.

.06 *On-Line Filer.* An On-Line Filer is a taxpayer that electronically files a Form 940 through a Transmitter using a personal computer, modem, and commercial tax preparation software.

.07 *Electronic Filing Help Desks* The Electronic Filing Help Desks ("*e-file*" Help Desks) in Austin, Texas, and in Memphis, Tennessee, are responsible for the administration of the Form 940 *e-file* Program. See section 17 of this revenue procedure for a description of their respective responsibilities, and the address and telephone number of each *e-file* Help Desk.

.08 *Letter of Application.* A Letter of Application ("LOA") is a paper or electronic request that is submitted to the Service by a prospective Electronic Filer or On-Line Filer to participate in the Form 940 *e-file* Program and, if submitted by an Authorized Signatory, to receive a Personal Identification Number. A sample LOA is printed in Publication 3715.

.09 *Personal Identification Number.* A Personal Identification Number ("PIN") is a number assigned by the Service to the Authorized Signatory for purposes of signing an electronically-filed Form 940.

.10 *Processing Interruption.* A Processing Interruption is an abnormal termination of a program run caused by the electronic data submitted by an Electronic Filer.

.11 *Reporting Agent Authorization.* A Reporting Agent Authorization ("Authorization") allows a taxpayer to designate an Agent. The Authorization may be submitted on Form 8655, or any other instrument that complies with Rev. Proc. 96–17, as modified by section 18 of this revenue procedure. An Authorization must be submitted for each taxpayer on the Reporting Agent's List.

.12 *Reporting Agent's List.* For purposes of the Form 940 *e-file* Program, a Reporting Agent's List ("Agent's List") identifies all taxpayers for whom an Agent will file Forms 940 electronically. A separate Authorization must be submitted for each taxpayer on the Agent's List. The Agent's List must contain each taxpayer's employer identification number ("EIN").

.13 *User identification/password.* The user identification/password ("userid/password") consists of an identification number (userid) issued by the Service and a confidential set of characters (password) that, when used in conjunction with each other, permit an Electronic Filer access to the Form 940 *e-file* Program.

.14 *Validated Reporting Agent's List.* A Validated Reporting Agent's List ("Validated Agent's List") is a list of taxpayers and their EINs prepared by an Agent that is confirmed and assigned name controls by the Service. A Validated Agent's List is to be used as a source for the identification of each taxpayer by an Electronic Filer that is an Agent. Once the Service returns a Validated Agent's List, the Agent must use it to fill in certain required fields (for example, the name control field) of the electronic transmission. See Publication 3715.

SECTION 5. APPLICATION FOR THE FORM 940 e-file PROGRAM

.01 A prospective Electronic Filer must first submit an LOA to the Service to participate in the Form 940 *e-file* Program. The LOA of a prospective Electronic Filer may be submitted electronically or by paper. See Publication 3715 for a sample LOA for an Agent, a Software Developer, and a Transmitter, and the application procedures.

.02 A prospective On-Line Filer must submit an electronic LOA through a Transmitter to participate in the Form 940 *e-file* Program. A prospective On-Line Filer must use the electronic LOA provided in the commercial tax preparation software used by the taxpayer in order to participate in the Form 940 *e-file* Program. The Transmitter is required to batch and bundle the electronic LOA files, and then transmit those files to the Service. The Transmitter is required to send an acknowledgment to the On-Line Filer to verify that the electronic LOA was transmitted successfully to the Service.

.03 In addition to the LOA, an Agent must also include an Agent's List, providing the names of all taxpayers for which it will file returns. Each name on the Agent's List must be accompanied by an Authorization made on Form 8655, or acceptable substitute, except as provided in section 5.04 of this revenue procedure. See Rev. Proc. 96–17, as modified by section 18 of this revenue procedure, for general instructions on preparing Form 8655. See section 6.10 of this revenue procedure for instructions on adding names to, or deleting names from, the Agent's List.

.04 A revised Authorization is not required to replace an Authorization made on Form 8655 with a revision date before October 1995 (or its equivalent) that was previously submitted to the Service by an Agent, if the Authorization places no restriction on the medium for filing Form 940, and the Agent:

(1) advises its client that its Forms 940 may be filed electronically, and provides the client with the option of rejecting electronic filing as the medium for filing its Forms 940. An Agent may use the most efficient and timely method of clearly providing this notification to a client. A client's rejection of electronic filing for its Forms 940 must be submitted in writing to the Agent; and

(2) immediately removes from its electronic filing client base any client that rejects having its Forms 940 filed electronically.

SECTION 6. ACCEPTANCE IN THE FORM 940 *e-file* PROGRAM

.01 A prospective Electronic Filer or On-Line Filer will receive an acceptance or rejection regarding its LOA for the Form 940 *e-file* Program within 45 days of the Service's receipt of their completed LOA.

.02 An Electronic Filer that is accepted in the Form 940 *e-file* Program will be required to submit a successful test transmission before being granted approval to file tax returns. Details regarding test requirements may be found in Publication 3715.

.03 After evaluating the test file, the Service will notify an Electronic Filer in writing of approval or denial of electronic filing privileges. An approval remains in effect unless the Electronic Filer:

(1) that is an Agent fails to comply with the Authorization requirements of sections 5.03 and 5.04 of this revenue procedure;

(2) that is a Software Developer fails to comply with the requirements of section 8.04 of this revenue procedure;

(3) that is a Transmitter fails to comply with the requirements of section 8.03 of this revenue procedure; or

(4) is suspended from the Form 940 *e-file* Program. See section 14 of this rev-

enue procedure for the effect of a suspension.

.04 The acceptance by the Service of a Software Developer as an Electronic Filer:

(1) establishes only that the test electronic transmission(s) are formatted properly and may be processed by the Service;

(2) is not an endorsement by the Service of the software or the quality of services provided by the Software Developer; and

(3) does not entitle the Software Developer to electronically file Forms 940 unless the Software Developer is also accepted in the Form 940 *e-file* Program as an Agent or Transmitter.

.05 If an LOA is approved, the Service will send the following:

(1) for an Electronic Filer, a notification of approval that will contain the userid/password, and information and procedures regarding signing onto the system for electronically filing Forms 940; and

(2) for an Authorized Signatory, a PIN that may be used only by the Authorized Signatory named in the LOA.

.06 Upon receipt of the document(s) referenced in section 6.05 of this revenue procedure, the Electronic Filer must return the following documents to the Service:

(1) an acknowledgment signed by each employee recipient of the userid/password indicating possession of, and responsibility for, the userid/password; and

(2) where applicable, an acknowledgment signed by the Authorized Signatory indicating possession of, and responsibility for, the proper use of the PIN for signing tax returns (pursuant to § 301.6061–1) filed in the Form 940 *e-file* Program.

See Publication 3715 for a sample userid/password and PIN receipt.

.07 Upon receipt of the PIN referenced in section 6.05(2) of this revenue procedure, the On-Line Filer must return an acknowledgment signed by the Authorized Signatory indicating possession of, and responsibility for, the proper use of the PIN for signing tax returns (pursuant to § 301.6061–1) filed in the Form 940 *e-file* Program.

.08 The Service will activate the userid/password and the PIN upon receiving the Electronic Filer's or On-Line Filer's acknowledgments referenced in sections 6.06 and 6.07 of this revenue procedure.

.09 If a prospective Electronic Filer that is an Agent is denied, or does not receive, approval to participate in the Form 940 *e-file* Program before the end of the year for which the Forms 940 will be filed, the Agent may file the Forms 940 on magnetic tape (if the Agent meets the requirements of Rev. Proc. 96–18) or prepare paper Forms 940. See section 9.02 of this revenue procedure for the circumstances that must exist for an Electronic Filer who is an Agent to use a Form 8655 as authority to sign and file a paper Form 940.

.10 After a Reporting Agent is notified that the application for electronically filing Forms 940 has been approved, the Agent may need to add and delete taxpayers' names from the Agent's List.

(1) To add taxpayers, the Agent must submit an Add Llist with names to be added, their respective employer identification numbers, and Authorization for each taxpayer added to the Agent's List. The Service will validate and mail the validated Add List to the Agent within 10 business days of receiving the Add List.

(2) To delete taxpayers, the Agent must submit a Delete List with the names to be deleted, and if known, a short statement indicating which taxpayers will not remain in business.

SECTION 7. ELECTRONIC FILING OF FORM 940

.01 An Electronic Filer that is an Agent must ensure that a current electronic Form 940 is filed on or before the due date of the return. The due dates prescribed for filing paper Forms 940 with the Service also apply to returns filed under the Form 940 *e-file* Program. Forms 940 are due on or before the last day of the first calendar month following the calendar year for which the return is made. However, a return for which all tax deposits were made when due may be filed by the 10th day of the second calendar month following the end of the calendar year.

.02 An Electronic Filer that is a Transmitter must ensure that an electronic Form 940 is transmitted to the Service on or before the due date of the return, as described in sec. 7.01, without regard to extensions.

.03 An electronically-filed Form 940 is not considered filed until it has been acknowledged as accepted for processing by the Service. If an electronically-filed Form 940 is transmitted to the Service on or before the return due date, and acknowledged as accepted for processing, the return will be deemed timely filed. If an electronically-filed Form 940 is initially transmitted to the Service on or before the return due date and is ultimately rejected, but the Electronic Filer complies with section 7.04 or 7.05 of this revenue procedure, as appropriate, and the On-Line Filer also complies with section 7.06 of this revenue procedure, the return will be deemed timely filed.

.04 An electronic transmission that causes a Processing Interruption will not be accepted for processing by the Service. An Electronic Filer that is an Agent will be asked to resubmit the return(s). If the electronic transmission is acknowledged as rejected by the Service, the Agent should correct the error(s) and retransmit the return(s) on the same calendar day. If the Agent chooses not to have the previously-rejected return retransmitted, or if the return still cannot be accepted for processing, a paper Form 940 (or a Form 940 on magnetic tape if the Electronic Filer meets the requirements of Rev. Proc. 96–18) must be filed by the later of: (1) the due date of the return; or (2) within five calendar days of the rejection or notice that the return cannot be retransmitted, with an explanation of why the return is being filed after the due date. For the penalty for failure to file a timely return, see section 16 of this revenue procedure.

.05 If a Processing Interruption occurs with an Electronic Filer that is a Transmitter, and the Transmitter cannot promptly correct any transmission error that causes an electronic transmission to be rejected, then the Transmitter, within 24 hours of receiving the rejection acknowledgment, must take reasonable steps to inform the On-Line Filer that the return has not been filed. When the Transmitter advises the On-Line Filer that the return has not been filed, the Transmitter must provide the On-Line Filer with the reject code(s), an explanation of the reject code(s), and the sequence number of each reject code(s). See Publication 3715 for an explanation of the reject codes.

.06 If the On-Line Filer chooses not to have the electronic portion of the return corrected and transmitted to the Service, or if the electronic portion of the return cannot be accepted for processing by the Service, the On-Line Filer must file a paper Form 940 by the later of: (1) the due date of the return; or (2) within five calendar days of the rejection acknowledgment described in section 7.05, with an explanation of why the return is being filed after the due date. For the penalty for failure to file a timely return, see section 16 of this revenue procedure.

SECTION 8. RESPONSIBILITIES OF PARTICIPANTS IN FORM 940 *e-file* PROGRAM

.01 To ensure that complete returns are accurately and efficiently filed, Electronic Filers must comply with the technical specifications detailed in Publication 3715.

.02 An Electronic Filer or On-Line Filer must comply with the following applicable userid/password and PIN requirements:

(1) if an Electronic Filer suspects that the confidentiality of the userid/password has been compromised, the Electronic Filer must contact the Austin, Texas, *e-file* Help Desk within 24 hours for instructions on how to proceed. See section 17 of this revenue procedure for Service contact information;

(2) the Electronic Filer or On-Line Filer is responsible for ensuring that the PIN remains the confidential information of the Authorized Signatory. If the Electronic Filer or On-Line Filer suspects that the confidentiality of the PIN has been compromised, the Electronic Filer or On-Line Filer must contact the Austin, Texas, *e-file* Help Desk within 24 hours for instructions on how to proceed. See section 17 of this revenue procedure for Service contact information;

(3) if the Authorized Signatory changes, the Electronic Filer or On-Line Filer must notify the Service of the name and title of the new Authorized Signatory for the electronically-filed Form 940 and apply for a new PIN no later than 15 days before the filing of another return. After this notification, the Service will deactivate the current PIN and issue a new PIN to the new Authorized Signatory. The new Authorized Signatory must submit a PIN receipt as specified in section 6.06 or 6.07 of this revenue procedure in order to activate the new PIN; and

(4) the Authorized Signatory must manually enter the PIN signature for each transmission of electronically-filed Forms 940.

.03 An Electronic Filer that is a Transmitter must:

(1) retrieve the acknowledgment file (in which the Service states whether it accepts or rejects the electronic portion of a taxpayer's return for processing) within two work days of transmission;

(2) match the acknowledgment file to the original transmission file and send to the On-Line Filer either:

(a) an acceptance notice within two days of retrieving the acknowledgment file; or

(b) a rejection notice within 24 hours of retrieving the acknowledgment file;

(3) immediately contact the appropriate service center for further instructions if an acknowledgment of acceptance for processing has not been received by the Transmitter within two work days of transmission or if a Transmitter receives an acknowledgment for a return that was not transmitted on the designated transmission;

(4) promptly correct any transmission error that causes an electronic transmission to be rejected; and

(5) ensure the security of all transmitted data.

.04 An Electronic Filer that is a Software Developer must:

(1) promptly correct any software error that may cause, or causes, an electronic return to be rejected;

(2) promptly distribute any such software correction;

(3) ensure that any software package that will be used to transmit returns from multiple Electronic Filers that are Agents has the capability of combining these returns into one Service transmission file; and

(4) not incorporate into its software a Service-assigned PIN.

.05 An Agent must retain the following material for four years after the due date of the return, unless otherwise notified by the Service:

(1) a complete copy of the electronically-filed Form 940;

(2) a copy of the Service's acknowledgement of receipt of the return; and

(3) a copy of each Authorization.

.06 An Electronic Filer that is an Agent or a Transmitter must:

(1) provide the taxpayer with a copy of the taxpayer's electronically-filed Form 940. This information may be provided on a replica or an official form or in any other format that provides all of the return information and references the line numbers of the official form);

(2) advise the taxpayer to retain a copy of the return and any supporting material; and

(3) provide the taxpayer, upon request, with the date the return was transmitted to the Service and the date the Service acknowledged receipt of the taxpayer's return.

SECTION 9. ALTERNATIVE FILING PROCEDURES

.01 Procedures for the filing of Form 940 on magnetic tape are in Rev. Proc. 96–18 and the specifications are in Publication 1314.

.02 An Electronic Filer that is an Agent may use an Authorization to sign and file a paper Form 940 under the following circumstances:

(1) the late receipt of payroll information from a taxpayer would jeopardize the timely submission of the taxpayer's return;

(2) the amendment of returns filed under the Form 940 *e-file* Program;

(3) the rejection of an electronic transmission that would jeopardize the timely submission of the taxpayer's return;

(4) an authorization by the Service for an Agent to file paper Forms 940 instead of electronically-filed Forms 940;

(5) the suspension of an Agent from the Form 940 e-file Program as provided in section 14.02(3) of this revenue procedure; or

(6) a prospective Electronic Filer that is an Agent is denied, or does not receive, approval to participate in the Form 940 e-file Program before the end of the year for which the Forms 940 will be filed.

.03 An Agent may prepare a paper Form 940 for the taxpayer's signature. A taxpayer's authorized representative that is not an Agent participating in the Form 940 *e-file* Program (including a suspended Agent) must have a valid power of attorney (usually a Form 2848, Power of Attorney and Declaration of Representative) that authorizes the representative to sign and file a paper Form 940 on behalf of a taxpayer.

.04 Each paper Form 940 must be signed by the taxpayer, the taxpayer's authorized representative, or a participating Agent to the extent permitted under section 9.02 of this revenue procedure.

SECTION 10. REVISION OF COMPUTER SPECIFICATIONS BY THE SERVICE

.01 If Publication 3715 is revised, the Service, if necessary, will advise all current Electronic Filers to submit test files prior to filing under the new specifications. Failure to submit a test file may later result in a Processing Interruption, which may result in a notice of suspension. See section 12 of this revenue procedure concerning the reasons for suspension of electronic filing privileges.

.02 If an Electronic Filer is unable to comply with the changes in specifications, the Electronic Filer must contact the appropriate *e-file* Help Desk for further instructions. See section 17 of this revenue procedure for Service contact information.

SECTION 11. ADVERTISING STANDARDS

.01 An Electronic Filer must:

(1) comply with the advertising and solicitation provisions of 31 CFR Part 10 (Treasury Department Circular No. 230). This circular prohibits the use or participation in the use of any form of public communication containing a false, fraudulent, misleading, deceptive, unduly influencing, coercive, or unfair statement or claim. In addition, advertising must not imply a special relationship with the Service, Financial Management Service ("FMS"), or the Treasury Department;

(2) adhere to all relevant federal, state, and local consumer protection laws;

(3) not use the Service's name, "Internal Revenue Service" or "IRS", within a firm's name;

(4) not use improper or misleading advertising in relation to the Form 940 *e-file* Program;

(5) not carry the Service, FMS, or other Treasury Seals on its advertising material;

(6) clearly state the names of all cooperating parties if advertising for a cooperative electronic return filing project (public/private sector);

(7) pre-record any radio or television advertisement and keep a copy of this advertisement for a period of at least 36 months from the date of the last transmission or use; and

(8) retain a copy of any actual direct mailing or fax communications, along with a list or other description of persons to whom the communication was mailed, faxed, or otherwise distributed for a period of at least 36 months from the date of the last mailing, fax, or distribution.

.02 Acceptance to participate in the Form 940 *e-file* Program does not imply endorsement by the Service, FMS, or the Treasury Department of the software or quality of services provided.

SECTION 12. REASONS FOR SUSPENSION

.01 The Service reserves the right to suspend an Electronic Filer from the Form 940 *e-file* Program for the following reasons (this list is not all-inclusive):

(1) submitting tax returns for which the Service did not receive Authorizations;

(2) repeatedly submitting tax returns that cause a Processing Interruption;

(3) submitting tax returns that cause a Processing Interruption after failing to submit the test file required by section 6.02 of this revenue procedure;

(4) failing to comply with the responsibilities of an Electronic Filer set forth in section 8 of this revenue procedure;

(5) failing to abide by the advertising standards in section 11 of this revenue procedure; or

(6) significant complaints about an Electronic Filer's performance in the Form 940 *e-file* Program.

.02 If the Electronic Filing Coordinator informs an Electronic Filer that a certain action is a reason for suspension and the action continues, the service center director may send the Electronic Filer a notice proposing suspension of the Electronic Filer. However, a notice proposing suspension may be sent without a warning if the Electronic Filer's action indicates an intentional disregard of rules. A notice proposing suspension will describe the reason(s) for the proposed suspension, and indicate the length of the suspension and the conditions that need to be met before the suspension will terminate.

.03 An Electronic Filer that is an Agent or Transmitter has an obligation to notify its Form 940 *e-file* Program clients when that Agent or Transmitter is suspended from filing under the Form 940 *e-file* Program as provided in sections 14.02(4) and 14.03 of this revenue procedure. The Service reserves the right to extend the period of suspension of any Agent or Transmitter that fails to comply with this requirement.

SECTION 13. ADMINISTRATIVE REVIEW PROCESS FOR PROPOSED SUSPENSION

.01 An Electronic Filer that receives a notice proposing suspension may request an administrative review prior to the proposed suspension taking effect.

.02 The request for an administrative review must be in writing and contain detailed reasons, with supporting documentation, for withdrawal of the proposed suspension.

.03 The written request for an administrative review and a copy of the notice proposing suspension must be delivered to the Electronic Filing Coordinator within 30 calendar days of the date on the notice proposing suspension. The Electronic Filing Coordinator will forward the written request to the National Program Analyst for Electronic Filing of Business Returns ("National Coordinator") if the service center director continues to believe that suspension is warranted.

.04 After consideration of the written request for an administrative review, the National Coordinator will either issue a suspension letter or notify the Electronic Filer in writing that the proposed suspension is withdrawn.

.05 If an Electronic Filer receives a suspension letter, the Electronic Filing Coordinator's subsequent determination of whether a reason for suspension has been corrected is not subject to review or appeal.

.06 If an Electronic Filer does not timely submit a written request for an administrative review, the service center director will issue a suspension letter.

.07 Failure to submit a written request for an administrative review within the 30-day period described in section 13.03 of this revenue procedure irrevocably terminates the Electronic Filer's right to an administrative review of the proposed suspension.

SECTION 14. EFFECT OF SUSPENSION

.01 An Electronic Filer's suspension will continue for the length of time specified in the suspension letter, or until the conditions for terminating the suspension have been met, whichever is later.

.02 In the case of an Electronic Filer that is an Agent, the following additional rules apply:

(1) if a Form 940 is due (without regard to extensions) within 60 days from the date on the suspension letter, the Agent may file the Form 940 under the Form 940 *e-file* Program;

(2) if a Form 940 is due (without regard to extensions) more than 60 days from the date on the suspension letter, the Agent may not file the Form 940 under the Form 940 *e-file* Program;

(3) if a suspended Agent has a power of attorney from a taxpayer that authorizes the Agent to sign and file Form 940, the suspended Agent will be able to sign and file a paper Form 940 for the taxpayer. See section 9.03 of this revenue procedure. Form 8655 does not authorize the filing of paper Forms 940 outside of the Form 940 *e-file* Program; and

(4) an Agent must provide written notification of a suspension to a taxpayer at least 45 days before the due date of the taxpayer's first return affected by the suspension. This notification must be provided even though the Agent may believe that the Agent will be able to meet the conditions for terminating the suspension before the due date.

.03 A Transmitter that receives a suspension letter described in section 13.04 from the Service may not accept any further LOAs from prospective On-Line Filers that want to participate in the Form 940 *e-file* Program and must immediately inform current On-Line Filers of its inability to transmit Forms 940 during its suspension

.04 An Electronic Filer will be able to participate in the Form 940 *e-file* Program from which the Electronic Filer was suspended, without reapplying to the Form 940 *e-file* Program, after:

(1) the stated suspension period expires; and

(2) the reason(s) for suspension is corrected.

SECTION 15. APPEAL OF SUSPENSION

.01 If an Electronic Filer receives a suspension letter from the National Coordinator, the Electronic Filer is entitled to appeal, by written protest, to the National Director of Appeals. The written protest must be sent to the National Coordinator, who will forward it to the National Director of Appeals. During the appeals process, the suspension remains in effect.

.02 The written protest must be received by the National Coordinator within 30 calendar days of the date of the suspension letter. The written protest must contain detailed reasons, with supporting documentation, for termination of the suspension.

.03 Within 15 calendar days of receipt of a written protest, the National Coordinator will forward the file on the Electronic Filer and the material described in section 15.02 of this revenue procedure to the National Director of Appeals.

.04 Failure to appeal within the 30-day period described in section 15.02 of this revenue procedure irrevocably terminates the Electronic Filer's right to appeal the suspension.

SECTION 16. PENALTY FOR FAILURE TO TIMELY FILE A RETURN

Section 6651(a)(1) provides that for each month (or part thereof) a return is not filed when required (determined with regard to any extensions of time for filing), there is a penalty of 5 percent of the unpaid tax not to exceed 25 percent, absent reasonable cause. A taxpayer does not establish reasonable cause simply by engaging a competent Electronic Filer to file the taxpayer's return. However, if the Electronic Filer has reasonable cause under § 6651(a) for failing to timely file the taxpayer's return, the taxpayer will also have reasonable cause for that failure, and the failure-to-file penalty will be abated.

SECTION 17. INTERNAL REVENUE SERVICE CONTACT

.01 The responsibility for the Form 940 *e-file* Program is divided between the Electronic Filing Help Desk of the Austin Service Center and the Memphis Electronic Filing Desk. Questions should be directed to the appropriate Electronic Filing Help Desk as follows:

(1) All questions regarding application to the Form 940 *e-file* Program, acceptance into the Form 940 *e-file* Program, userid/passwords, and PINs should be directed to the Austin Service Center *e-file* Help Desk at the following address or telephone number:

Address
Internal Revenue Service
Austin Service Center
Electronic Filing Help Desk
P.O. Box 1231
Stop 6380 AUSC
Austin, TX 78767
Attention: Electronic Filing

Telephone Number:
(512) 460-8900 (not a toll-free number)

(2) All questions regarding the 940 On-Line Option (that allows taxpayers to use the World Wide Web, via a Transmitter, to file Form 940 electronically) should be directed to the Austin Service Center *e-file* Help Desk at the address or telephone number identified in section 17.01(1) of this revenue procedure.

(3) All questions concerning the 940 *e-file* Option (that allows taxpayers to use a Reporting Agent to prepare, sign and electronically file Form 940 for the taxpayer), except those matters identified in section 17.01(1) of this revenue procedure, should be directed to the Memphis Electronic Help Desk at the following address or telephone number:

Address
Memphis Electronic Filing Desk
P.O. Box 30309 AMF
Memphis, TN 38130
ATTN: ELF Unit Stop 26

Telephone Number
(901) 546-2690 Ext. 7519

.02 General information about electronic filing of tax forms can be found at the following web site:

Web site for electronic services:
www.irs.gov/prod/elec_svs

.03 All questions regarding publications may be directed to the following web site:

Web site for publications:
www.irs.gov/forms_pubs

SECTION 18 EFFECT ON OTHER DOCUMENTS

Section 6.05 of Rev. Proc. 96–17, 1996–1 C.B. 633, is modified to provide the same relief as set forth in section 5.04 of this revenue procedure (regarding an Agent not having to replace a previously submitted Authorization under certain circumstances).

SECTION 19. EFFECTIVE DATE

This revenue procedure is effective for taxable years commencing after December 31, 1999.

SECTION 20. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1710.

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

The collections of information in this revenue procedure are in sections 5, 6, 7, 8, 10, and 11. This information is required by the Service to implement the Form 940 *e-file* Program and to enable taxpayers to file their Forms 940 electronically. The information will be used to ensure that taxpayers receive accurate and essential information regarding the filing of their electronic returns and to identify persons involved in the filing of electronic returns. The collections of information are required to retain the benefit of participating in the Form 940 *e-file* Program. The likely respondents are business or other for-profit institutions; federal, state or local governments; nonprofit institutions; and small businesses or organizations.

The estimated total annual reporting and recordkeeping burden is 207,127 hours. The estimated annual burden per respondent/recordkeeper varies from 10 minutes to 5 hours, depending on individual circumstances, with an estimated average of 32 minutes. The estimated number of respondents and recordkeepers is 390,685. The estimated annual frequency of responses is on occasion.

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

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26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability. (Also Part I, §§ 860E, 860H; 1.860E–1.)

Rev. Proc. 2001–12

SECTION 1. PURPOSE

This revenue procedure sets forth a safe harbor for establishing the lack of improper knowledge under § 1.860E–1(c) of the Income Tax Regulations for transfers of noneconomic residual interests in real estate mortgage investment conduits (REMICs) and ownership interests in Financial Asset Securitization Investment Trusts (FASITs).

SECTION 2. BACKGROUND

The current regulations governing REMICs contain rules governing the transfer of noneconomic residual interests in REMICs. In general, a transfer of a noneconomic residual interest is disregarded for all tax purposes if a significant purpose of the transfer is to enable the transferor to impede the assessment or collection of tax. This purpose exists if the transferor, at the time of the transfer, either knew or should have known that the transferee would be unwilling or unable to pay taxes due on its share of the REMIC's taxable income.

The current regulations also contain a safe harbor for establishing the lack of a purpose to impede the assessment or collection of tax. Under the safe harbor, a transferor of a noneconomic residual interest in a REMIC is presumed to lack this purpose if two requirements are satisfied. First, the transferor must conduct a reasonable investigation of the transferee's financial condition. Second, the transferor must secure a representation from the transferee stating that the transferee understands the tax obligations associated with holding a residual interest and intends to pay those taxes.

The Internal Revenue Service and Treasury have been concerned that some transferors of residual interests have claimed they satisfy the safe harbor even though the economics of a transfer clearly indicate the transferees are unwilling or unable to pay the tax associated with holding the interest. For this reason, on February 7, 2000, the Service published in the Federal Register a notice of proposed rulemaking (65 Fed. Reg. 5807) designed to clarify the safe harbor. The proposed regulation explains that the safe harbor is unavailable unless the present value of the anticipated tax liabilities associated with holding the residual interest does not exceed the sum of: (1) the present value of any consideration given to the transferee to acquire the interest; (2) the present value of the expected future distributions on the interest; and (3) the present value of the anticipated tax savings associated with holding the interest as the REMIC generates losses. This clarification is proposed to be effective on February 4, 2000. The notice of proposed rulemaking published on February 7, 2000 also contained proposed rules for FASITs. Proposed § 1.860H–6(g) provides requirements for transfers of FASIT ownership interests and adopts a safe harbor for establishing lack of improper knowledge by reference to the safe harbor provisions of the REMIC regulations.

Some commentators have stated that, although current regulations are inadequate, the proposed regulations are inappropriately restrictive. This revenue procedure sets forth an alternate safe harbor that may be used while the Service and Treasury consider the comments on the proposed regulations.

SECTION 3. SCOPE

This revenue procedure applies to all transfers of noneconomic residual interests in REMICs. The principles set forth in this revenue procedure, appropriately adjusted with respect to terminology and other technical differences between the REMIC and FASIT provisions, also apply to transfers of ownership interests in FASITs. See section 8 for applicability.

SECTION 4. PROCEDURE

A transferor of a residual interest in a REMIC is presumed not to have improper knowledge under § 1.860E–1(c) of the regulations if–

.01 The transferor conducted, at the time of the transfer, a reasonable investigation of the financial condition of the transferee and, as a result of the investigation, the transferor found that the transferee had historically paid its debts as they came due and found no significant evidence to indicate that the transferee will not continue to pay its debts as they come due in the future;

.02 The transferee represents to the transferor that it understands that, as the holder of the residual interest, the transferee may incur tax liabilities in excess of any cash flows generated by the interest and that the transferee intends to pay taxes associated with holding the residual interest as they become due; and

.03 Either section 5 or section 6 is satisfied.

SECTION 5. FORMULA TEST

.01 The present value of the anticipated tax liabilities associated with holding the residual interest does not exceed the sum of–

(1) The present value of any consideration given to the transferee to acquire the interest;

(2) The present value of the expected future distributions on the interest; and

(3) The present value of the anticipated tax savings associated with holding the interest as the REMIC generates losses.

.02 For purposes of section 5.01 of this revenue procedure, both of the following rules apply:

(1) The transferee is assumed to pay tax at a rate equal to the highest rate of tax specified in § 11(b)(1) of the Internal Revenue Code; and

(2) Present values are computed using a discount rate equal to the applicable Federal rate prescribed by § 1274(d) compounded semiannually. (A lower discount rate may be used if the transferee can demonstrate that it regularly borrows, in the course of its trade or business, substantial funds at such lower rate from unrelated third parties.)

SECTION 6. ASSET TEST

.01 The following three requirements must be satisfied–

(1) At the time of the transfer, and at the close of each of the transferee's two fiscal years preceding the year of transfer, the transferee's gross assets for financial reporting purposes exceed $100 million and its net assets for financial reporting purposes exceed $10 million;

(2) The transferee is an eligible corporation (as defined in § 860L(a)(2)) that makes a written agreement that any subsequent transfer of the interest will be to another eligible corporation in a transaction that satisfies section 4; and

(3) The facts and circumstances known to the transferor on or before the date of the transfer must not reasonably indicate that the taxes associated with the residual interest will not be paid. The consideration given to the transferee to acquire the noneconomic residual interest in the REMIC is only one factor to be considered. However, if the amount of consideration is so low that under any set of reasonable assumptions a reasonable person would conclude that the taxes associated with holding the residual interest will not be paid, then the transferor is deemed to know that the transferee cannot or will not pay. In determining whether the amount is too low, the specific terms of the formula test in section 5 of this revenue procedure need not be used.

.02 For purposes of section 6.01 of this revenue procedure, all of the following rules apply:

(1) The gross assets and net assets of a transferee do not include any obligation of any person related to the transferee (as defined in § 860L(g)) or any other asset if a principal purpose for holding or acquiring that asset is to permit the transferee to satisfy section 6 of this revenue procedure;

(2) A transfer fails to meet the requirements of section 6 of this revenue procedure if the transferor knows, or has reason to know, that the transferee will not honor the restrictions on subsequent transfers of the residual interest; and

(3) Section 6.01(2) fails to be satisfied in the case of any transfer or assignment of the interest to a foreign branch of an eligible corporation or any other arrangement by which the interest is at any time subject to net tax by a foreign country or possession of the United States.

SECTION 7. EXAMPLES

.01 *Example 1. Transfer to partnership.* *X* transfers a noneconomic residual interest in a REMIC to Partnership *P*. *Y* and *Z* are the partners of *P*. The transfer does not satisfy the formula test of section 5. Even if *Y* and *Z* are eligible corporations that satisfy section 6.01(1) and that make the written agreement in section 6.01(2), the transfer fails to qualify under section 4 because *P* is a partnership rather than an eligible corporation.

.02 *Example 2. Transfer to corporation without capacity to carry additional residual interests.* During the first ten months of a year, Bank transfers five residual interests to Corporation *U* under circumstances meeting the requirements of section 6. Bank is the major creditor of *U* and for that reason has access to *U*'s financial records. During the last month of the year, Bank transfers three additional residual interests to *U*. At the time of transfer, *U*'s financial records indicate it has retained the previously transferred residual interests. Bank has knowledge of *U*'s financial circumstances, including the aggregate tax liabilities it has assumed with respect to REMIC residual interests, that would reasonably cause Bank to conclude that *U* will be unable to meet its tax liabilities when due. The transfers in the last month of the year fail to satisfy section 4 and 6.01(3) because Bank has reason to know that *U* will not be able to pay the tax due on those interests.

SECTION 8. EFFECTIVE DATE

This revenue procedure applies to all transfers of noneconomic residual interests in REMICs and all transfers of FASIT ownership interests occurring on or after February 4, 2000, until the date specified in future published guidance.

DRAFTING INFORMATION

A principal author of this revenue procedure is Courtney Shepardson of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue procedure contact Courtney Shepardson at (202) 622-3940 (not a toll-free call).

26 CFR 601.602: Tax forms and instructions.
(Also Part I, §§ 1, 32, 59, 63, 68, 132, 135, 151, 170, 213, 220, 512, 513, 685, 877, 2032A, 2503, 2523, 2631, 4001, 4003, 4261, 6033, 6039F, 6323, 6334, 6601, 7430, 7702B)

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Table of Contents

SECTION 1. PURPOSE

This revenue procedure sets forth inflation adjusted items for 2001.

SECTION 2. CHANGES

.01 This revenue procedure reflects the unpublished corrections made by the Bureau of Labor Statistics (BLS) in the Consumer Price Index for All Urban Consumers (CPI-U) for September 1999 through December 1999 that will be required if the Taxpayer Relief Act of 2000 is enacted. The 2000 Act passed the House as H.R. 2614 on October 26, 2000. A provision having the same effect is contained in the Community Renewal Tax Relief Act of 2000 pending in the Congress as of the date of publication of this revenue procedure. Specific items that would be affected by the legislation are:

(1) the tax rate tables (set forth in section 3.01 of this revenue procedure);

(2) certain figures relating to the earned income tax credit (section 3.03);

(3) the aggregate amount of gifts received from foreign persons for purposes of information reporting § 6039F (section 3.22); and

(4) the amount used to determine the validity of certain tax liens under § 6323(b)(7) (section 3.23).

.02 Part I of section 3 of this revenue procedure reflects the figures that will apply if the legislation is enacted. Part II of section 3 provides the alternative figures for items affected by the legislation that will apply in the event that the 2000 Act is not enacted. The Service will issue subsequent notification clarifying whether the amounts set forth in Part I or Part II are applicable for 2001.

.03 There are no changes from the preceding year in the list of items adjusted.

SECTION 3. 2001 ADJUSTED ITEMS

Part I – Inflation-adjusted Items Applicable if Pending Legislation is Enacted

.01 *Tax Rate Tables*. For tax years beginning in 2001, the tax rate tables under § 1 are as follows:

TABLE 1 - Section 1(a). — MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES

If Taxable Income Is:	The Tax Is:
Not Over $45,200	15% of the taxable income
Over $45,200 but not over $109,250	$6,780.00 plus 28% of the excess over $45,200
Over $109,250 but not over $166,500	$24,714.00 plus 31% of the excess over $109,250
Over $166,500 but not over $297,350	$42,461.50 plus 36% of the excess over $166,500
Over $297,350	$89,567.50 plus 39.6% of the excess over $297,350

TABLE 2 - Section 1(b). — HEADS OF HOUSEHOLDS

If Taxable Income Is:	The Tax Is:
Not Over $36,250	15% of the taxable income
Over $36,250 but not over $93,650	$5,437.50 plus 28% of the excess over $36,250
Over $93,650 but not over $151,650	$21,509.50 plus 31% of the excess over $93,650
Over $151,650 but not over $297,350	$39,489.50 plus 36% of the excess over $151,650
Over $297,350	$91,941.50 plus 39.6% of the excess over $297,350

TABLE 3 - Section 1(c). — UNMARRIED INDIVIDUALS (OTHER THAN SURVIVING SPOUSES AND HEADS OF HOUSEHOLDS)

If Taxable Income Is:	The Tax Is:
Not Over $27,050	15% of the taxable income
Over $27,050 but not over $65,550	$4,057.50 plus 28% of the excess over $27,050
Over $65,550 but not over $136,750	$14,837.50 plus 31% of the excess over $65,550
Over $136,750 but not over $297,350	$36,909.50 plus 36% of the excess over $136,750
Over $297,350	$94,725.50 plus 39.6% of the excess over $297,350

TABLE 4 - Section 1(d). — MARRIED INDIVIDUALS FILING SEPARATE RETURNS

If Taxable Income Is:	The Tax Is:
Not Over $22,600	15% of the taxable income
Over $22,600 but not over $54,625	$3,390.00 plus 28% of the excess over $22,600
Over $54,625 but not over $83,250	$12,357.00 plus 31% of the excess over $54,625
Over $83,250 but not over $148,675	$21,230.75 plus 36% of the excess over $83,250
Over $148,675	$44,783.75 plus 39.6% of the excess over $148,675

TABLE 5 - Section 1(e). — ESTATES AND TRUSTS

If Taxable Income Is:	The Tax Is:
Not Over $1,800	15% of the taxable income
Over $1,800 but not over $4,250	$270.00 plus 28% of the excess over $1,800
Over $4,250 but not over $6,500	$956.00 plus 31% of the excess over $4,250
Over $6,500 but not over $8,900	$1,653.50 plus 36% of the excess over $6,500
Over $8,900	$2,517.50 plus 39.6% of the excess over $8,900

.02 *Unearned Income of Minor Children Taxed as if Parent's Income (the "Kiddie Tax").* For tax years beginning in 2001, the amount in § 1(g)(4)(A)(ii)(I), which is used to reduce the net unearned income reported on the child's return that is subject to the "kiddie tax," is $750. (This amount is the same as the $750 standard deduction amount provided in section 3.05(2) of this revenue procedure.) The same $750 amount is used for purposes of § 1(g)(7) (that is, determining whether a parent may elect to include a child's gross income in the parent's gross income and for calculating the "kiddie tax").

.03 *Earned Income Tax Credit.*

(1) *In general.* For tax years beginning in 2001, the following amounts are used to determine the earned income tax credit under § 32(b). The "earned income amount" is the amount of earned income at or above which the maximum amount of the earned income tax credit is allowed. The "threshold phaseout amount" is the amount of modified adjusted gross income (or, if greater, earned income) above which the maximum amount of the credit begins to phase out. The "completed phaseout amount" is the amount of modified adjusted gross income (or if greater, earned income) at or above which no credit is allowed.

Number of Children	*Maximum Amount of the Credit*	*Earned Income Amount*	*Threshold Phaseout Amount*	*Completed Phaseout Amount*
1	$2,428	$ 7,140	$13,090	$28,281
2 or more	$4,008	$10,020	$13,090	$32,121
None	$ 364	$ 4,760	$ 5,950	$10,710

The Internal Revenue Service, in the instructions for the Form 1040 series, provides tables showing the amount of the earned income tax credit for each type of taxpayer.

(2) *Excessive investment income.* For tax years beginning in 2001, the earned income tax credit is denied under § 32(i) if the aggregate amount of certain investment income exceeds $2,450.

.04 *Alternative Minimum Tax Exemption for a Child Subject to the "Kiddie Tax."* For tax years beginning in 2001, in the case of a child to whom the § 1(g) "kiddie tax" applies, the exemption amount under § 55 and § 59(j) for purposes of the alternative minimum tax under § 55 may not exceed the sum of (A) such child's earned income for the taxable year, plus (B) $5,350.

.05 *Standard Deduction.*

(1) *In general.* For tax years beginning in 2001, the standard deduction amounts under § 63(c)(2) are as follows:

Filing Status	*Standard Deduction*
MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES (§ 1(a))	$7,600
HEADS OF HOUSEHOLDS (§ 1(b))	$6,650
UNMARRIED INDIVIDUALS (OTHER THAN SURVIVING SPOUSES AND HEADS OF HOUSEHOLDS) (§ 1(c))	$4,550
MARRIED INDIVIDUALS FILING SEPARATE RETURNS (§ 1(d))	$3,800

(2) *Dependent*. For tax years beginning in 2001, the standard deduction amount under § 63(c)(5) for an individual who may be claimed as a dependent by another taxpayer may not exceed the greater of $750, or the sum of $250 and the individual's earned income.

(3) *Aged and blind*. For tax years beginning in 2001, the additional standard deduction amounts under § 63(f) for the aged and for the blind are $900 for each. These amounts are increased to $1,100 if the individual is also unmarried and not a surviving spouse.

.06 *Overall Limitation on Itemized Deductions*. For tax years beginning in 2001, the "applicable amount" of adjusted gross income under § 68(b), above which the amount of otherwise allowable itemized deductions is reduced under § 68, is $132,950 (or $66,475 for a separate return filed by a married individual).

.07 *Qualified Transportation Fringe*. For tax years beginning in 2001, the monthly limitation under § 132(f)(2)(A), regarding the aggregate fringe benefit exclusion amount for transportation in a commuter highway vehicle and any transit pass, is $65. The monthly limitation under § 132(f)(2)(B) regarding the fringe benefit exclusion amount for qualified parking is $180.

.08 *Income from United States Savings Bonds for Taxpayers Who Pay Qualified Higher Education Expenses*. For tax years beginning in 2001, the exclusion under § 135, regarding income from United States savings bonds for taxpayers who pay qualified higher education expenses, begins to phase out for modified adjusted gross income above $83,650 for joint returns and $55,750 for other returns. This exclusion completely phases out for modified adjusted gross income of $113,650 or more for joint returns and $70,750 or more for other returns.

.09 *Personal Exemption*.

(1) *Exemption amount*. For tax years beginning in 2001, the personal exemption amount under § 151(d) is $2,900.

(2) *Phaseout*. For tax years beginning in 2001, the personal exemption amount begins to phase out at, and is completely phased out after, the following adjusted gross income amounts:

Filing Status	*Threshold Phaseout Amount*	*Completed Phaseout Amount After*
Code § 1(a)	$199,450	$321,950
Code § 1(b)	$166,200	$288,700
Code § 1(c)	$132,950	$255,450
Code § 1(d)	$ 99,725	$160,975

.10 *Eligible Long-Term Care Premiums*. For tax years beginning in 2001, the limitations under § 213(d), regarding eligible long-term care premiums includible in the term "medical care," are as follows:

Attained age before the close of the taxable year:

40 or less	$ 230
More than 40 but not more than 50	$ 430
More than 50 but not more than 60	$ 860
More than 60 but not more than 70	$2,290
More than 70	$2,860

.11 *Medical Savings Accounts*.

(1) *Self-only coverage*. For tax years beginning in 2001, the term "high deductible health plan" as defined in § 220(c)(2)(A) means, in the case of self-only coverage, a health plan which has an annual deductible that is not less than $1,600 and not more than $2,400, and under which the annual out-of-pocket expenses required to be paid (other than for premiums) for covered benefits does not exceed $3,200.

(2) *Family coverage*. For tax years beginning in 2001, the term "high deductible health plan" means, in the case of family coverage, a health plan which has an annual deductible that is not less than $3,200 and not more than $4,800,

and under which the annual out-of-pocket expenses required to be paid (other than for premiums) for covered benefits does not exceed $5,850.

.12 *Treatment of Dues Paid to Agricultural or Horticultural Organizations.* For tax years beginning in 2001, the limitation under § 512(d)(1), regarding the exemption of annual dues required to be paid by a member to an agricultural or horticultural organization, is $116.

.13 *Insubstantial Benefit Limitations for Contributions Associated with Charitable Fund-Raising Campaigns.*

(1) *Low cost article.* For tax years beginning in 2001, the unrelated business income of certain exempt organizations under § 513(h)(2) does not include a "low cost article" of $7.60 or less.

(2) *Other insubstantial benefits.* For tax years beginning in 2001, the $5, $25, and $50 guidelines in section 3 of Rev. Proc. 90–12, 1990–1 C.B. 471 (as amplified and modified), for disregarding the value of insubstantial benefits received by a donor in return for a fully deductible charitable contribution under § 170, are $7.60, $38, and $76, respectively.

.14 *Funeral Trusts.* For a contract entered into during calendar year 2001 for a "qualified funeral trust," as defined in § 685, the trust may not accept aggregate contributions by or for the benefit of an individual in excess of $7,500.

.15 *Expatriation to Avoid Tax.* For calendar year 2001, the thresholds used under § 877(a)(2), regarding whether an individual's loss of United States citizenship had the avoidance of United States taxes as one of its principal purposes, are more than $115,000 for "average annual net income tax" and $579,000 or more for "net worth."

.16 *Valuation of Qualified Real Property in Decedent's Gross Estate.* For an estate of a decedent dying in calendar year 2001, if the executor elects to use the special use valuation method under § 2032A for qualified real property, the aggregate decrease in the value of qualified real property resulting from electing to use § 2032A that is taken into account for purposes of the estate tax may not exceed $800,000.

.17 *Annual Exclusion for Gifts.*

(1) For calendar year 2001, the first $10,000 of gifts to any person (other than gifts of future interests in property) are not included in the total amount of taxable gifts under § 2503 made during that year.

(2) For calendar year 2001, the first $106,000 of gifts to a spouse who is not a citizen of the United States (other than gifts of future interests in property) are not included in the total amount of taxable gifts under §§ 2503 and 2523(i)(2) made during that year.

.18 *Generation-Skipping Transfer Tax Exemption.* For calendar year 2001, the generation-skipping transfer tax exemption under § 2631, which is allowed in determining the "inclusion ratio" defined in § 2642, is $1,060,000.

.19 *Luxury Automobile Excise Tax.* For calendar year 2001, the excise tax under §§ 4001 and 4003 is imposed on the first retail sale of a passenger vehicle (including certain parts or accessories installed within six months of the date after the vehicle was first placed in service), to the extent the price exceeds $38,000.

.20 *Passenger Air Transportation Excise Tax.* For calendar year 2001, the tax under § 4261(c) on any amount paid (whether within or without the United States) for any transportation of any person by air, if such transportation begins or ends in the United States, generally is $12.80. However, in the case of a domestic segment beginning or ending in Alaska or Hawaii as described in § 4261(c)(3), the tax only applies to departures and is at the rate of $6.40.

.21 *Reporting Exception for Certain Exempt Organizations with Nondeductible Lobbying Expenditures.* For tax years beginning in 2001, the annual per person, family, or entity dues limitation to qualify for the reporting exception under § 6033(e)(3) (and section 5.05 of Rev. Proc. 98–19, 1998–7 I.R.B. 30), regarding certain exempt organizations with nondeductible lobbying expenditures, is $81 or less.

.22 *Notice of Large Gifts Received from Foreign Persons.* For tax years beginning in 2001, recipients of gifts from certain foreign persons may have to report these gifts under § 6039F if the aggregate value of gifts received in a taxable year exceeds $11,273.

.23 *Persons against Which a Federal Tax Lien is Not Valid.* For calendar year 2001, a federal tax lien is not valid against (1) certain purchasers under § 6323(b)(4) that purchased personal property in a casual sale for less than $1,100, or (2) a mechanic's lienor under § 6323(b)(7) that repaired or improved certain residential property if the contract price with the owner is not more than $5,490.

.24 *Property Exempt from Levy.* For calendar year 2001, the value of property exempt from levy under § 6334(a)(2) (fuel, provisions, furniture, and other household personal effects, as well as arms for personal use, livestock, and poultry) may not exceed $6,560. The value of property exempt from levy under § 6334(a)(3) (books and tools necessary for the trade, business, or profession of the taxpayer) may not exceed $3,280.

.25 *Interest on a Certain Portion of the Estate Tax Payable in Installments.* For an estate of a decedent dying in calendar year 2001, the dollar amount used to determine the "2-percent portion" (for purposes of calculating interest under § 6601(j)) of the estate tax payable in installments under § 6166 is $1,060,000.

.26 *Attorney Fee Awards.* For fees incurred in calendar year 2001, the attorney fee award limitation under § 7430(c)(1)(B)(iii) is $140 per hour.

.27 *Periodic Payments Received under Qualified Long-Term Care Insurance Contracts or under Certain Life Insurance Contracts.* For calendar year 2001, the stated dollar amount of the per diem limitation under § 7702B(d)(4), regarding periodic payments received under a qualified long-term care insurance contract or periodic payments received under a life insurance contract that are treated as paid by reason of the death of a chronically ill individual, is $200.

Part II – Inflation-adjusted Items Applicable if Pending Legislation is not Enacted

.01 *Tax Rate Tables.* For tax years beginning in 2001, the tax rate tables under § 1 are as follows:

TABLE 1 - Section 1(a). — MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES

If Taxable Income Is:	The Tax Is:
Not Over $45,200	15% of the taxable income
Over $45,200 but not over $109,250	$6,780.00 plus 28% of the excess over $45,200
Over $109,250 but not over $166,450	$24,714.00 plus 31% of the excess over $109,250
Over $166,450 but not over $297,300	$42,446.00 plus 36% of the excess over $166,450
Over $297,300	$89,552.00 plus 39.6% of the excess over $297,300

TABLE 2 - Section 1(b). — HEADS OF HOUSEHOLDS

If Taxable Income Is:	The Tax Is:
Not Over $36,250	15% of the taxable income
Over $36,250 but not over $93,600	$5,437.50 plus 28% of the excess over $36,250
Over $93,600 but not over $151,600	$21,495.50 plus 31% of the excess over $93,600
Over $151,600 but not over $297,300	$39,475.50 plus 36% of the excess over $151,600
Over $297,300	$91,927.50 plus 39.6% of the excess over $297,300

TABLE 3 - Section 1(c). — UNMARRIED INDIVIDUALS (OTHER THAN SURVIVING SPOUSES AND HEADS OF HOUSEHOLDS)

If Taxable Income Is:	The Tax Is:
Not Over $27,050	15% of the taxable income
Over $27,050 but not over $65,550	$4,057.50 plus 28% of the excess over $27,050
Over $65,550 but not over $136,750	$14,837.50 plus 31% of the excess over $65,550
Over $136,750 but not over $297,300	$36,909.50 plus 36% of the excess over $136,750
Over $297,300	$94,707.50 plus 39.6% of the excess over $297,300

TABLE 4 - Section 1(d). — MARRIED INDIVIDUALS FILING SEPARATE RETURNS

If Taxable Income Is:	The Tax Is:
Not Over $22,600	15% of the taxable income
Over $22,600 but not over $54,625	$3,390.00 plus 28% of the excess over $22,600
Over $54,625 but not over $83,225	$12,357.00 plus 31% of the excess over $54,625
Over $83,225 but not over $148,650	$21,223.00 plus 36% of the excess over $83,225
Over $148,650	$44,776.00 plus 39.6% of the excess over $148,650

TABLE 5 - Section 1(e). — ESTATES AND TRUSTS

If Taxable Income Is:	The Tax Is:
Not Over $1,800	15% of the taxable income
Over $1,800 but not over $4,250	$270.00 plus 28% of the excess over $1,800
Over $4,250 but not over $6,500	$956.00 plus 31% of the excess over $4,250
Over $6,500 but not over $8,900	$1,653.50 plus 36% of the excess over $6,500
Over $8,900	$2,517.50 plus 39.6% of the excess over $8,900

.03 *Earned Income Tax Credit*.

(1) *In general*. For tax years beginning in 2001, the following amounts are used to determine the earned income tax credit under § 32(b). The "earned income amount" is the amount of earned income at or above which the maximum amount of the earned income tax credit is allowed. The "threshold phaseout amount" is the amount of modified adjusted gross income (or, if greater, earned income) above which the maximum amount of the credit begins to phase out. The "completed phaseout amount" is the amount of modified adjusted gross income (or if greater, earned income) at or above which no credit is allowed.

Number of Children	*Maximum Amount of the Credit*	*Earned Income Amount*	*Threshold Phaseout Amount*	*Completed Phaseout Amount*
1	$2,424	$ 7,130	$13,090	$28,260
2 or more	$4,008	$10,020	$13,090	$32,121
None	$ 364	$ 4,760	$ 5,950	$10,710

.22 *Notice of Large Gifts Received from Foreign Persons*. For tax years beginning in 2001, recipients of gifts from certain foreign persons may have to report these gifts under § 6039F if the aggregate value of gifts received in a taxable year exceeds $11,271.

.23 *Persons against Which a Federal Tax Lien is Not Valid*. For calendar year 2001, a federal tax lien is not valid against (1) certain purchasers under § 6323(b)(4) that purchased personal property in a casual sale for less than $1,100, or (2) a mechanic's lienor under § 6323(b)(7) that repaired or improved certain residential property if the contract price with the owner is not more than $5,480.

SECTION 4. EFFECTIVE DATE

.01 *General Rule*. Except as provided in section 4.02, this revenue procedure applies to tax years beginning in 2001.

.02 *Calendar Year Rule*. This revenue procedure applies to transactions or events occurring in calendar year 2001 for purposes of section 3.14 (funeral trusts), section 3.15 (expatriation to avoid tax), section 3.16 (valuation of qualified real property in decedent's gross estate), section 3.17 (annual exclusion for gifts), section 3.18 (generation-skipping transfer tax exemption), section 3.19 (luxury automobile excise tax), section 3.20 (passenger air transportation excise tax), section 3.23 (persons against which a federal tax lien is not valid), section 3.24 (property exempt from levy), section 3.25 (interest on a certain portion of the estate tax payable in installments), section 3.26 (attorney fee awards), and section 3.27 (periodic payments received under qualified long-term care insurance contracts or under certain life insurance contracts).

SECTION 5. DRAFTING INFORMATION

The principal author of this revenue procedure is Paul Tellier of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Tellier at (202) 622-4930 (not a toll-free call).

26 CFR 601.601: Rules and regulations.
(Also Part I, § 1397E)

Rev. Proc. 2001–14

SECTION 1. PURPOSE

This revenue procedure sets forth the maximum face amount of Qualified Zone Academy Bonds ("Bond" or "Bonds") that may be issued for each State during 2001. For this purpose "State" includes the District of Columbia and the possessions of the United States.

SECTION 2. BACKGROUND

.01 Section 226 of the Taxpayer Relief Act of 1997, Pub. L. 105–34, 111 Stat. 821 (1997), added § 1397E to the Internal Revenue Code to provide a credit to holder of Bonds under certain circumstances so that the Bonds generally can be issued without discount or interest. Ninety-five percent of Bond proceeds are to be used for qualified purposes, as defined by § 1397E(d)(5), with respect to a qualified zone academy, as defined by § 1397E-(d)(4).

.02 Section 1397E(e)(1), as amended by § 509 of the Tax Relief Extension Act of 1999, Pub. L. 106–170, 113 Stat. 1860 (1999) provides that the aggregate amount of Bonds that may be issued for the States is limited to $400 million for each of the years, 1998, 1999, 2000, and 2001 (the "national limitation"). This amount is to be allocated among the States by the Secretary on the basis of their respective populations below the poverty level (as defined by the Office of Management and Budget) and is to be further allocated by each State to qualified zone academies within the State or possession.

.03 Section 1397E(e)(4), as amended, by § 509 of the Tax Relief Extension Act of 1999, Pub. L. 106–170, 113 Stat. 1860 (1999) provides that any carryforward of a limitation amount may be carried only to the first 2 years (3 years for carryforwards from 1998 or 1999) following the unused limitation year. For this purpose a limitation amount shall be treated as used on a first–in first–out basis.

.04 Rev. Proc. 98–9, 1998–1 C.B. 341, Rev. Proc. 98–57, 1998–2 C.B. 682, and Rev. Proc. 2000–10, 2000–2 I.R.B. 287, respectively, allocated the national limitation for 1998, 1999, and 2000 among the States and possessions.

SECTION 3. SCOPE

This revenue procedure applies to Bonds issued under § 1397E during 2001.

SECTION 4. NATIONAL QUALIFIED ZONE ACADEMY BOND LIMITATION FOR 2001

The total face amount of bonds that may be issued in 2001 is $400 million. This amount is allocated among the States as follows:

STATE	MAXIMUM FACE AMOUNT OF BONDS THAT MAY BE ISSUED DURING 2001 (thousands of dollars)
ALABAMA	$ 7,641
ALASKA	545
ARIZONA	6,640
ARKANSAS	4,343
CALIFORNIA	52,969
COLORADO	3,899
CONNECTICUT	2,699
DELAWARE	908
DISTRICT OF COLUMBIA	896
FLORIDA	21,699
GEORGIA	11,635
HAWAII	1,496
IDAHO	2,015
ILLINOIS	13,905
INDIANA	4,611
IOWA	2,492
KANSAS	3,750
KENTUCKY	5,550
LOUISIANA	9,721
MAINE	1,538
MARYLAND	4,372
MASSACHUSETTS	8,367
MICHIGAN	11,080
MINNESOTA	3,982
MISSISSIPPI	5,162
MISSOURI	7,346
MONTANA	1,595
NEBRASKA	2,103
NEVADA	2,368
NEW HAMPSHIRE	1,071
NEW JERSEY	7,356
NEW MEXICO	4,171
NEW YORK	29,712
NORTH CAROLINA	11,961
NORTH DAKOTA	954
OHIO	15,643
OKLAHOMA	4,939

STATE	MAXIMUM FACE AMOUNT OF BONDS THAT MAY BE ISSUED DURING 2001 (thousands of dollars)
OREGON	$ 4,839
PENNSYLVANIA	13,056
RHODE ISLAND	1,136
SOUTH CAROLINA	5,265
SOUTH DAKOTA	654
TENNESSEE	7,557
TEXAS	34,818
UTAH	1,406
VERMONT	667
VIRGINIA	6,288
WASHINGTON	6,333
WEST VIRGINIA	3,285
WISCONSIN	5,229
WYOMING	644
AMERICAN SAMOA	350
GUAM	251
NORTHERN MARIANAS	408
PUERTO RICO	26,308
VIRGIN ISLANDS	372

SECTION 6. EFFECTIVE DATE

This revenue procedure applies to Bonds issued after December 31, 2000.

DRAFTING INFORMATION

The principal author of this revenue procedure is David White of the Office of Assistant Chief Counsel (Tax Exempt/Employment Tax/Government Entities). For further information regarding this revenue procedure contact Mr. White at (202) 622-3980 (not a /toll free call).

Notice of Proposed Rulemaking and Notice of Public Hearing

Guidance Under Section 355(e); Recognition of Gain on Certain Distributions of Stock or Securities In Connection With an Acquisition.

REG–107566–00

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to recognition of gain on certain distributions of stock or securities of a controlled corporation in connection with an acquisition. Changes to the applicable law were made by the Taxpayer Relief Act of 1997. These proposed regulations affect corporations and are necessary to provide them with guidance needed to comply with these changes. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by April 24, 2001. Outlines of topics to be discussed at the public hearing scheduled for May 15, 2001, at 10 a.m. must be received by April 24, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG–107566–00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG–107566–00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.us treas.gov/tax_regs/regslist.html. The public hearing will be held in Room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Brendan P. O'Hara, (202) 622-7530; concerning submissions of comments, delivering comments, the hearing, and/or to be placed on the building access list to attend the hearing, Guy R. Traynor, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

A. *State of the Law Before Section 355(e)*

Section 355 generally provides that, if a corporation distributes to its shareholders stock of a corporation that it controls immediately before the distribution and certain other conditions are met, neither the distributing corporation (hereinafter referred to as Distributing) nor its shareholders recognize gain or loss. A number of the conditions for tax free treatment (for example, the continuity of interest requirement of §1.355–2(c), the "no device" requirement of section 355(a)(1)(B), the 5-year active business requirement of section 355(b), and the limitation on disqualified stock under section 355(d)) operate to limit the circumstances in which Distributing or the controlled corporation (hereinafter referred to as Controlled) can undergo changes of control in conjunction with a distribution that qualifies for corporate and shareholder-level nonrecognition under section 355. Nevertheless, prior to the enactment of section 355(e), it was possible for such changes to occur, for example, in the context of tax free reorganizations, while qualifying for tax free treatment under section 355. See, e.g., *Commissioner v. Mary Archer W. Morris Trust*, 367 F.2d 794 (4th Cir. 1966).

B. *Enactment of Section 355(e)*

Section 355(e), which was enacted in 1997, provides that the stock of a controlled corporation generally will not be qualified property under section 355(c)(2) or section 361(c)(2) if the stock is distributed as "part of a plan (or series of related transactions) pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation." Thus, if section 355(e) applies to a distribution, Distributing is taxed on the amount by which the distributed stock's fair market value exceeds its basis. Distributee shareholders receive Controlled stock tax free, but do not increase their bases to reflect the corporate level gain recognized by Distributing on the distribution.

Section 355(e)(2)(B) provides that, unless the taxpayer establishes otherwise, a plan (or series of related transactions) (hereinafter referred to as a plan) exists if "1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation during the 4-year period beginning on the date which is 2 years before the date of the distribution."

The committee reports state that section 355 was intended to permit the tax free division of existing business arrangements among existing shareholders. The reports state that "[i]n cases in which it is intended that new shareholders will acquire ownership of a business in connection with a spin off, the transaction more closely resembles a corporate level disposition of the portion of the business that is acquired" and provide that gain is recognized "if, pursuant to a plan or arrangement in existence on the date of distribution, either the controlled or distributing corporation is acquired . . .." H.R. Rep. No. 105–148, at 462 (1997); see also S. Rep. No. 105–33, at 139–40 (1997) (slight variation in language). The Conference Report adds, "[a]s under the House bill and Senate amendment, a public offering of sufficient size can result in an acquisition that causes gain recognition under the provision." H.R. Conf. Rep. No. 105–220, at 533 (1997).

C. *Previous Proposal of Regulations*

On August 24, 1999, the IRS and the Department of the Treasury published proposed regulations under section 355(e) (REG–116733–98, 1999–2 C.B. 392) in the **Federal Register** (64 F.R. 46155) (hereinafter referred to as the 1999 proposed regulations). The 1999 proposed regulations provided the exclusive means by which a taxpayer could establish that a distribution and an acquisition were not part of a plan, and required that the taxpayer must establish the absence of a plan with clear and convincing evidence.

A public hearing regarding the 1999 proposed regulations was held on March 2, 2000. In addition, written comments were received. Commentators asserted that the approach of the 1999 proposed regulations, providing exclusive rebuttals for establishing that transactions are not part of a plan, was inappropriate because it unfairly limited the evidence taxpayers could produce that may be relevant to whether transactions are part of a plan. In addition, commentators argued that section 355(e) does not require the IRS and the Department of the Treasury to adopt a clear and convincing evidence standard for establishing whether transactions are part of a plan. Further, commentators were concerned that the exclusive rebuttals contained in the 1999 proposed regulations may not be available in cases in which there was an intent to facilitate any acquisition, regardless of its type or size, even if the acquisition being tested was not the intended acquisition. Finally, one of the rebuttals in the 1999 proposed regulations was only available if the taxpayer proves, among other things, that "[a]t the time of the distribution, neither the distributing corporation, the controlled corporation, nor their controlling shareholders reasonably would have anticipated that it was more likely than not that one or more persons would acquire a 50-percent or greater interest in the distributing corporation or the controlled corporation within 2 years after the distribution . . . who would not have acquired such interests if the distribution had not occurred." 1999 Prop. Reg. §1.355–7(a)(2)(iii)(B). Many commentators indicated that determining whether it was reasonably anticipated that an event was more likely than not to occur was impractical and that the consequent uncertainty inhibited normal business transactions.

Explanation of Provisions

After consideration of the comments received, the IRS and the Department of the Treasury have decided to withdraw the 1999 proposed regulations and issue new proposed regulations (hereinafter referred to as the 2000 proposed regulations) to provide guidance concerning the interpretation of the phrase "plan (or series of related transactions)." The 2000 proposed regulations also address the determination of Distributing's gain when multiple controlled corporations are distributed and the distributions are part of a plan pursuant to which a 50-percent or greater interest in one or more, but not all, of the distributed controlled corporations is acquired.

The IRS and the Department of the Treasury plan to issue regulations addressing other issues arising under section 355(e), including the definition of an acquisition, the application of the aggregation and attribution rules, the treatment of successors and predecessors, and the administration of the statute of limitations provision of section 355(e)(4)(E). Comments concerning the 2000 proposed regulations, the additional issues described above, and other issues that should be addressed in regulations are welcome.

A. *Plan or Series of Related Transactions*

The 2000 proposed regulations provide that whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances. They include nonexclusive lists of facts and circumstances to be considered in making the determination. Because the determination of whether a plan exists is dependent on the facts and circumstances, the 2000 proposed regulations provide a general statement of the policy underlying whether a distribution and an acquisition are part of a plan for purposes of section 355(e).

In the case of an acquisition after a distribution, the 2000 proposed regulations provide that, in general, the distribution and acquisition are considered part of a plan if Distributing, Controlled, or any of their respective controlling shareholders intended, on the date of the distribution, that the acquisition or a similar acquisition occur in connection with the distribution. The reference to "a similar acquisition" ensures that changes in the terms of the acquisition intended at the time of the distribution (including, in certain circumstances, a substitution of acquirer) do not prevent the distribution and the acquisition that actually occurs from being considered part of a plan.

In the case of an acquisition before a distribution, the 2000 proposed regulations provide that, in general, the distribution and acquisition are considered part of a plan if Distributing, Controlled, or any of their respective controlling shareholders intended, on the date of the acquisition, that a distribution occur in connection with the acquisition.

As indicated above, the facts and circumstances surrounding the distribution and the acquisition must be examined to determine whether the transactions were intended to occur in connection with each other. In addition, the 2000 proposed regulations contain six safe harbor provisions that, when applicable, provide that the acquisition and distribution are not part of a plan.

Under the 2000 proposed regulations, Distributing must test each acquisition of Distributing or Controlled stock to determine whether it is part of a plan that includes a distribution. The 2000 proposed regulations aggregate all acquisitions of stock of a corporation that are pursuant to a plan including a particular distribution to determine whether the 50 percent threshold of section 355(e)(2)(A)(ii) is met.

1. Facts and Circumstances

For those situations to which the safe harbor provisions do not apply, the 2000 proposed regulations provide two nonexclusive lists of facts and circumstances (hereinafter referred to as factors) to consider in assessing whether an acquisition and a distribution are part of a plan. One list of factors tends to demonstrate that a distribution and an acquisition are part of a plan and the other list tends to demonstrate that a distribution and an acquisition are not part of a plan. The weight of the factors depends on the particular case. The existence of a plan should not be determined merely by comparing the number of factors tending to show that the acquisition and distribution are, or are not, part of a plan.

Plan Factors

Many of the factors tending to show that a distribution and an acquisition are part of a plan (the plan factors) focus on whether Distributing, Controlled or their respective controlling shareholders participated in discussions with outside parties regarding the second transaction of the pair being tested before the first transaction occurred (factors (i), (ii), (iii), (iv), (v), and (vi)). Such discussions provide evidence that Distributing, Controlled or any of their respective controlling shareholders had an intent that the transactions occur in connection with each other.

Other plan factors (factors (vii), (viii), and (ix)) inquire into other indications of the intent of Distributing, Controlled and their respective controlling shareholders. Factor (vii) considers whether the distribution was motivated by a business purpose to facilitate the acquisition or a similar acquisition of Distributing or Controlled. The operating rule in proposed §1.355–7(e)(1)(i) states that evidence of a business purpose to facilitate an acquisition of Distributing or Controlled exists if there was a reasonable certainty that within 6 months after the distribution an acquisition would occur, an agreement, understanding, or arrangement would exist, or substantial negotiations would occur regarding an acquisition. The operating rule in proposed §1.355–7(e)(1)(ii) applies to acquisitions before a distribution, asking whether the acquisition occurred after the date of the public announcement of the planned distribution, or whether, at the time of the acquisition, it was reasonably certain that within 6 months after the acquisition the distribution would occur, an agreement, understanding, or arrangement would exist, or substantial negotiations would occur regarding the distribution. The operating rule in proposed §1.355–7(e)(2) provides that the fact that internal discussions occurred may be indicative of the business purpose that motivated the distribution. The operating rule contained in proposed §1.355–7(e)(3) provides that, if Distributing distributes Controlled stock intending, in whole or substantial part, to decrease the likelihood of the acquisition of Distributing or Controlled by separating it from another corporation that is likely to be acquired, Distributing is treated as having a business purpose to facilitate the acquisition of the corporation that was acquired.

The rule regarding reasonable certainty is necessary to implement section 355(e) because where a taxpayer was reasonably certain that an acquisition would occur, that acquisition was likely to be taken into account in determining whether to effect a distribution. While the IRS and the Department of the Treasury believe that reasonable certainty (even where no discussions with potential acquirers have occurred) is relevant in determining whether a plan exists, it should be noted that this concept is significantly modified from the 1999 proposed regulations. This operating rule will apply only in cases where there was a strong probability that, within 6 months after the distribution, an acquisition would occur, an agreement, understanding, or arrangement would exist, or substantial negotiations would occur.

Factor (viii) considers whether an acquisition and a distribution occured within 6 months of each other, or whether there was an agreement, understanding, arrangement, or substantial negotiations regarding the second transaction (or, if an acquisition is the second transaction, a similar acquisition) within 6 months after the first transaction.

Finally, factor (ix) examines whether the debt allocation between Distributing and Controlled made an acquisition of Distributing or Controlled likely in order to service the debt.

Nonplan Factors

The 2000 proposed regulations also provide a nonexclusive list of factors tending to show that a distribution and an acquisition are not part of a plan (the nonplan factors). Just as discussions with outside parties about the second transaction prior to the first transaction tend to show that Distributing, Controlled or their respective controlling shareholders had an intent that the second transaction occur in connection with the first transaction, the absence of such discussions tends to show that the transactions did not occur in connection with each other. Thus, there are nonplan factors that are analogous to the plan factors related to discussions (factors (i), (ii), and (iv)).

The existence of a corporate business purpose, other than a business purpose to facilitate the acquisition or a similar acquisition, that motivated Distributing, in whole or substantial part, to make the stock distribution tends to show that a distribution and an acquisition are not part of a plan (factor (vi)). The presence of a business purpose to facilitate the acquisition or a similar acquisition is relevant in determining the extent to which the distribution was motivated in whole or substantial part by another corporate business purpose within the meaning of §1.355–2. Analyzing whether there is another substantial corporate business purpose for the distribution in light of an acquisition-related purpose is similar to analyzing whether there is a corporate business purpose for a distribution in light of the potential avoidance of federal taxes. See §1.355–2(b)(1) and (5), *Example 8*. Thus, another business purpose must be real and substantial even in light of the acquisition business purpose. In making this determination, the operating rules in proposed §1.355–7(e) apply.

Factors (iii) and (v) consider whether there was an identifiable, unexpected change in market or business conditions after the first of the two transactions being tested that resulted in the second, unexpected transaction. Factor (vii) considers whether the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition or a previously proposed similar acquisition.

2. Safe Harbors

The 2000 proposed regulations include six safe harbor provisions. A distribution and an acquisition are not part of a plan if they are described in one of the safe harbors. The first two safe harbors address acquisitions more than 6 months after a distribution. Safe Harbor I applies to an acquisition more than 6 months after a distribution if there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition before a date that is 6 months after the distribution and the distribution was motivated in whole or substantial part by a corporate business purpose other than a business purpose to facilitate an acquisition. The nonacquisition corporate business purpose for the distribution is considered in light of any business purpose to facilitate an acquisition, and the operating rules in proposed §1.355–7(e) apply.

Safe Harbor II, like Safe Harbor I, applies only to acquisitions more than 6 months after a distribution for which there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition before a date that is 6 months after the distribution. However, where Safe Harbor I applies to cases where the distribution was motivated in whole or substantial part by a nonacquisition business purpose, Safe Harbor II applies to situations where the distribution was motivated in whole or substantial part by a business purpose to facilitate an acquisition. Under Safe Harbor II, an acquisition will not be treated as part of a plan with a distribution if the distribution was motivated in whole or substantial part by a corporate business purpose to facilitate an acquisition or acquisitions of no more than 33 percent of the stock of Distributing or Controlled, and no more than 20 percent of the stock of the corporation whose stock was acquired in the acquisition or acquisitions that motivated the distribution was either acquired or the subject of an agreement, understanding, arrangement, or substantial negotiations before a date that is 6 months after the distribution. Safe Harbor II is intended to alleviate the concerns commentators expressed about the unavailability of the rebuttals in the 1999 proposed regulations if the distribution was motivated by an intent to facilitate an acquisition regardless of its type or size.

Safe Harbors III and IV address acquisitions and distributions more than 2 years apart. Under Safe Harbor III, acquisitions more than 2 years after a distribution are not pursuant to a plan if there is no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition at the time of the distribution or within 6 months thereafter. Under Safe Harbor IV, acquisitions more than 2 years before a distribution are not part of a plan if there is no agreement, understanding, arrangement, or substantial negotiations concerning the distribution at the time of the acquisition or within 6 months thereafter.

Safe Harbor V provides that an acquisition of Distributing or Controlled stock that is listed on an established market (as defined in the 2000 proposed regulations) is not part of a plan if the stock is transferred between shareholders of Distributing or Controlled who are not 5-percent shareholders. In general, a person will be considered a 5-percent shareholder if, immediately before or after each transfer, the person owns, directly or indirectly, or together with related persons (as described in sections 267(b) and 707(b)), 5 percent or more of any class of stock of the corporation whose stock is transferred.

Safe Harbor VI provides that an acquisition of stock by an employee or director in connection with the performance of services, including an acquisition resulting from the exercise of certain compensatory stock options, is not part of a plan.

3. Agreement, Understanding, Arrangement, or Substantial Negotiations

There are many references in the 2000 proposed regulations to the existence of an agreement, understanding, arrangement, or substantial negotiations. The 2000 proposed regulations do not define those concepts precisely. A binding contract clearly is included as an agreement but, depending on all relevant facts and circumstances, parties can have an agreement, understanding, or arrangement even though they have not reached agreement on all terms. Under certain circumstances, such as in public offerings or auctions of Distributing's or Controlled's stock, an agreement, understanding, arrangement, or substantial negotiations can exist regarding an acquisition even if the acquirer has not been specifically identified.

4. Options

The 2000 proposed regulations enumerate interests treated as options. If stock of Distributing or Controlled is acquired pursuant to an option, the option is treated as an agreement to acquire stock on the date of writing unless Distributing establishes that, on the later of the date of the stock distribution or the writing of the option, the option was not more likely than not to be exercised. The 2000 proposed regulations also address the treatment of an agreement, understanding, or arrangement to write an option and substantial negotiations regarding the writing of an option. The 2000 proposed regulations exempt certain options from treatment as options unless they are written, transferred, or listed with a principal purpose of avoiding the application of section 355(e) or the 2000 proposed regulations. The enumerated exceptions cover certain commercially customary options that are unlikely to be used to avoid section 355(e) or the 2000 proposed regulations.

B. Any Controlled Corporation

Section 355(e)(2)(A)(ii) provides that section 355(e)(1), which causes Distributing to recognize its gain in Controlled stock as if Distributing had sold the stock for its fair market value, applies to any distribution to which section 355 (or so much of section 356 as relates to section 355) applies and "which is part of a plan . . . pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation *or any controlled corporation*" (emphasis added). A question has arisen concerning the measure of gain to Distributing if, pursuant to a plan, the stock of more than 1 controlled corporation is distributed and stock representing a 50-percent or greater interest is acquired in some, but not all, of the distributed controlled corporations. The 2000 proposed regulations clarify that under those circumstances, Distributing only recognizes gain on the stock of the distributed controlled corporations that were subject to 50-percent or greater acquisitions. If Distributing is the acquired corporation, it must recognize gain on all of the distributed controlled corporations.

Proposed Effective Date

The regulations in this section are proposed to apply to distributions occurring after the regulations in this section are published as final regulations in the **Federal Register**.

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. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue 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 comments (preferably a signed original and eight (8) copies) and comments sent via the Internet that are submitted timely to the IRS. The Department of the Treasury and the IRS specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for May 15, 2001, beginning at 10 a.m. in Room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (preferably a signed original and eight (8) copies) by April 24, 2001. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Brendan P. O'Hara, Office of the Associate Chief Counsel (Corporate). However, other personnel from the Department of the Treasury and the IRS participated in their development.

* * * * *

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 is amended by adding an entry in numerical order to read in part as follows:
Authority: 26 U.S.C. 7805 * * *
Section 1.355–7 also issued under 26 U.S.C. 355(e)(5). * * *

Par. 2. Section 1.355–0 is amended by revising the section heading and adding introductory text and an entry for §1.355–7 to read in part as follows:

§1.355–0 Outline of sections.

In order to facilitate the use of §§1.355–1 through 1.355–7, this section lists the major paragraphs in those sections as follows:
* * * * *

§1.355–7 Recognition of gain on certain distributions of stock or securities in connection with an acquisition.

(a) In general.
(b) Plan.
(c) Multiple acquisitions.
(d) Facts and circumstances.
(e) Operating rules.
(1) Reasonable certainty evidence of business purpose to facilitate an acquisition.
(2) Internal discussion evidence of business purpose.
(3) Hostile takeover defense.
(4) Effect of distribution on trading in stock.
(5) Consequences of section 355(e) disregarded for certain purposes.
(6) Substantial diminution of risk.
(f) Safe harbors.
(1) Safe Harbor I.
(2) Safe Harbor II.
(3) Safe Harbor III.
(4) Safe Harbor IV.
(5) Safe Harbor V.
(i) In general.
(ii) Special rules.
(6) Safe Harbor VI.
(g) Stock acquired by exercise of options, warrants, convertible obligations, and other similar interests.
(1) Treatment of options.
(i) General rule.
(ii) Agreement, understanding, arrangement, or substantial negotiations to write an option.
(2) Instruments treated as options.
(3) Instruments generally not treated as options.
(i) Escrow, pledge, or other security agreements.
(ii) Compensatory options.
(iii) Options exercisable only upon death, disability, mental incompetency, or separation from service.
(iv) Rights of first refusal.
(v) Other enumerated instruments.
(h) Multiple controlled corporations.
(i) [Reserved]
(j) Valuation.
(k) Definitions.
(1) Agreement, understanding, arrangement, or substantial negotiations.
(2) Controlled corporation.
(3) Controlling shareholder.
(4) Established market.
(5) Five-percent shareholder.
(l) [Reserved]
(m) Examples.
(n) Effective date.

Par. 3. Section 1.355–7 is added to read as follows:

§1.355–7 Recognition of gain on certain distributions of stock or securities in connection with an acquisition.

(a) *In general.* Except as provided in section 355(e) and in this section, section 355(e) applies to any distribution—

(1) To which section 355 (or so much of section 356 as relates to section 355) applies; and

(2) That is part of a plan (or series of related transactions) (hereinafter, plan) pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation (Distributing) or any controlled corporation (Controlled).

(b) *Plan.* (1) Whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances. In general, in the case of an acquisition after a distribution, the distribution and the acquisition are considered part of a plan if Distributing, Controlled, or any of their respective controlling shareholders intended, on the date of the distribution, that the acquisition or a similar acquisition occur in connection with the distribution. In general, in the case of an acquisition before a distribution, the acquisition and the distribution are considered part of a plan if Distributing, Controlled, or any of their respective controlling shareholders intended, on the date of the acquisition, that a distribution occur in connection with the acquisition.

(2) For purposes of paragraph (b)(1) of this section, the actual acquisition and the intended acquisition may be similar even though the identity of the person acquiring stock of Distributing or Controlled (acquirer), the timing of the acquisition or the terms of the actual acquisition are different from the intended acquisition. For example, in the case of a public offering or auction, the actual acquisition and the intended acquisition may be similar even though there are changes in the terms of the stock, the class of stock being offered, the size of the offering, the timing of the offering, the price of the stock, or the participants in the public offering or auction.

(c) *Multiple acquisitions*. All acquisitions of stock of Distributing or Controlled that are considered to be part of a plan with a distribution pursuant to paragraph (b) of this section will be aggregated for purposes of the 50-percent test of paragraph (a)(2) of this section.

(d) *Facts and circumstances*. (1) The facts and circumstances to be considered in demonstrating whether a distribution and an acquisition are part of a plan include, but are not limited to, the facts and circumstances specified in paragraphs (d)(2) and (d)(3) of this section. The weight to be given each of the facts and circumstances depends on the particular case. Therefore, whether a distribution and an acquisition are part of a plan does not depend on the relative number of facts and circumstances present under paragraph (d)(2) as compared to paragraph (d)(3) of this section.

(2) Among the facts and circumstances tending to show that a distribution and an acquisition are part of a plan are the following:

(i) In the case of an acquisition (other than involving a public offering or auction) after a distribution, Distributing or Controlled and the acquirer (or any of their respective controlling shareholders) discussed the acquisition or a similar acquisition by the acquirer before the distribution. The weight to be accorded the discussions depends on the nature, extent and timing of the discussions. The existence of an agreement, understanding, arrangement or substantial negotiations at the time of the distribution is given substantial weight.

(ii) In the case of an acquisition (other than involving a public offering or auction) after a distribution, Distributing or Controlled and a potential acquirer (or any of their respective controlling shareholders) discussed an acquisition before the distribution and a similar acquisition by a different person occurred after the distribution. The weight to be accorded the discussions depends on the nature, extent and timing of the discussions and the similarity of the acquisition actually occurring to the acquisition discussed before the distribution.

(iii) In the case of an acquisition involving a public offering or auction after a distribution, Distributing or Controlled (or any of their respective controlling shareholders) discussed the acquisition with an investment banker or other outside adviser before the distribution. The weight to be accorded the discussions depends on the nature, extent and timing of the discussions.

(iv) In the case of an acquisition before a distribution, Distributing or Controlled and the acquirer (or any of their respective controlling shareholders) discussed a distribution before the acquisition. The weight to be accorded the discussions depends on the nature, extent and timing of the discussions.

(v) In the case of an acquisition before a distribution, Distributing or Controlled and a potential acquirer (or any of their respective controlling shareholders) discussed a distribution before the acquisition and a similar acquisition by a different person occurred before the distribution. The weight to be accorded the discussions depends on the nature, extent and timing of the discussions and the similarity of the acquisition actually occurring to the potential acquisition that was discussed.

(vi) In the case of an acquisition involving a public offering or auction before a distribution, Distributing or Controlled (or any of their respective controlling shareholders) discussed a distribution with an investment banker or other outside adviser before the acquisition. The weight to be accorded the discussions depends on the nature, extent and timing of the discussions.

(vii) In the case of an acquisition either before or after a distribution, the distribution was motivated by a business purpose to facilitate the acquisition or a similar acquisition of Distributing or Controlled.

(viii) In the case of an acquisition either before or after a distribution, the acquisition and the distribution occurred within 6 months of each other or there was an agreement, understanding, arrangement, or substantial negotiations regarding the second transaction within 6 months after the first transaction. Also, in the case of an acquisition occurring after a distribution, there was an agreement, understanding, arrangement, or substantial negotiations regarding a similar acquisition at the time of the distribution or within 6 months thereafter.

(ix) In the case of an acquisition either before or after a distribution, the debt allocation between Distributing and Controlled made an acquisition of Distributing or Controlled likely in order to service the debt.

(3) Among the facts and circumstances tending to show that a distribution and an acquisition are not part of a plan are the following:

(i) In the case of an acquisition (other than involving a public offering or auction) after a distribution, neither Distributing nor Controlled and the acquirer or any potential acquirer (nor any of their respective controlling shareholders) discussed the acquisition or a similar acquisition before the distribution.

(ii) In the case of an acquisition involving a public offering or auction after a distribution, neither Distributing nor Controlled (nor any of their respective controlling shareholders) discussed the acquisition with an investment banker or other outside adviser before the distribution.

(iii) In the case of an acquisition after a distribution, there was an identifiable, unexpected change in market or business conditions occurring after the distribution that resulted in the acquisition that was otherwise unexpected at the time of the distribution.

(iv) In the case of an acquisition (other than involving a public offering or auction) before a distribution, neither Distributing nor Controlled and the acquirer (nor any of their respective controlling shareholders) discussed a distribution before the acquisition. This paragraph (d)(3)(iv) does not apply if the acquisition occurred after the date of the public announcement of the planned distribution.

(v) In the case of an acquisition before a distribution, there was an identifiable, unexpected change in market or business conditions occurring after the acquisition that resulted in a distribution that was otherwise unexpected.

(vi) In the case of an acquisition either before or after a distribution, the distribution was motivated in whole or substantial part by a corporate business purpose (within the meaning of §1.355–2(b)) other than a business purpose to facilitate the acquisition or a similar acquisition of Distributing or Controlled. The presence of a business purpose to facilitate the acquisition or a similar acquisition of Distributing or Controlled is relevant in determining the extent to which the distribution was motivated by a corporate business purpose (within the meaning of §1.355–2(b)) other than a business purpose to facilitate the acquisition or a similar acquisition of Distributing or Controlled.

(vii) In the case of an acquisition either before or after a distribution, the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition or a similar acquisition (including a previously proposed similar acquisition that did not occur).

(e) *Operating rules*. The operating rules contained in this paragraph (e) apply for all purposes of this section.

(1) *Reasonable certainty evidence of business purpose to facilitate an acquisition*. (i) In the case of an acquisition after a distribution, if, at the time of the distribution, it was reasonably certain that before a date that is 6 months after the distribution an acquisition would occur, an agreement, understanding, or arrangement would exist, or substantial negotiations would occur regarding an acquisition of Distributing or Controlled, the reasonable certainty is evidence of a business purpose to facilitate an acquisition of Distributing or Controlled.

(ii) In the case of an acquisition before a distribution, if the acquisition occurred after the date of the public announcement of the planned distribution, or if, at the time of the acquisition, it was reasonably certain that before a date that is 6 months after the acquisition the distribution would occur, an agreement, understanding, or arrangement would exist, or substantial negotiations would occur regarding the distribution, the public announcement or reasonable certainty is evidence of a business purpose to facilitate an acquisition of Distributing or Controlled.

(2) *Internal discussions evidence of business purpose*. The fact that internal discussions regarding an acquisition occurred may be indicative of the business purpose that motivated the distribution.

(3) *Hostile takeover defense*. If Distributing distributes Controlled stock intending, in whole or substantial part, to decrease the likelihood of the acquisition of Distributing or Controlled by separating it from another corporation that is likely to be acquired, Distributing will be treated as having a business purpose to facilitate the acquisition of the corporation that was likely to be acquired.

(4) *Effect of distribution on trading in stock.* The fact that the distribution made all or a part of the stock of Controlled available for trading or made Distributing or Controlled's stock trade more actively is not taken into account in determining whether the distribution and an acquisition of Distributing or Controlled stock were part of a plan.

(5) *Consequences of section 355(e) disregarded for certain purposes*. For purposes of determining the intentions of the relevant parties under this section, the consequences of the application of section 355(e), and the existence of any contractual indemnity by Controlled for tax resulting from the application of section 355(e) caused by an acquisition of Controlled, are disregarded.

(6) *Substantial diminution of risk*. The running of any time period prescribed in this section shall be suspended for any period during which risk of loss is substantially diminished under the principles of section 355(d)(6)(B).

(f) *Safe harbors*—(1) *Safe Harbor I*. (i) A distribution and an acquisition occurring after the distribution will not be considered part of a plan if—

(A) The acquisition occurred more than 6 months after the distribution and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition before a date that is 6 months after the distribution; and

(B) The distribution was motivated in whole or substantial part by a corporate business purpose (within the meaning of §1.355–2(b)) other than a business purpose to facilitate an acquisition of Distributing or Controlled.

(ii) For purposes of paragraph (f)(1)(i)(B) of this section, the presence of a business purpose to facilitate an acquisition of Distributing or Controlled is relevant in determining the extent to which the distribution was motivated by a corporate business purpose (within the meaning of §1.355–2(b)) other than a business purpose to facilitate an acquisition of Distributing or Controlled.

(2) *Safe Harbor II*. A distribution and an acquisition occurring after the distribution will not be considered part of a plan if—

(i) The acquisition occurred more than 6 months after the distribution and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition before a date that is 6 months after the distribution; and

(ii) The distribution was motivated in whole or substantial part by a corporate business purpose (within the meaning of §1.355–2(b)) to facilitate an acquisition or acquisitions of no more than 33 percent of the stock of Distributing or Controlled, and no more than 20 percent of the stock of the corporation (whose stock was acquired in the acquisition or acquisitions that motivated the distribution) was either acquired or the subject of an agreement, understanding, arrangement, or substantial negotiations before a date that is 6 months after the distribution.

(3) *Safe Harbor III*. If an acquisition occurs more than 2 years after a distribution and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition at the time of the distribution or within 6 months thereafter, the acquisition and the distribution are not part of a plan.

(4) *Safe Harbor IV*. If an acquisition occurs more than 2 years before a distribution, and there was no agreement, understanding, arrangement, or substantial negotiations concerning the distribution at the time of the acquisition or within 6 months thereafter, the acquisition and the distribution are not part of a plan.

(5) *Safe Harbor V*—(i) *In general*. An acquisition of Distributing or Controlled stock that is listed on an established market is not part of a plan if the acquisition is pursuant to a transfer between shareholders of Distributing or Controlled, neither of whom is a 5-percent shareholder. For purposes of the preceding sentence, the term 5-percent shareholder is defined in paragraph (k)(5) of this section, except that the corporation can rely on Schedules 13D and 13G (or any similar schedules) filed with the Securities and Exchange Commission to identify its 5-percent shareholders.

(ii) *Special rules*—(A) This paragraph (f)(5) does not apply to public offerings or redemptions.

(B) This paragraph (f)(5) does not apply to a transfer of stock by or to a person who, pursuant to a formal or informal understanding with other persons (the coordinating group), has joined in coordinated transfers of stock if, at any time during the period the understanding exists, the coordinating group owns, in the aggregate, 5 percent or more of the stock of the corporation whose stock is transferred (determined by vote or value) immediately before or after each transfer or at the time of the distribution. A principal element in determining if such an understanding exists is whether the investment decision of each person is based on the investment decision of 1 or more other existing or prospective shareholders.

(C) This paragraph (f)(5) does not apply to a transfer of stock by or to a person if the corporation the stock of which is being transferred knows, or has reason to know, that the person (or a coordinating group, treating it as a single person) intends to become a 5-percent shareholder at any time during the 4-year period beginning 2 years before the distribution.

(6) *Safe Harbor VI*. If stock of Distributing or Controlled is acquired by an employee or director of Distributing, Controlled, or a person related to Distributing or Controlled under section 355(d)(7)(A), in connection with the performance of services as an employee or director for the corporation or a person related to it under section 355(d)(7)(A) (and that is not excessive by reference to the services performed) in a transaction to which section 83 applies, the acquisition is not an acquisition that is part of a plan as described in paragraph (b)(1) of this section.

(g) Stock acquired by exercise of options, warrants, convertible obligations, and other similar interests—(1) Treatment of options—(i) *General rule*. For purposes of this section, if stock of Distributing or Controlled is acquired pursuant to an option, the option will be treated as an agreement to acquire the stock on the date the option is written unless Distributing establishes that on the later of the date of the stock distribution or the writing of the option, the option was not more likely than not to be exercised. The determination of whether an option was more likely than not to be exercised is based on all the facts and circumstances, taking control premiums and minority and blockage discounts into account in determining the fair market value of stock underlying an option.

(ii) *Agreement, understanding, arrangement, or substantial negotiations to write an option*. If there is an agreement, understanding, or arrangement to write an option, the option will be treated as written on the date of the agreement, understanding, or arrangement. If an agreement, understanding, or arrangement to write an option is reached, or an option is written, more than 6 months but not more than 2 years after the distribution, and there were substantial negotiations regarding the writing of the option or the acquisition of the stock underlying the option before the end of the 6-month period beginning on the date of the distribution, the option will be treated as written within 6 months after the distribution.

(2) *Instruments treated as options*. For purposes of this paragraph (g), except to the extent provided in paragraph (g)(3) of this section, call options, warrants, convertible obligations, the conversion feature of convertible stock, put options, redemption agreements (including rights to cause the redemption of stock), any other instruments that provide for the right or possibility to issue, redeem, or transfer stock (including an option on an option), or any other similar interests are treated as options.

(3) *Instruments generally not treated as options*. For purposes of this paragraph (g), the following are not treated as options unless (in the case of paragraphs (g)(3)(i), (iii), and (iv) of this section) written, transferred (directly or indirectly), or listed with a principal purpose of avoiding the application of section 355(e) or this section.

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

(ii) Compensatory options. An option to acquire stock in Distributing or Controlled with customary terms and conditions provided to an employee or director of Distributing, Controlled, or a person related to Distributing or Controlled under section 355(d)(7)(A), in connection with the performance of services as an employee or director for the corporation or a person related to it under section 355(d)(7)(A) (and that is not excessive by reference to the services performed) and that immediately after the distribution and within 6 months thereafter—

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

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

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

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

(v) *Other enumerated instruments*. Any other instrument the Commissioner may designate in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin. See §601.601(d)(2) of this chapter.

(h) *Multiple controlled corporations*. Only the stock or securities of a controlled corporation in which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest as part of a plan involving the distribution of that corporation will be treated as not qualified property under section 355(e)(1) if—

(1) The stock or securities of more than 1 controlled corporation are distributed in distributions to which section 355 (or so much of section 356 as relates to section 355) applies; and

(2) One or more persons do not acquire, directly or indirectly, stock representing a 50-percent or greater interest in Distributing pursuant to a plan involving any of those distributions.

(i) [Reserved]

(j) *Valuation*. Except as provided in paragraph (g)(1)(i) of this section, for purposes of section 355(e) and this section, all shares of stock within a single class are considered to have the same value. Thus, control premiums and minority and blockage discounts within a single class are not taken into account.

(k) *Definitions*—(1) *Agreement, understanding, arrangement, or substantial negotiations*. Whether an agreement, understanding, or arrangement exists depends on the facts and circumstances. The parties do not necessarily have to have entered into a binding contract or have reached agreement on all terms to have an agreement, understanding, or arrangement. However, an agreement, understanding, or arrangement clearly exists if enforceable rights to acquire stock exist. In public offerings or auctions by Distributing or Controlled of Distributing or Controlled's stock, an agreement, understanding, arrangement, or substantial negotiations can exist even if the acquirer has not been specifically identified. The existence of such an agreement, understanding, arrangement, or substantial negotiations will be based on discussions with an investment banker or other outside adviser.

(2) *Controlled corporation*. For purposes of this section, a controlled corporation is a corporation the stock of which is distributed in a distribution to which section 355 (or so much of section 356 as relates to section 355) applies.

(3) *Controlling shareholder*. (i) A controlling shareholder of a corporation the stock of which is not listed on an established market is any person who, directly or indirectly, or together with related persons (as described in sections 267(b) and 707(b)), possesses voting power in Distributing or Controlled representing a meaningful voice in the governance of the corporation.

(ii) A controlling shareholder of a corporation the stock of which is listed on an established market is a 5-percent shareholder who actively participates in the management or operation of the corporation.

(iii) For purposes of this section, a person is a controlling shareholder if that person meets the definition of controlling shareholder in this paragraph (k)(3) immediately before or immediately after the acquisition being tested.

(iv) If a distribution precedes an acquisition, Controlled's controlling shareholders immediately after the distribution are considered Controlled's controlling shareholders at the time of the distribution.

(4) *Established Market*. An established market is—

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

(ii) An interdealer quotation system sponsored by a national securities association registered under section 15A of the Securities Act of 1934 (15 U.S.C. 78o–3); or

(iii) Any additional market that the Commissioner may designate in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(5) *Five-percent shareholder*. A person will be considered a 5-percent shareholder of a corporation the stock of which is listed on an established market if the person owns, directly or indirectly, or together with related persons (as described in sections 267(b) and 707(b)) 5 percent or more of any class of stock of the corporation whose stock is transferred. A person is a 5-percent shareholder if the person meets the requirements of the preceding sentence immediately before or after each transfer. All options are treated as exercised for the purpose of determining whether the shareholder is a 5-percent shareholder.

(l) [Reserved]

(m) *Examples*. The following examples illustrate paragraphs (a) through (k) of this section. Throughout these examples, assume that Distributing (D) owns all of the stock of Controlled (C). Assume further that D distributes the stock of C in a distribution to which section 355 applies and to which section 355(d) does not apply. Unless otherwise stated, assume the corporations do not have controlling shareholders. No inference should be drawn from any example concerning whether any requirements of section 355 other than those of section 355(e) are satisfied. The examples are as follows:

Example 1. Unwanted assets. (i) D is in business 1. C is in business 2. D is relatively small in its industry. D wants to combine with X, a larger corporation also engaged in business 1. X and D begin negotiating for X to acquire D, but X does not want to acquire C. To facilitate the acquisition of D by X, D agrees to distribute all the stock of C *pro rata* before the acquisition. D and X enter into a binding contract for D to merge into X subject to several conditions. D distributes C and D merges into X one month later. As a result of the merger, D's former shareholders own less than 50 percent of the stock of X.

(ii) No Safe Harbor applies to this acquisition.

(iii) The issue is whether the distribution of C and the merger of D into X are part of a plan. To determine whether the distribution of C and the merger of D into X are part of a plan, D must consider all the facts and circumstances, including those described in paragraph (d) of this section.

(iv) The following tends to show that the distribution of C and the merger of D into X are part of a plan: X and D discussed the acquisition before the distribution (paragraph (d)(2)(i) of this section), D was motivated by a business purpose to facilitate the merger (paragraph (d)(2)(vii) of this section), and the distribution and the merger occurred within 6 months of each other (paragraph (d)(2)(viii) of this section). Because the merger was not only discussed, but was agreed to, before the distribution, the fact described in paragraph (d)(2)(i) of this section is given substantial weight.

(v) None of the facts and circumstances listed in paragraph (d)(3) of this section, tending to show that a distribution and an acquisition are not part of a plan, exist in this case.

(vi) The distribution of C and the merger of D into X are part of a plan under paragraph (b)(1) of this section.

Example 2. Substituted acquirer. (i) The facts are the same as in *Example 1*, except that after D distributes C, X is unable to fulfill one of the conditions of the merger agreement and the merger of D into X does not occur. Y, one of X's competitors, perceives this as an opportunity and begins discussing with D a merger into Y. Five months after D distributes C, D merges into Y. As a result of the merger, the D shareholders own less than 50 percent of the outstanding Y stock.

(ii) No Safe Harbor applies to this acquisition.

(iii) The issue is whether the distribution of C and the merger of D into Y are part of a plan. To determine whether the distribution of C and the merger of D into Y are part of a plan, D must consider all the facts and circumstances, including those described in paragraph (d) of this section.

(iv) The following tends to show that the distribution of C and the merger of D into Y are part of a plan: X, a potential acquirer, and D discussed an acquisition before the distribution and a similar acquisition by Y occurred (paragraph (d)(2)(ii) of this section), D was motivated by a business purpose to facilitate an acquisition similar to the merger with Y (paragraph (d)(2)(vii) of this section), and the distribution and the merger occurred within 6 months of each other (paragraph (d)(2)(viii) of this section).

(v) As in *Example 1*, none of the facts and circumstances listed in paragraph (d)(3) of this section exist in this case. Although a substituted acquirer acquired D, the merger of D into Y was similar to the negotiated merger of D into X.

(vi) The distribution of C and the merger of D into Y are part of a plan under paragraph (b)(1) of this section.

Example 3. Public offering. (i) D's managers, directors, and investment banker discuss the possibility of offering D stock to the public. They decide a public offering of 50 percent of D's stock with D as a stand alone corporation would be in D's best interest. To facilitate a stock offering by D of 50 percent of its stock, D distributes all the stock of C *pro rata* to D's shareholders. D issues new shares amounting to 50 percent of its stock to the public in a public offering 7 months after the distribution.

(ii) No Safe Harbor applies to this acquisition. Safe Harbor V, relating to public trading, does not apply to public offerings (paragraph (f)(5)(ii)(A) of this section).

(iii) The issue is whether the distribution of C and the public offering by D are part of a plan. To determine whether the distribution of C and the public offering by D are part of a plan, D must consider all the facts and circumstances, including those described in paragraph (d) of this section.

(iv) The following tends to show that the distribution of C and the public offering by D are part of a plan: D discussed the public offering with its investment banker before the distribution (paragraph (d)(2)(iii) of this section), D was motivated by a business purpose to facilitate the public offering (paragraph (d)(2)(vii) of this section), and there were substantial negotiations regarding the public offering within 6 months after the distribution (paragraph (d)(2)(viii) of this section).

(v) None of the facts and circumstances listed in paragraph (d)(3) of this section, tending to show that a distribution and an acquisition are not part of a plan, exist in this case.

(vi) The distribution of C and the public offering by D are part of a plan under paragraph (b)(1) of this section.

Example 4. Public offering followed by unexpected opportunity—(i) *Facts*. D's managers, directors, and investment banker discuss the possibility of offering C stock to the public. D decides to distribute C *pro rata* to D's shareholders solely to facilitate a 20 percent stock offering by C. To take advantage of favorable market conditions, C issues new shares amounting to 20 percent of its stock in a public offering 1 month before D distributes its remaining 80 percent of the C stock. The public offering documents disclose the intended distribution of C, which is expected to occur shortly after the public offering. At the time of the distribution, it is not reasonably certain that an acquisition will occur, an agreement, understanding, or arrangement concerning an acquisition will exist, or substantial negotiations concerning an acquisition will occur within 6 months. Two months after the distribution, C is approached unexpectedly regarding an opportunity to acquire X. Five months after the distribution, C acquires X in exchange for 40 percent of the C stock.

(ii) *Public offering*. (A) No Safe Harbor applies to the public offering. Safe Harbor V, related to public trading, does not apply to public offerings (paragraph (f)(5)(ii)(A) of this section).

(B) The issue is whether the 20 percent public offering by C and the distribution by D of the remaining C stock are part of a plan. To determine whether the distribution and the public offering are part of a plan, D must consider all the facts and circumstances, including those described in paragraph (d) of this section.

(C) Under paragraph (d)(2) of this section, the following tends to show that the distribution of C and the public offering are part of a plan: D discussed the distribution with its investment banker before the public offering (paragraph (d)(2)(vi) of this section), D was motivated by a business purpose to facilitate the public offering (paragraph (d)(2)(vii) of this section), and the public offering and the distribution occurred within 6 months of each other (paragraph (d)(2)(viii) of this section).

(D) None of the facts and circumstances listed in paragraph (d)(3) of this section, tending to show that a distribution and an acquisition are not part of a plan, exist in this case.

(E) The public offering of C and the distribution of C are part of a plan under paragraph (b)(1) of this section.

(iii) *X acquisition*. (A) No Safe Harbor applies to the X acquisition.

(B) The issue is whether the distribution of C and the acquisition by C of X are part of a plan. To determine whether the distribution of C and the acquisition by C of X are part of a plan, D must consider all the facts and circumstances, including those described in paragraph (d) of this section.

(C) Under paragraph (d)(2) of this section, the following tends to show that the distribution of C and acquisition by C of X are part of a plan: The distribution and the acquisition occurred within 6 months of each other (paragraph (d)(2)(viii) of this section). The fact described in paragraph (d)(2)(vii) of this section does not exist in this case because D's business purpose was to facilitate the public offering and C's acquisition of X is not similar to that acquisition.

(D) Under paragraph (d)(3) of this section, the following tends to show that the distribution of C and the acquisition by C of X are not part of a plan: Neither D, C, nor their respective controlling shareholders discussed the acquisition of X or a similar acquisition with potential acquirers before the distribution (paragraph (d)(3)(i) of this section), D had a substantial business purpose for the distribution other than a business purpose to facilitate the acquisition of X or a similar acquisition (paragraph (d)(3)(vi) of this section), and the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition of X (paragraph (d)(3)(vii) of this section). The distribution was announced and accomplished to facilitate the 20 percent public offering by C. D and C were unaware of the opportunity to acquire X at the time of the distribution.

(E) Weighing the facts and circumstances, the acquisition by C of X and the distribution of C by D are not part of a plan under paragraph (b)(1) of this section.

(F) If C's acquisition of X had occurred more than 6 months after the distribution and had not been the subject of an agreement, understanding, arrangement, or substantial negotiations before the date that is 6 months after the distribution, Safe Harbor II would have applied to C's acquisition of X.

Example 5. Hot market. (i) D is a widely held corporation the stock of which is listed on an established market. D announces a distribution of C and distributes C pro rata to D's shareholders. By contract, C agrees to indemnify D for any imposition of tax under section 355(e) caused by the acts of C. The distribution is motivated by a desire to improve D's access to financing at preferred customer interest rates, which will be more readily available if D separates from C. At the time of the distribution, although D has not been approached by any potential acquirer of C, it is reasonably certain that within 6 months after the distribution either an acquisition of C will occur or there will be an agreement, understanding, arrangement, or substantial negotiations regarding an acquisition of C. Corporation Y acquires C in a merger described in section 368(a)(2)(E) within 6 months after the distribution. The C shareholders receive less than 50 percent of the stock of Y in the exchange.

(ii) No Safe Harbor applies to this acquisition.

(iii) The issue is whether the distribution of C and the acquisition of C by Y are part of a plan. To determine whether the distribution of C and the acquisition of C by Y are part of a plan, D must consider all the facts and circumstances, including those described in paragraph (d) of this section.

(iv) Under paragraph (d)(2) of this section, the following tends to show that the distribution of C and the acquisition of C by Y are part of a plan: The acquisition and the distribution occurred within 6 months of each other (paragraph (d)(2)(viii) of this section). In addition, the distribution may be motivated by a business purpose to facilitate the acquisition or a similar acquisition because there is evidence of a business purpose to facilitate an acquisition by reason of the fact that at the time of the distribution it was reasonably certain that an acquisition of C would occur or there would be an agreement, understanding, arrangement, or substantial negotiations regarding an acquisition of C within 6 months after the distribution (paragraphs (d)(2)(vii) and (e)(1)(i) of this section).

(v) Under paragraph (d)(3) of this section, the following tends to show that the distribution of C and the acquisition of C by Y are not part of a plan: Neither D, C, nor their respective controlling shareholders discussed the acquisition or a similar acquisition with Y or any other potential acquirers before the distribution (paragraph (d)(3)(i) of this section). Furthermore, D may be able to demonstrate that the distribution was motivated in whole or substantial part by a corporate business purpose other than a business purpose to facilitate the acquisition or a similar acquisition (paragraph (d)(3)(vi) of this section). D's stated purpose for the distribution (facilitating D's access to favorable financing) must be evaluated in light of the evidence of a business purpose to facilitate an acquisition. D also may be able to demonstrate that the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition (paragraph (d)(3)(vii) of this section).

(vi) Under paragraph (e)(5) of this section, the existence of the indemnity is irrelevant in analyzing whether the distribution and acquisition of C are part of a plan.

(vii) In determining whether the distribution of C and the acquisition of C by Y are part of a plan, one should consider the importance of D's stated business purpose for the distribution in light of the reasonable certainty that C would be acquired or there would be an agreement, understanding, arrangement, or substantial negotiations regarding an acquisition of C within 6 months after the distribution. If D's stated business purpose for the distribution is substantial even though the reasonable certainty that C would be acquired is evidence of a business purpose to facilitate an acquisition, and if D would have distributed C regardless of Y's acquisition of C, Y's acquisition of C and D's distribution of C are not part of a plan.

Example 6. *Unexpected opportunity*. (i) D, the stock of which is listed on an established market, announces that it will distribute all the stock of C *pro rata* to D's shareholders. At the time of the announcement, the distribution is motivated wholly by a corporate business purpose (within the meaning of §1.355–2(b)) other than a business purpose to facilitate an acquisition. After the announcement but before the distribution, widely held X becomes available as an acquisition target. There were no discussions between D and X before the announcement. D negotiates with and acquires X before the distribution. After the acquisition, X's former shareholders own 55 percent of D's stock. D distributes the stock of C *pro rata* within 6 months after the acquisition of X.

(ii) No Safe Harbor applies to this acquisition.

(iii) The issue is whether the acquisition of X by D and the distribution of C are part of a plan. To determine whether the distribution of C and the acquisition of X by D are part of a plan, D must consider all the facts and circumstances, including those described in paragraph (d) of this section.

(iv) Under paragraph (d)(2) of this section, the following tends to show that the acquisition of X by D and the distribution of C are part of a plan: The acquisition and the distribution occurred within 6 months of each other (paragraph (d)(2)(viii) of this section). Also, the distribution may be motivated by a business purpose to facilitate the acquisition or a similar acquisition because there is evidence of a business purpose to facilitate an acquisition by reason of the fact that the acquisition occurred after the public announcement of the planned distribution (paragraphs (d)(2)(vii) and (e)(1)(ii) of this section).

(v) Under paragraph (d)(3) of this section, D would assert that the following tends to show that the distribution of C and the acquisition of X by D are not part of a plan: The distribution was motivated by a corporate business purpose other than a business purpose to facilitate the acquisition or a similar acquisition (paragraph (d)(3)(vi) of this section), and the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition (paragraph (d)(3)(vii) of this section). That D decided to distribute C and announced that decision before it became aware of the opportunity to acquire X suggests that the distribution would have occurred at approximately the same time and in similar form regardless of D's acquisition of X. X's lack of participation in the decision also helps establish that fact.

(vi) In determining whether the distribution of C and acquisition of X by D are part of a plan, one should consider the importance of D's business purpose for the distribution in light of D's opportunity to acquire X. If D can establish that the distribution continued to be motivated by the stated business purpose, and if D would have distributed C regardless of D's acquisition of X, then D's acquisition of X and D's distribution of C are not part of a plan.

Example 7. *Multiple acquisitions*—(i) *Facts*. (A) D, the stock of which is listed on an established market, engages in business 1. C engages in business 2. D has a business strategy of growth through acquisitions and is interested in continually expanding business 1. D's ownership of C has been an impediment to acquisitions by D. D believes the distribution of C will make its acquisition program more economical overall, regardless of D's success with any particular acquisition target. D has no specific goals regarding how much D stock will be used for acquisitions.

(B) D and its investment banker identify X and Y as potential acquisition targets before D publicly announces the planned distribution. After D publicly announces the distribution, the sole purpose of which is to facilitate acquisitions by D, but before the distribution date, D negotiates with X, but has no contact with Y. D distributes all of the C stock. One month after the distribution, D consummates the negotiated acquisition of X. A, X's sole shareholder, receives 30 percent of D's stock. Seven months after the distribution, D begins negotiating with Y. One year after the distribution, D acquires Y. Y's shareholders receive 19 percent of D's stock. After the distribution, D and its investment banker identify Z as another desirable target. Eighteen months after the distribution, D acquires Z. Z's shareholders receive 17 percent of D's stock. If aggregated, the acquisitions of X, Y and Z would result in a change in the stock ownership of D of more than 50 percent.

(ii) *X acquisition*. (A) No Safe Harbor applies to the X acquisition.

(B) The issue is whether the distribution of C and the acquisition of X by D are part of a plan. To determine whether the distribution of C and the acquisition of X by D are part of a plan, D must consider all the facts and circumstances, including those described in paragraph (d) of this section.

(C) Under paragraph (d)(2) of this section, the following tends to show that the distribution of C and the acquisition of X by D are part of a plan: D and X discussed the acquisition before the distribution (paragraph (d)(2)(i) of this section), D had a business purpose to facilitate the X acquisition or a similar acquisition (paragraph (d)(2)(vii) of this section), and the distribution and the X acquisition occurred within 6 months of each other (paragraph (d)(2)(viii) of this section).

(D) None of the facts and circumstances listed in paragraph (d)(3) of this section, tending to show that a distribution and an acquisition are not part of a plan, exist in this case.

(E) The distribution of C and the acquisition of X are part of a plan under paragraph (b)(1) of this section.

(iii) *Y acquisition*. (A) No Safe Harbor applies to the Y acquisition. Safe Harbor I does not apply because the distribution was not motivated in whole or substantial part by a corporate business purpose (within the meaning of §1.355–2(b)) other than a business purpose to facilitate an acquisition. Safe Harbor II does not apply because D's business purpose to facilitate acquisitions was not limited to 33 percent or less of the D stock. Also, more than 20 percent of D's stock was acquired in an acquisition that motivated the distribution before the date that was 6 months after the distribution (D's acquisition of X using 30 percent of D's stock 1 month after the distribution).

(B) The issue is whether the distribution of C and the acquisition of Y by D are part of a plan. To determine whether the distribution of C and the acquisition of Y by D are part of a plan, D must consider all the facts and circumstances, including those described in paragraph (d) of this section.

(C) Under paragraph (d)(2) of this section, the following tends to show that the distribution of C and the acquisition of Y by D are part of a plan: D and a potential acquirer (X) discussed an acquisition before the distribution and a similar acquisition with a different acquirer (Y) occurred (paragraph (d)(2)(ii) of this section) and D had a business purpose to facilitate the Y acquisition or a similar acquisition (paragraph (d)(2)(vii) of this section).

(D) None of the facts and circumstances listed in paragraph (d)(3) of this section, tending to show that a distribution and an acquisition are not part of a plan, exist in this case.

(E) The distribution of C and the acquisition of Y are part of a plan under paragraph (b)(1) of this section.

(iv) *Z acquisition*. The analysis is identical to the Y acquisition. The distribution of C and the acquisition of Z are part of a plan under paragraph (b)(1) of this section.

(v) Under paragraph (c) of this section, all acquisitions of stock of D pursuant to a plan involving a distribution will be aggregated for purposes of the 50-percent test of paragraph (a)(2) of this section. Because the acquisitions by D of X, Y, and Z are each part of a plan involving D's distribution of C, those three acquisitions are aggregated.

(n) *Effective date*. This section applies to distributions occurring after these regulations are published as final regulations in the **Federal Register**.

Robert E. Wenzel,
Deputy Commissioner
of Internal Revenue.

(Filed by the Office of the Federal Register on December 29, 2000, 8:45 a.m., and published in the issue of the Federal Register for January 2, 2001, 66 F.R. 66)

New Revision of Publication 547, *Casualties, Disasters, and Thefts*

Announcement 2001–6

Publication 547, revised December 2000, will be available soon from the Internal Revenue Service. It replaces the February 1999 revision.

This publication explains the tax treatment of casualties, thefts, and losses on deposits.

You can get a copy of this publication by calling 1-800-TAX-FORM (1-800-829-3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. The publication is also available on the IRS Internet web site at ***www.irs.gov.***

New Code V for the 2001 Form W-2, Box 12; Correction

Announcement 2001–7

Purpose

The purpose of this announcement is to advise employers of a change to Announcement 2000–97(2000–48 I.R.B. 557). Announcement 2000–97 advised employers that a new code (Code V—Income from the exercise of nonstatutory stock options) was added for use in box 12. In response to employer concerns about implementing the reporting procedures, the use of Code V is **optional** for the 2001 Forms W-2.

Nonstatutory Stock Options

When an employee (or former employee) exercises nonstatutory stock option(s), employers are currently required to include the excess of the fair market value of the stock received upon exercise of the option(s) over the amount paid for that stock on Form W-2 in boxes 1, 3 (up to the social security wage base), and 5. Any compensation related to the exercise of the nonstatutory stock option(s) currently included in boxes 1, 3 (if applicable), and 5 should also be reported separately in box 12, using **Code V**. This separate reporting in box 12 is *optional* for the 2001 Forms W-2.

New Revision of Publication 583, *Starting a Business and Keeping Records*

Announcement 2001–8

Publication 583, revised December 2000, is now available from the Internal Revenue Service. It replaces the January 1999 revision.

This publication provides basic federal tax and recordkeeping information for people who are starting a business.

You can get a copy of this publication by calling 1-800-TAX-FORM (1-800-829-3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. The publication is also available on the IRS Internet web site at **www.irs.gov.**

Extension of Test of Mediation Procedure for Appeals

Announcement 2001–9

Summary: This document extends the test of the mediation procedure set forth in Announcement 98–99, 1998–2 C.B. 650, for an additional one-year period beginning on January 16, 2001, the date this announcement is published in the Internal Revenue Bulletin.

The mediation procedure allows taxpayers, in certain cases that are already in the Appeals administrative process and that are not docketed in any court, to request mediation of one or more issues as a dispute resolution technique. Under the procedure, the taxpayer and Appeals attempt to negotiate a settlement, assisted by an objective and neutral third party who has no authority to impose a decision.

Background: Announcement 98–99, which contains the procedures that taxpayers may use to request mediation, applies to factual issues involving an adjustment of $1 million or more that are already in the Appeals administrative process. A two-year test of the mediation procedure concluded on November 15, 2000.

As Appeals transitions to its modernized structure, it is considering proposals to expand its alternative dispute resolution (ADR) processes. After this review is completed, Appeals plans to promulgate guidance expanding the mediation program as provided for under § 7123(b)(1) of the Internal Revenue Code.

Changes: To meet the goals of the Service's restructuring, Appeals has reorganized its staffing. Therefore, position and office titles in Announcement 98–99 are substituted as follows, along with an updated mailing address for Headquarters Appeals:

Position Title Changes

Old	*New*
National Director of Appeals	Chief Appeals
Assistant Regional Director of Appeals (ARDA-LC)	Area Director
Appeals Associate Chief	Appeals Team Manager
Appeals Team Chief	Appeals Team Case Leader

Office Title/Address Changes

Old	*New*
National Director of Appeals 901 D Street, SW Box 68 Washington, DC 20024 Attn: C:AP:ADR & CS, Room 236	Chief Appeals 1099 14^{th} Street, NW Suite 4200 - East Washington, DC 20005 Attn: Appeals LMSB Operations
National Office Appeals	Headquarters Appeals
Appeals Region	Appeals Area
Office of Alternative Dispute Resolution and Customer Service Programs	Appeals LMSB Operations

In addition to the above changes, responsibility for the management of the Appeals mediation program has been transferred from the Office of Alternative Dispute Resolution and Customer Service Programs to Appeals LMSB Operations.

Effective Date: This Announcement extends the test of the mediation procedure set forth in Announcement 98–99, for an additional one-year period beginning on January 16, 2001, the date this Announcement is published in the Internal Revenue Bulletin.

Drafting Information: The author of this announcement is Sandy Cohen, Appeals LMSB Operations, Headquarters Appeals. For further information regarding this announcement, call Mr. Cohen at (202) 694-1818 (not a toll-free number).

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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