Internal Revenue
bulletin

Bulletin No. 2002–47
November 25, 2002

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. 2002–67, page 873.
Charitable contributions. This ruling addresses the tax consequences under section 170 of the Code (regarding the deduction allowed for contributions and gifts to charity) of a taxpayer's transfer of a used car to the authorized agent of a charity.

T.D. 9019, page 874.
Unit livestock price method. Final regulations under section 471 of the Code provide rules relating to the annual reevaluation of unit livestock prices and the depreciation of livestock raised for drafting, breeding, or dairy purposes.

REG–131478–02, page 892.
Proposed regulations under section 1502 of the Code redetermine the basis of stock of a subsidiary member of a consolidated group immediately prior to certain dispositions and deconsolidations of such stock. In addition, the regulations suspend certain losses recognized on the disposition of such stock. The regulations apply to corporations filing consolidated returns. A public hearing is scheduled for January 15, 2003.

EMPLOYEE PLANS

Notice 2002–74, page 884.
Weighted average interest rate update. The weighted average interest rate for November 2002 and the resulting permissible range of interest rates used to calculate current liability for purposes of the full funding limitation of section 412(c)(7) of the Code are set forth.

EMPLOYMENT TAX

Ct. D. 2076, page 875.
Assessment for unpaid taxes. The Supreme Court has concluded that the Internal Revenue Service's statutory authorization to make assessments for unpaid taxes is reasonably read to cover restaurateur's FICA taxes based on an aggregate estimate of all unreported employee tips. **United States v. Fior D'Italia, Inc.**

REG–209116–89, page 889.
Withdrawal of requirement of making quarterly payments of the railroad unemployment repayment tax. In prior years, a repayment tax was levied on wages to repay certain loans to the railroad unemployment fund. Sections 3321 and 3322 of the Code provided for the time and manner of making these payments. Any loans which applied to this repayment tax have been fully repaid. Thus, the requirement is no longer relevant. EE–79–89 withdrawn.

ADMINISTRATIVE

REG–103777–02, page 889.
Proposed regulations under section 7122 of the Code provide for the imposition of a $150.00 user fee for the processing of offers to compromise. The charging of user fees implements the Independent Offices Appropriations Act, 31 U.S.C. section 9701. The proposed user fee would not apply to offers based on doubt as to liability, offers made by low income taxpayers, offers accepted to promote effective tax administration, and offers accepted based on doubt as to collectibility where there has been a determination that, although an amount greater than the amount offered could be collected, collection of more than the amount offered would create economic hardship within the meaning of regulations section 301.6343–1.

Notice 2002–75, page 884.
Annual accounting periods; automatic approval. This notice proposes a revenue procedure that, when finalized, will provide guidance for individuals to obtain automatic approval of the Commissioner to change their annual accounting period to the calendar year. Rev. Proc. 66–50 modified, amplified, and superseded. Rev. Proc. 81–40 modified and superseded.

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

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 Other Related Items, 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.

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

26 CFR 1.170A–1: Charitable, etc., contributions and gifts; allowance of deduction.

Charitable contributions. This revenue ruling addresses the tax consequences under section 170 of the Code (regarding the deduction allowed for contributions and gifts to charity) of a taxpayer's transfer of a used car to the authorized agent of a charity.

Rev. Rul. 2002–67

ISSUES

(1) For purposes of § 170 of the Internal Revenue Code, may a donor's transfer of a car to a charity's authorized agent be treated as a transfer to the charity?

(2) May the contemporaneous written acknowledgment required by § 170(f)(8) be provided to the donor by the charity's authorized agent?

(3) May a donor use an established used car pricing guide to determine the value of a car donated to a charity?

FACTS

Situation 1. O is a charitable organization described in § 170(c)(2). *O* is located in, and conducts its activities in, State *A*.

X is a for-profit entity located and licensed to sell cars in State *A*. Pursuant to a written agreement, *O* and *X* establish an agency relationship that is valid under the applicable law of State *A*. The agreement provides that *X*, acting as *O*'s authorized agent, will administer a fund-raising program for *O* in exchange for a fee. *X*'s activities under the agreement are subject to *O*'s review and approval.

The agreement provides that *X* will act on *O*'s behalf to (1) solicit donations of used cars, (2) accept, process, and sell the cars, (3) transfer the proceeds of the sales to *O*, less *X*'s fee, and (4) provide each donor with substantiation of that donor's contribution, including an acknowledgment that contains the information required by § 170(f)(8)(B).

To assist *O* in furthering its charitable purposes, *B*, an individual who itemizes federal income tax deductions, transfers a used car to *X* as *O*'s authorized agent. *B* does not receive anything of value in exchange for the car. *B* consults an established used car pricing guide, which lists $4,500 as the current sales price for a car of the same make, model, and year as *B*'s car and sold in *B*'s area, if the car is in excellent condition. The guide lists $3,000 as the current sales price for such a car if it is in average condition. The guide does not provide a sales price for a car that is in poor condition.

The guide states that a car is in excellent condition if it has no defects; in average condition if it has some defects, but is safe to drive; and in poor condition if it needs substantial mechanical or body repairs, or is unsafe to drive. *B*'s car is in average condition.

Situation 2. The facts are the same as in *Situation 1*, except that *B*'s car is in poor condition.

LAW AND ANALYSIS

Issue (1)

Section 170(a)(1) allows as a deduction, subject to certain limitations and restrictions, any charitable contribution (as defined in § 170(c)), payment of which is made within the taxable year. Section 170(c) defines charitable contribution, in part, as a contribution to or for the use of an entity described in § 170(c)(2).

It is well established that a charity may receive contributions through its authorized agent. *See, e.g.*, § 1.170A–1(b) of the Income Tax Regulations; Rev. Rul. 85–184, 1985–2 C.B. 84. Because *O* and *X* have established a valid agency relationship under the law of State *A*, *X* has the authority to act on *O*'s behalf according to the terms of their agency agreement. Thus, for purposes of § 170, *B*'s transfer of the car to *X* as *O*'s authorized agent is treated as a transfer to *O*. The determination of whether an agency relationship exists is based upon the requirements of state law. Not all contractual relationships will result in an agency relationship under state law.

Issue (2)

Section 170(f)(8)(A) provides that no deduction is allowed under § 170(a) for any contribution of $250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgment of the contribution by the donee organization that meets the requirements of § 170(f)(8)(B).

Because *X* is authorized by *O* to act as *O*'s agent in administering *O*'s fund-raising program, a written acknowledgment provided to *B* by *X* will satisfy the requirement of § 170(f)(8)(A) that the acknowledgment be made by the donee organization.

Issue (3)

Section 1.170A–1(c)(1) provides that if a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property at the time of the contribution.

Section 1.170A–1(c)(2) states that fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts. The quantity in which property is donated is a factor in determining fair market value. *See, e.g.*, Rev. Rul. 80–233, 1980–2 C.B. 69 (the best evidence of fair market value of bibles is the price at which similar quantities of bibles were sold in arms'-length transactions at the time of the contribution).

The fair market value of a car is the price at which the car would change hands between a willing buyer and a willing seller. There is no single correct way to determine fair market value of a car; any reasonable method may be used.

One method of determining fair market value of a single donated car is by reference to an established used car pricing guide. However, a used car pricing guide establishes fair market value only if the guide lists the sales price for a car that is the same make, model, and year, sold in the same area, and in the same condition, as the donated car.

Situation 1. The established used car pricing guide lists $3,000 as the current sales price for a car that is the same make, model, and year as *B*'s car, sold in the same area, and in the same condition (*i.e.*, average). Therefore, the fair market value of *B*'s car, and the amount treated as a charitable contribution under § 170, is $3,000. *B* also could have determined the value of the car by any other reasonable method.

Situation 2. The established used car pricing guide does not list a sales price for a car of the same make, model, and year as *B*'s car, sold in the same area, and in the same condition (*i.e.*, poor). Because the guide does not provide a value for a car in poor condition, the guide does not establish the fair market value of *B*'s car. *B* must establish the fair market value of the car using some other method that is reasonable under the circumstances.

INFORMATION REPORTING

For information regarding a charity's obligation to report amounts paid and received in connection with fund-raising programs, see Instructions for Form 990 and Announcement 2002–87, 2002–39 I.R.B. 624.

HOLDINGS

(1) For purposes of § 170, a donor's transfer of a car to a charity's authorized agent may be treated as a transfer to the charity.

(2) The contemporaneous written acknowledgment required by § 170(f)(8) may be provided to the donor by the charity's authorized agent.

(3) A donor may use an established used car pricing guide to determine the fair market value of a single donated car if the guide lists a sales price for a car that is the same make, model, and year, sold in the same area, and in the same condition, as the donated car. However, a donor may not use an established used car pricing guide to determine the fair market value of a single donated car if the guide does not list a sales price for a car in the same condition as the donated car. In such a case, the donor must use some other method that is reasonable under the circumstances to determine the value of the car. See Publication 561, "*Determining the Value of Donated Property*." Taxpayers are reminded that if they claim a deduction of more that $5,000 for the contribution of a car, they need to obtain a qualified appraisal.

DRAFTING INFORMATION

The principal author of this revenue ruling is Patricia Zweibel of the Office of the Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue ruling, contact Ms. Zweibel at (202) 622–5020 (not a toll-free call).

Section 471.—General Rule for Inventories

26 CFR 1.471–6: Inventories of livestock raisers and other farmers.

T.D. 9019

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Unit Livestock Price Method

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the use of the unit-livestock-price method of accounting. The regulations affect livestock raisers and other farmers that elect to use the unit-livestock-price method. These regulations provide rules relating to the annual reevaluation of unit prices and the depreciation of livestock raised for draft, breeding, or dairy purposes.

EFFECTIVE DATE: These regulations are effective October 28, 2002.

FOR FURTHER INFORMATION CONTACT: A. Katharine Jacob Kiss at (202) 622–4930 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR Part 1) under section 471 of the Internal Revenue Code (Code). A notice of proposed rulemaking (REG–125626–01, 2002–9 I.R.B. 604) was published in the **Federal Register** (67 FR 5074) on February 4, 2002. No public hearing was requested or held. One comment responding to the notice of proposed rulemaking was received. The proposed regulations are adopted by this Treasury decision.

Explanation of Provisions

The unit-livestock-price method provides for the valuation of different classes of animals in inventory at a standard unit price for each animal within a class. A taxpayer using the unit-livestock-price method must annually reevaluate its unit prices and must adjust the prices upward to reflect increases in the costs of raising livestock. The regulations allow taxpayers to both increase and decrease unit prices without obtaining the consent of the Commissioner. The regulations also clarify that a livestock raiser that uses the unit-livestock-price method may elect to remove from inventory after maturity an animal raised for draft, breeding, or dairy purposes and treat the inventoriable cost of such animal as an asset subject to depreciation.

In the notice of proposed rulemaking, the IRS and Treasury Department requested comments on whether safe harbor unit prices should be made available to taxpayers using the unit-livestock-price method and, if so, what index should be used. The sole commentator requested that safe harbor unit prices should be made available, and suggested using the price index developed by a local state extension service for the safe harbor unit prices. Due to the lack of widespread interest in developing and using safe harbor unit prices, the final regulations do not adopt that suggestion.

Effective Date

These regulations are applicable to taxable years ending after October 28, 2002.

Special Analyses

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

Associate Chief Counsel (Income Tax and Accounting). 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 1.471–6 also issued under 26 U.S.C. 471. * * *

Par. 2. Section 1.471–6 is amended as follows:

1. In paragraph (c), the last sentence is removed.
2. Paragraph (f) is revised.
3. In paragraph (g), the first sentence is amended by removing the language "capital assets" and adding in its place "property used in a trade or business."

The revisions read as follows:

§ 1.471–6 Inventories of livestock raisers and other farmers.

* * * * *

(f) A taxpayer that elects to use the "unit-livestock-price method" must apply it to all livestock raised, whether for sale or for draft, breeding, or dairy purposes. The inventoriable costs of animals raised for draft, breeding, or dairy purposes can, at the election of the livestock raiser, be included in inventory or treated as property used in a trade or business subject to depreciation after maturity. See § 1.263A–4 for rules regarding the computation of inventoriable costs for purposes of the unit-livestock-price method. Once established, the methods of accounting used by the taxpayer to determine unit prices and to classify animals must be consistently applied in all subsequent taxable years. A taxpayer that uses the unit-livestock-price method must annually reevaluate its unit prices and adjust the prices either upward to reflect increases, or downward to reflect decreases, in the costs of raising livestock. The consent of the Commissioner is not required to make such upward or downward adjustments. No other changes in the classification of animals or unit prices may be made without the consent of the Commissioner. See § 1.446–1(e) for procedures for obtaining the consent of the Commissioner. The provisions of this paragraph (f) apply to taxable years ending after October 28, 2002.

* * * * *

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved October 2, 2002.

Pamela F. Olson,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 25, 2002, 8:45 a.m., and published in the issue of the Federal Register for October 28, 2002, 67 F.R. 65697)

Section 3101.—Rate of Tax

Ct. D. 2076

SUPREME COURT OF THE UNITED STATES

No. 01–463

UNITED STATES *v.* FIOR D'ITALIA, INC.

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

June 17, 2002

Syllabus

Employers must pay Federal Insurance Contribution Act (FICA) taxes, calculated as a percentage of the wages, including tips, that their employees receive. 26 U.S.C. Secs. 3101, 3111, 3121(q). An employee reports the tip amount to the employer, who sends copies of the reports to the Internal Revenue Service (IRS). 26 CFR Sec. 31.6011(a)–1(a). In 1991 and 1992, respondent Fior D'Italia restaurant paid FICA taxes based on the tip amount its employees reported, but the reports also showed that the tips listed on customers' credit card slips far exceeded the reported amount. The IRS made a compliance check and assessed additional FICA taxes using an "aggregate estimation" method, under which it examined the credit card slips; found the average percentage tip paid by those customers; assumed that cash-paying customers paid at same rate; calculated total tips by multiplying the tip rates by Fior D'Italia's total receipts; subtracted the tips already reported; applied the FICA tax rate to the remainder; and assessed additional taxes owed. After paying a portion of the taxes, Fior D'Italia filed this refund suit, claiming that the tax statutes did not authorize the IRS to use the aggregate estimation method, but required it to first determine the tips that each individual employee received and then use that information to calculate the employer's total FICA tax liability. Fior D'Italia agreed that it would not dispute the accuracy of the particular calculation in this case. The District Court ruled for Fior D'Italia, and the Ninth Circuit affirmed.

Held: The tax law authorizes the IRS to use the aggregate estimation method. Pp. 3–14.

(a) An assessment is entitled to a legal presumption of correctness. By granting the IRS assessment authority, 26 U.S.C. Sec. 6201(a) must simultaneously grant it power to decide *how* to make that assessment within certain limits, which are not exceeded when the IRS estimates tax liability using a reasonable method. Pp. 3–5.

(b) The FICA statute's language, taken as a whole, does not prevent using an aggregate estimation method. Fior D'Italia claims that, because Sec. 3121(q) speaks in the singular — "tips received by *an* employee in the course of *his* employment" — an employer's liability attaches to each individual payment, not when the payments are later summed and reported. However, Sec. 3121(q) is a definitional section. Sections 3111(a) and (b), which impose the tax, speak in the plural — "wages" paid to "individuals" by the employer "with respect to employment" — and thus impose liability for the *totality* of the "wages" paid, which totality, says the definitional section, includes each individual employee's tips. Pp. 5–6.

(c) Contrary to the Ninth Circuit's view, there is no reason to read Sec. 446(b) — which authorizes the IRS to use estimation methods for determining income tax liability — or Sec. 6205(a)(1) — which authorizes the Secretary to adopt regulations prescribing mechanisms for employers to adjust FICA tax liability — as limiting the IRS' authority to use an aggregate estimation method to compute in computing FICA tax liability. Pp. 6–7.

(d) Certain features of an aggregate estimate — that it includes tips that should not count in calculating FICA tax, *e.g.*, tips amounting to less than $20 per month; and that a calculation based on credit card slips can overstate the aggregate amount because, *e.g.*, cash-paying customers tend to leave a lower percentage tip — do not show that the method is so unreasonable as to violate the law. Absent Fior D'Italia's stipulation that it would not challenge the IRS calculation's accuracy, a taxpayer would be free and able to present evidence that the assessment is inaccurate in a particular case. Pp. 7–10.

(e) The fact that the employer is placed in an awkward position by the requirement that it pay taxes only on tips reported by its employees, even when it knows those reports are inaccurate, does not make aggregate estimation unlawful. Section 3121(q) makes clear that penalties will not attach and interest will not accrue unless the IRS actually demands the money and the restaurant refuses to pay the amount demanded in a timely fashion. Pp. 9–11.

(f) Finally, even assuming that an improper motive on the IRS' part could render unlawful its use of a statutorily permissible enforcement method in certain circumstances, Fior D'Italia has not shown that the IRS has acted illegally in this case. It has presented a general claim that the aggregate estimation method lends itself to abusive agency action. But agency action cannot be found unreasonable in all cases simply because of a general possibility of abuse, which exists in respect to many discretionary enforcement powers. Pp. 11–13.

242 F.3d 844, reversed.

BREYER, J., delivered the opinion of the Court, in which REHNQUIST, C.J., and STEVENS, O'CONNOR, KENNEDY, and GINSBURG, JJ., joined. SOUTER, J., filed a dissenting opinion in which SCALIA and THOMAS, JJ., joined.

SUPREME COURT OF THE UNITED STATES

No. 01–463

UNITED STATES, PETITIONER *v.* FIOR D'ITALIA, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

June 17, 2002

JUSTICE BREYER delivered the opinion of the Court.

Employers must pay Federal Insurance Contribution Act taxes (popularly known as Social Security taxes or FICA taxes), calculated as a percentage of the wages — including the tips — that their employees receive. 26 U.S.C. Sec. 3101, 3111, 3121(q). This case focuses upon the Government's efforts to assess a restaurant for FICA taxes based upon tips that its employees may have received but did not report. We must decide whether the law authorizes the Internal Revenue Service (IRS) to base that assessment upon its *aggregate estimate* of all the tips that the restaurant's customers paid its employees, or whether the law requires the IRS instead to determine total tip income by estimating each *individual employee's* tip income separately, then adding individual estimates together to create a total. In our view, the law authorizes the IRS to use the aggregate estimation method.

I

The tax law imposes, not only on employees, but also "on every employer," an "excise tax," *i.e.*, a FICA tax, in an amount equal to a percentage "of the wages . . . paid by him with respect to employment." Sec. 3111(a) (setting forth basic Social Security tax); Sec. 3111(b) (using identical language to set forth additional hospital insurance tax). It specifies that "tips received by an employee in the course of his employment shall be considered remuneration" and "deemed to have been paid by the employer" for purposes of the FICA tax sections. Sec. 3121(q). It also requires an employee who receives wages in the form of tips to report the amount of those tips to the employer, who must send copies of those reports to the IRS. 26 CFR Sec. 31.6011(a)–1(a) (2001).

In 1991 and 1992, the reports provided to San Francisco's Fior D'Italia restaurant (and ultimately to the IRS) by the restaurant's employees showed that total tip income amounted to $247,181 and $220,845, in each year, respectively. And Fior D'Italia calculated and paid its FICA tax based on these amounts. The same reports, however, also showed that customers had listed tips on their credit card slips amounting to far more than the amount reported by the employees ($364,786 in 1991 and $338,161 in 1992). Not surprisingly, this discrepancy led the IRS to conduct a compliance check. And that check led the IRS to issue an assessment against Fior D'Italia for additional FICA tax.

To calculate the added tax it found owing, the IRS used what it calls an "aggregate estimation" method. That method was a very simple one. The IRS examined the restaurant's credit card slips for the years in question, finding that customers had tipped, on average, 14.49% of their bills in 1991 and 14.29% in 1992. Assuming that cash-paying customers on average tipped at those rates also, the IRS calculated total tips by multiplying the tip rates by the restaurant's total receipts. It then subtracted tips already reported and applied the FICA tax rate to the remainder. The results for 1991 showed total tips amounting to $403,726 and unreported tips amounting to $156,545. The same figures for 1992 showed $368,374 and $147,529. The IRS issued an assessment against Fior D'Italia for additional FICA taxes owed, amounting to $11,976 for 1991 and $11,286 for 1992.

After paying a portion of the taxes assessed, the restaurant brought this refund suit, while the IRS filed a counterclaim for the remainder. The restaurant argued that the tax statutes did not authorize the IRS to use its "aggregate estimation" method; rather, they required the IRS first to determine the tips that each individual employee received and then to use that information to calculate the employer's total FICA tax liability. Simplifying the case, the restaurant agreed that "[f]or purpose[s] of this litigation," it would "not dispute the facts, estimates and/or determinations" that the IRS had "used . . . as a basis for its calculation" of the employees' "aggregate unreported tip income." App. 35. And the District Court decided the sole remaining legal question — the question of the *statutory authority* to estimate tip income in the aggregate — in Fior D'Italia's favor.

The Court of Appeals affirmed the District Court by a vote of 2 to 1, the majority concluding that the IRS is not legally authorized to use its aggregate estimation method, at least not without first adopting its own authorizing regulation. In light of differences among the Circuits, compare 242 F.3d 844 (CA9 2001) (case below), with *330 West Hubbard Restaurant Corp. v. United States*, 203 F.3d 990, 997 (CA7 2000), *Bubble Room, Inc. v. United States*, 159 F.3d 553, 568 (CA Fed. 1998), and *Morrison Restaurants, Inc. v. United States*, 118 F.3d 1526, 1530 (CA11 1997), we granted the Government's petition for certiorari. We now reverse.

II

An "assessment" amounts to an IRS determination that a taxpayer owes the Federal Government a certain amount of unpaid taxes. It is well established in the tax law that an assessment is entitled to a legal presumption of correctness — a presumption that can help the Government prove its case against a taxpayer in court. See, *e.g.*, *United States v. Janis*, 428 U.S. 433, 440 (1976); *Palmer v. IRS*, 116 F.3d 1309, 1312 (CA9 1997); *Psaty v. United States*, 442 F.2d 1154, 1160 (CA3 1971); *United States v. Lease*, 346 F.2d 696, 700 (CA2 1965). We consider here the Government's authority to make an assessment in a particular way, namely by directly estimating the aggregate tips that a restaurant's employees have received rather than estimating (and then summing) the tips received by each individual employee.

The Internal Revenue Code says that the IRS, as delegate of the Secretary of Treasury,

> "is authorized and required to make the inquiries, determinations, and *assessments* of all taxes . . . which have not been duly paid . . . ." 26 U.S.C. Sec. 6201(a) (emphasis added).

This provision, by granting the IRS assessment authority, must simultaneously grant the IRS power to decide *how* to make that assessment — at least within certain limits. And the courts have consistently held that those limits are not exceeded when the IRS *estimates* an individual's tax liability — as long as the method used to make the estimate is a "reasonable" one. See, *e.g.*, *Erickson v. Commissioner*, 937 F.2d 1548, 1551 (CA10 1991) (estimate made with reference to taxpayer's purchasing record was "presumptively correct" when based on "reasonable foundation"). See also, *Janis*, *supra*, at 437 (upholding estimate of tax liability over 77-day period made by extrapolating information based on gross proceeds from 5-day period); *Dodge v. Commissioner*, 981 F.2d 350, 353–354 (CA8 1992) (upholding estimate using bank deposits by taxpayer); *Pollard v. Commissioner*, 786 F.2d 1063, 1066 (CA11 1986) (upholding estimate using statistical tables reflecting cost of living where taxpayer lived); *Gerardo v. Commissioner*, 552 F.2d 549, 551–552 (CA3 1977) (upholding estimate using extrapolation of income over 1-year period based on gross receipts from two days); *Mendelson v. Commissioner*, 305 F.2d 519, 521–522 (CA7 1962) (upholding estimate of waitress' tip income based on restaurant's gross receipts and average tips earned by all waitresses employed by restaurant); *McQuatters v. Commissioner*, 32 CCH TCM 1122 (1973) (same).

Fior D'Italia does not challenge this basic principle of law. Rather, it seeks to explain why this principle should not apply here, or why it should not determine the outcome of this case in the Government's favor.

A

Fior D'Italia's primary argument rests upon the statute that imposes the FICA tax. It points out that the tax law says there is "imposed on every employer" an "excise tax" calculated on the basis of "wages . . . paid by him" as those "wages" are "defined in" Sec. 3121. Secs. 3111(a), (b). It adds that the subsection of Sec. 3121 which specifies that "wages" includes tips (subsection q) refers to "tips" as those "received by *an* employee in the course of *his* employment," *i.e.*, to tips received by each employee individually. (Emphasis added.) Fior D'Italia emphasizes Sec. 3121(q)'s reference to the employee in the singular to conclude that the "employer's liability for FICA taxes therefore attaches to *each* of these individual payments not when they are later summed and reported." Brief for Respondent 28 (emphasis in original).

In our view, Fior D'Italia's linguistic argument makes too much out of too little. The language it finds key, the words "tips received by an employee" is contained in a definitional section, Sec. 3121(q), not in the sections that impose the tax, Secs. 3111(a), (b). The definitional section speaks in the singular. It says that an employee's (singular) tips "shall be considered remuneration" for purposes of the latter, tax imposing sections. Sec. 3121(q). But the latter operational sections speak in the plural. They impose on employers a FICA tax calculated as a percentage of the "wages" (plural) paid to "individuals" (plural) by the employer "with respect to employment." Secs. 3111(a), (b). The operational sections consequently impose liability for the *totality* of the "wages" that the employer pays, which totality of "wages," says the definitional section, shall include the tips that each individual employee earns. It is as if a tax were imposed on "all of a restaurant's dishes," with a definitional section specifying that "dishes" shall "include each customer's silverware." We simply do not see how this kind of language, taken as a whole, argues against use of an aggregate estimation method that seeks to determine the restaurant's total FICA tax liability.

B

The Ninth Circuit relied in part upon two other statutory provisions. The first, 26 U.S.C. Sec. 446(b), has been interpreted to authorize the IRS to use methods of estimation for determining *income* tax liability. See, *e.g.*, *Mendelson*, *supra*, at 521–522 (authorizing estimate of waitress' gross receipts). The court felt this provision negatively implies a lack of IRS authority to use the aggregate estimation method in respect to other taxes, such as employer FICA taxes, where no such provision applies. 242 F.3d, at 849. The second, 26 U.S.C. Sec. 6205(a)(1), authorizes the Secretary to adopt regulations that prescribe mechanisms for employers to adjust FICA tax liability. The court felt this provision negatively implies a lack of IRS authority to use an aggregate estimation method in the absence of a regulation. 242 F.3d, at 851.

After examining the statutes, however, we cannot find any negative implication. The first says that, where a taxpayer has used "a method of accounting" that "does not clearly reflect income," or has used "no method of accounting" at all, "the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income." Sec. 446(b). This provision applies to only one corner of income tax law, and even within that corner it says nothing about any particular method of calculation. To read it negatively would significantly limit IRS authority in that respect both within and outside the field of income tax law. And there is simply no reason to believe that Congress intended any such limitation.

Section 6205(a)(1) refers to certain employment taxes, including FICA taxes, and says that when an employer initially pays "less than the correct amount of tax," then "proper adjustments . . . shall be made, without interest," in accordance with "regulations." The IRS has made clear that this provision refers to an employer's "adjustments," say, in an initially underreported tax liability, made *before* the IRS has assessed an underpayment. See generally 26 CFR Sec. 31.6205–1 (2001). Again, there is simply no reason to believe that Congress, in writing this provision applicable to a small corner of tax law, intended, through negative implication, to limit the IRS' general power to assess tax deficiencies. Indeed, Fior D'Italia has not advanced in this Court either "negative implication" argument relied on by the Ninth Circuit.

C

Fior D'Italia next points to several features of an "aggregate" estimate that, in its view, make it "unreasonable" (and therefore contrary to law) for the IRS to use that method. First, it notes that an aggregate estimate will sometimes include tips that should not count in calculating the FICA tax the employer owes. The law excludes an employee's tips from the FICA wages base insofar as those tips amount to less than $20 in a month. 26 U.S.C. Sec. 3121(a)(12)(B). It also excludes the portion of tips and other wages (including fixed salary) an employee receives that rises above a certain annual level — $53,400 in 1991 and $55,500 in 1992. Sec. 3121(a)(1); 242 F.3d, at 846, n. 4. These ceilings mean that if a waiter earns, say, $36,000 in fixed salary, reports $20,000 in tips, and fails to report $10,000 in tips, the restaurant would *not* owe additional taxes, because the waiter's reported income ($56,000) already exceeds the FICA ceiling. But if that waiter earns $36,000 in fixed salary, reports $10,000 in tips, and fails to report another $10,000 in tips, the restaurant *would* owe additional taxes on the unreported amount, because the waiter's reported income of $46,000 falls below the FICA ceiling.

Second, Fior D'Italia points out that an aggregate calculation based on credit card slips can overstate the aggregate amount of tips because it fails to account for the possibilities that: (1) customers who pay cash tend to leave a lower percentage of the bill as a tip; (2) some customers "stiff" the waiter, leaving no tip at all; (3) some customers write a high tip on the credit card slip, but ask for some cash back, leaving a net lower amount; and (4) some restaurants deduct the credit card company fee from the tip, leaving the employees with a lower net amount.

Fior D'Italia adds that these potential errors can make an enormous difference to a restaurant, for restaurant profits are often low, while the tax is high. Brief for Respondent 9–10, n. 6 (asserting that an assessment for unreported tips for all years since employer FICA tax provision was enacted would amount to two years' total profits). Indeed, the restaurant must pay this tax on the basis of amounts that the restaurant itself cannot control, for the restaurant's customers, not the restaurant itself, determine the level of tips. Fior D'Italia concludes that the IRS should avoid these problems by resting its assessment upon individual calculations of employee tip earnings, and argues that the IRS' failure to do so will always result in an overstatement of tax liability, rendering any assessment that results from aggregate estimates unreasonable and outside the limits of any delegated IRS authority.

In our view, these considerations do not show that the IRS' aggregate estimating method falls outside the bounds of what is reasonable. It bears repeating that in this litigation, Fior D'Italia stipulated that it would not challenge the particular IRS calculation as inaccurate. Absent such a stipulation, a taxpayer would remain free to present evidence that an assessment is inaccurate in a particular case. And we do not accept Fior D'Italia's claim that restaurants are unable to do so — that they "simply do not have the information to dispute" the IRS assessment. Tr. of Oral Arg. 36. Why does a restaurant owner not know, or why is that owner unable to find out: how many busboys or other personnel work for only a day or two — thereby likely earning less than $20 in tips; how many employees were likely to have earned more than $55,000 or so in 1992; how much less cash-paying customers tip; how often they "stiff" waiters or ask for a cash refund; and whether the restaurant owner deducts a credit card charge of, say 3%, from employee tips? After all, the restaurant need not prove these matters with precision. It need only demonstrate that use of the aggregate method in the particular case has likely produced an inaccurate result. And in doing so, it may well be able to convince a judge to insist upon a more accurate formula. See, *e.g., Erickson*, 937 F.2d, at 1551 ("*Some* reasonable foundation for the assessment is necessary to preserve the presumption of correctness" (emphasis in original)).

Nor has Fior D'Italia convinced us that individualized employee assessments will inevitably lead to a more "reasonable" assessment of employer liability than an aggregate estimate. After all, individual audits will be plagued by some of the same inaccuracies Fior D'Italia attributes to the aggregate estimation method, because they are, of course, *based on estimates themselves*. See, *e.g., Mendelson*, 305 F.2d, at 521–522; *McQuatters v. Commissioner*, CCH TCM 1122 (1973). Consequently, we cannot find that the aggregate method is, as a general matter, so unreasonable as to violate the law.

D

Fior D'Italia also mentions an IRS regulation that it believes creates a special problem of fairness when taken together with the "aggregate" assessment method. That regulation says that an employer, when calculating its FICA tax, must "include wages received by an employee in the form of tips *only to the extent of the tips reported . . . to the employer.*" 26 CFR Sec. 31.6011(a)–1(a) (2001) (emphasis added). How, then, asks Fior D'Italia, could the employer have calculated tax on a different amount, namely: (1) the amount of tips "reported"; plus (2) the amount of tips *received but not reported?* Indeed, Fior D'Italia itself did not do so initially, presumably because this regulation said it should not do so. See Brief for Respondent 16–17. And, if it should not do so, is it not seriously unfair for the IRS later to assess against it a tax deficiency based on this latter figure? "[T]here is no practical or legally authorized way," Fior D'Italia complains, for the restaurant to include the additional amount of tips for which the IRS might later seek tax payment. *Id.*, at 16.

The statute itself, however, responds to this concern. It says that, insofar as tips were received but not reported to the employer, *that* remuneration (*i.e.*, the unreported tips) shall not be deemed to have been paid by the employer until "the date on which notice and demand for such taxes is made to the employer by the Secretary." 26 U.S.C. Sec. 3121(q). This provision makes clear that it is not unfair or illegal to assess a tax deficiency on the unreported tips, for penalties will not attach and interest will not accrue unless the IRS actually demands the money *and* the restaurant refuses subsequently to pay the amount demanded in a timely fashion. See generally, Rev. Rul. 95–7, 1995–1 C.B. 185. Indeed, the statute (and its accompanying Revenue Ruling) contemplates both a restaurant that does not police employee tip reporting and a later assessment based on unreported tips. It makes clear that, at most, such a restaurant would have to create a reserve for potential later tax liability. Although the reporting scheme may place restaurants in an awkward position, the Tax Code seems to contemplate that position; and its bookkeeping awkwardness consequently fails to support the argument that aggregate estimation is unlawful.

E

Finally, Fior D'Italia suggests that the IRS is putting its "aggregate estimate" method to improper use. It traces a lengthy history of disagreement among restaurant workers, restaurant owners, and the IRS as to how best to enforce the restaurants' legal obligation to pay FICA taxes on unreported tip income. It notes that the IRS has agreed to create a special program, called the "Tip Reporting Alternative Commitment," whereby a restaurant promises to establish accurate tip reporting procedures in return for an IRS promise to base FICA tax liability on reported tips alone. It adds that any coercion used to force a restaurant to enter such a program (often unpopular with employees) would conflict with the views of Members of Congress and IRS officials, who have said that a restaurant should not be held responsible for its employees' failure to report all their tips as income. See, *e.g.*, Letter of Members of Congress to Secretary of Treasury Lloyd Bentsen, 32 Tax Analysts' Daily Tax Highlights & Documents 3913 (Mar. 4, 1994); App. 106, 107. It adds that Congress has enacted this view into two special laws: the first of which gives restaurants a nonrefundable tax credit on FICA taxes paid, *i.e.*, permits restaurants to offset any FICA it pays on employee tips on a dollar for dollar basis against its own income tax liability, 26 U.S.C. Sec. 45B; and the second of which forbids the IRS from "threaten[ing] to audit" a restaurant in order to "coerce" it into entering the special tip-reporting program. Internal Revenue Service Restructuring and Reform Act of 1998, 112 Stat. 755.

Fior D'Italia says that the IRS' recent use of an "aggregate estimate" approach runs contrary to the understanding that underlies this second statute, for it "effectively forces the employer into . . . verifying, investigating, monitoring, and policing compliance by its employees — responsibilities which Congress and the Courts have considered, evaluated, and steadfastly refused to transfer from IRS to the employer." Brief for Respondent 9. And it suggests that the IRS intends to use a legal victory here as a "threat," say to reopen back tax years, in order to require restaurant owners "to force" their "employees to report" all tips. *Id.*, at 14. Why else, asks Fior D'Italia, would the IRS bring this case? After all, given the dollar for dollar FICA/income tax setoff, this case may not even produce revenue for the Government.

Fior D'Italia's "abuse of power" argument, however, does not constitute a ground for holding unlawful the IRS' use of aggregate estimates. Even if we assume, for argument's sake, that an improper motive could render unlawful the use of a statutorily permissible enforcement method in certain circumstances, cf. *United States v. Powell*, 379 U.S. 48, 58 (1964), we note that Fior D'Italia has not demonstrated that the IRS has acted illegally *in this case.* Instead, it has presented a general claim to the effect that the aggregate estimation method lends itself to abusive agency action. But we cannot find agency action unreasonable in all cases simply because of a general *possibility* of abuse — a possibility that exists in respect to many discretionary enforcement powers. Cf. *Heckler v. Chaney*, 470 U.S. 821, 831 (1985).

The statutes and congressional documents that protect restaurants from onerous monitoring requirements consequently do not support Fior D'Italia's argument that aggregate estimates are statutorily prohibited. For example, the Internal Revenue Service Restructuring and Reform Act prohibits the IRS from "threaten[ing] to audit" restaurants as a means to "coerce" them into policing employee tip reporting, *supra,* at 12, but Fior D'Italia does not claim that the IRS has violated this statute. Nor, for that matter, has Fior D'Italia presented evidence that this particular litigation would fail to yield revenue to the Government (due to the availability of the FICA tax credit), or convincingly explained, even if so, why that fact, while making the case unremunerative, would automatically make it improper. And while other documents show that Congress has expressed concern regarding a restaurant's difficulty in trying to supervise its employees' reporting of their tips, they do not suggest that the aggregate estimate method is an unreasonable way of ascertaining unpaid FICA taxes for which the employer is indisputably liable (particularly when one recalls that the taxpayer generally remains free to challenge the accuracy of the calculation at issue, even though this taxpayer has waived its right to do so). Rather, as we have shown, the relevant Code provisions and case law support the use of aggregate estimates. See *supra,* at 3–5, 9–11.

We conclude that Fior D'Italia's discussion of IRS "abuse" is insufficient to show that the agency's use of aggregate estimates is prohibited by law. In saying this, we recognize that Fior D'Italia remains free to make its policy-related arguments to Congress.

III

For these reasons, and because Fior D'Italia has stipulated that it does not challenge the accuracy of the IRS assessment in this case, the decision of the Court of Appeals is

Reversed.

SUPREME COURT OF THE UNITED STATES

No. 01–463

UNITED STATES, PETITIONER *v.* FIOR D'ITALIA, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

June 17, 2002

JUSTICE SOUTER, with whom JUSTICE SCALIA and JUSTICE THOMAS join, dissenting.

The Court holds that the Internal Revenue Service's statutory authorization to make assessments for unpaid taxes is reasonably read to cover a restaurateur's FICA taxes based on an aggregate estimate of all unreported employee tips. I believe that reading the statute so broadly saddles employers with a burden unintended by Congress, and I respectfully dissent.

I

Taxes on earned income imposed by the Federal Insurance Contributions Act (FICA) pay for employees' benefits under the Social Security Act, 49 Stat. 622, as amended, 42 U.S.C. Sec. 401 *et seq.* (1994 ed. and Supp. V). In the simplest case, the employee is taxed on what he receives, and the employer is taxed on what he pays. See 26 U.S.C. Secs. 3101, 3111. For a long time, an employee's income from tips was not recognized as remuneration paid by the employer, and the corresponding FICA tax was imposed only on the employee. See Social Security Amendments of 1965, Sec. 313(c), 79 Stat. 382. In 1987, however, the Internal Revenue Code was amended to treat tip income within the remuneration on which the employer, too, is taxed, 26 U.S.C. Sec. 3121(q), and that is the present law.

The scheme is simple. The tips are includible in the employee's wages. The employee must report the amount of taxable tip income to the employer. Sec. 6053(a). "[L]arge food or beverage establishment[s]" must pass on that information to the Internal Revenue Service, Sec. 6053(c)(1), and must also report the total amount of tips shown on credit card slips. *Ibid.* The employer is subject to tax on the same amount of tip income listed on an employee's report to him and in turn reported by him to the Internal Revenue Service. For both the employer and the employee, however, taxable tip income is limited to income within what is known as the "wage band"; there is no tax on tips that amount to less than $20 in a given month, or on total remuneration in excess of the Social Security wage base ($53,400 and $55,500, respectively, in the years relevant to this case).

Because many employees report less tip income than they receive, their FICA taxes and their employers' matching amounts are less than they would be in a world of complete reporting. The IRS has chosen to counter dishonesty on the part of restaurant employees not by moving directly against them, but by going against their employers with assessments of unpaid FICA taxes based on an estimate of all tip income paid to all employees aggregated together. The Court finds these aggregated assessments authorized by the general provision for assessments of unpaid taxes, Sec. 6201, which benefits the Government with a presumption of correctness. See *United States v. Janis,* 428 U.S. 433, 440 (1976).[1] The practice of assessing FICA taxes against an employer on estimated aggregate tip income, however, raises anomaly after anomaly, to the point that one has to suspect that the Government's practice is wrong. An appreciation of these consequences, in fact, calls for a reading of the crucial provision, 26 U.S.C. Sec. 3121(q), in a straightforward way, which bars aggregate assessments and the anomalies that go with them.

II

A

The Social Security scheme of benefits and the FICA tax funding it have been characterized as a kind of "social insurance," *Flemming v. Nestor,* 363 U.S. 603, 609 (1960), in which employers and employees contribute matching amounts. Compare 26 U.S.C. Sec. 3101 with Sec. 3111. The payments that beneficiaries are entitled to receive are determined by the records of their wages earned. *Nestor, supra,* at 608.

Notwithstanding this basic structure, the IRS's aggregate estimation method creates a disjunction between amounts presumptively owed by an employer and those owed by an employee. It creates a comparable disproportion between the employer's tax and the employee's ultimate benefits, since an aggregate assessment does nothing to revise the earnings records of the individual employees for whose benefit the taxes are purportedly collected.[2] Thus, from the outset, the aggregate assessment fits poorly with the design of the system.

B

As the majority acknowledges, the next problem is that the aggregate estimation necessarily requires the use of generalized assumptions for calculating such estimates, and the assumptions actually used tend to inflate liability. In the first place, while the IRS's assumption that many employees are underreporting is indisputably sound, the assumption that every patron is not only tipping, but tipping 14.49% in 1991 and 14.29% in 1992, is probably not. Those percentages are based on two further assumptions: that patrons who pay with credit cards tip at the same rate as patrons who pay in cash, and that all patrons use the tip line of the credit card slip for tips, rather than to obtain cash. But what is most significant is that the IRS's method of aggregate estimation ignores the wage band entirely, assuming that all tips are subject to FICA tax, although this is not true in law, and certainly not always the case in fact.

C

The tendency of the Government's aggregation method to overestimate liability might not count much against it if it were fair to expect employers to keep the reports that would carry their burden to re-

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[1] In 1998, Congress altered the burdens of proof for tax cases, but the changes do not implicate FICA. See 26 U.S.C. Sec. 7491(a).

[2] Although the scheme does not create a vested right to benefits in any employee, see *Flemming v. Nestor,* 363 U.S. 603, 608–611 (1960), the legislative choice to tie benefits to earnings history evinces a general intent to create a rough parity between taxes paid and benefits received.

fute any contested assessment based on an aggregate estimate. But it is not fair.

Obviously, the only way an employer can refute probable inflation by estimate is to keep track of every employee's tips, *ante*, at 9, and at first blush, there might seem nothing unusual about expecting employers to do this.[3] The Code imposes a general obligation upon all taxpayers to keep records relevant to their liability according to regulations promulgated by the Secretary, 26 U.S.C. Sec. 6001, and, for the most part, the courts have viewed the burden on taxpayers to maintain such records as reasonable and, hence, as the justification for requiring taxpayers to disprove IRS estimates; the taxpayer who fails to attend to Sec. 6001 has only himself to blame. See, *e.g.*, *Kikalos v. Commissioner*, 190 F.3d 791, 792, n. 1 (CA7 1999); *Cracchiola v. Commissioner*, 643 F.2d 1383, 1385 (CA9 1981); *Meneguzzo v. Commissioner*, 43 T.C. 824, 831 (1965).[4] But the first blush ignores the one feature of Sec. 6001 relevant here. The provision states a single, glaring exception: employers need not keep records "in connection with charged tips" other than "charge receipts, records necessary to comply with section 6053(c), and copies of statements furnished by employees under section 6053(a)." *Ibid.* Employers are expressly excused from any effort to determine whether employees are properly reporting their tips; the Code tells them that they need not keep the information specific to each employee that would be necessary to determine if any tips fell short of the estimates or outside the wage band.[5] Presumably because of this statutory exception, the Secretary's regulations regarding employer recordkeeping do not impose any obligations beyond those mentioned in Sec. 6001. See 26 CFR Sec. 31.6001–5 (2001) (describing required records). This absolution from recordkeeping is mirrored by the fact that tips are uniquely excepted from the general rule that remuneration must be reported in W–2 statements. See 26 U.S.C. Sec. 6041(e). The upshot is that Congress has enacted a singular exception to the duty to keep records that would allow any ready wage band determinations or other checks on estimates, while the aggregate assessment practice of the IRS virtually reads the exception out of the Code.

The majority doubts that there is any practical difference between determining the liability of one employee, very possibly with an estimation similar to the one used here, and estimating the aggregate amount for an employer. *Ante,* at 9–10. But determinations limited to an individual employee will necessarily be more tailored, if only by taking the wage band into account. In fact, any such determination would occur in consequence of some audit of the employee, who would have an incentive to divulge information to contest the IRS's figures where possible, and generate the very paper trail an employer would need to contest liability while availing himself of the exception in Sec. 6001.

D

The strangeness of combining a statute excusing employers from recordkeeping with an administrative practice of making probably inflated assessments stands out even more starkly in light of the eccentric route the Government has to follow in a case like this in order to benefit from the presumption of correctness that an aggregate assessment carries. Under the general authorization to make assessments, 26 U.S.C. Sec. 6201, on which the Government relies, any assessment is preceded by liability for taxes. Sec. 6201(a) ("The Secretary is authorized . . . to make the inquiries, determinations, and assessments of all taxes . . . which have not been duly paid . . . "); *ante*, at 3 ("An 'assessment' amounts to an IRS determination that a taxpayer owes the Federal Government a certain amount of unpaid taxes "). After, but only after, assessment can the IRS take the further step of issuing notice and demand for the unpaid taxes assessed, Sec. 6303, so as to authorize the IRS to levy upon the taxpayer's property, or impose liens, Secs. 6321, 6331.

In the case of an employer's liability for FICA taxes on tips, however, this sequence cannot be followed if the employee does not report the tips to the employer in the first place, for it is the report, not the employee's receipt of the tips, that raises the employer's liability to pay the FICA tax. The employer may know from the credit slips that the employees' reports are egregiously inaccurate (wage band or no wage band), but the employer is still liable only on what the employee declares. In fact, the effect of Sec. 6053(c) is such that employers cannot help but know when underreporting is severe, since they are required to give the IRS a summary of the amount of reported tips and the amount of charged tips. Nonetheless, the employer remains liable solely for taxes on the reported tips.[6]

Indeed, even if the employer, seeing a disparity, paid extra FICA taxes on the assumption that the employees had underreported tips, the extra payment would be treated as an overpayment. See Tr. of Oral Arg. 8; *Jones v. Liberty Glass Co.*, 332 U.S. 524, 531 (1947) (overpayment is "any payment in excess of that which is properly due"). The overall implication is that employers are meant to pay taxes based on specific information provided by others. As a practical matter, the tips themselves are not the true basis for liability; instead, it is an employee report that creates the obligation.

Some event must therefore trigger liability for taxes on unreported tips before the IRS can make the assessment, and this

[3]Of course, even the IRS has not explained the precise manner in which the employer is expected to generate such records. Before the Court of Appeals, the IRS argued that the employer could require employees to pool all tips, and thereby keep track of them. See 242 F.3d 844, 848, n. 6 (CA9 2001). The court properly rejected this contention as "alter[ing] the way a restaurant does business. . . . It would be akin to saying that a restaurant must charge a fixed service charge in lieu of tips." *Ibid.* Before this Court, the IRS instead argued that "every employer should hire reliable people who they can trust to follow the rules." The official transcript records "Laughter." Tr. of Oral Arg. 27.

[4]Such is in keeping with the general rule that burdens shift to those with peculiar knowledge of the relevant facts. *Campbell v. United States*, 365 U.S. 85, 96 (1961) ("[T]he ordinary rule . . . does not place the burden upon a litigant of establishing facts peculiarly within the knowledge of his adversary"); *National Communications Assn. v. AT&T Corp.*, 238 F.3d 124, 130 (CA2 2001) ("[A]ll else being equal, the burden is better placed on the party with easier access to relevant information"); 9 J. Wigmore, Evidence Sec. 2486, p. 290 (1981) ("[T]he burden of proving a fact is said to be put on the party who presumably has peculiar means of knowledge" (emphasis deleted)).

[5]The statute refers only to charged tips, rather than cash tips, but the IRS does not dispute that the employer has no obligation to keep any records beyond those specifically required under 26 U.S.C. Sec. 6053, and the IRS's regulations on the subject do not impose any requirements with respect to cash tips. See 26 CFR Sec. 31.6001–5 (2001). Moreover, it would be irrational to read 26 U.S.C. Sec. 6001 to require an employer to keep detailed records only of cash tips while, for example, being relieved of the burden to record which employees received which charged tips, or whether the tip space was used for something other than tips, or how employees allocated charged tips amongst themselves via the process of "tipping out" (sharing tips with supporting waitstaff who do not receive their own tips, such as bartenders and hosts).

event turns out to be the notice and demand for which Sec. 3121(q) makes special provision in such a case.[7] Only after notice and demand can the Government proceed to assessment under Sec. 6201. Whereas the usual sequence is assessment, then notice and demand, see 26 U.S.C. Sec. 6303, here it is notice and demand, then assessment.

The IRS does not dispute this. It concedes that it does not rely upon Sec. 6201 before issuing the notice, see Reply Brief for United States 15–16, but instead performs a "pre-assessment" estimate (for which, incidentally, no statutory authorization exists). Then it issues notice and (liability having now attached) uses the same estimate for the official assessment under Sec. 6201.

Again, at first blush, it is tempting to say that the sequence of events may be unusual, but under the aggregate assessment practice the employer-taxpayer ends up in the same position he would have been in if he failed to pay FICA taxes on reported tips. But there are two very significant differences. It is true that the employer who is delinquent as to reported tips ends up subject to liability on the basis of third-party action (the employee's report) which assessment invests with a presumption of correctness, and which notice and demand then make a basis for possible liens and levies. But in that case, the employer's liability, and exposure to collection mechanisms, is subject to the important safeguard of the employee's report. Whatever the employee may do, it will not be in his interest to report more tips than he received, exposing himself (and, incidentally, his employer) to extra taxation. But this safeguard is entirely lost to the employer, through no fault of his own, if the Government can make aggregate assessments. The innocent employer has few records and no protection derived from the employee's interest. Yet without any such protection he is, on the Government's theory, immediately liable for the consequences of notice and demand at the very instant liability arises.

The second difference goes to the authority for estimating liability. The IRS finds this authority implicit in Sec. 6201, which authorizes assessments. *Ante*, at 4. In the usual case, the estimate is thus made in calculating the assessment, which occurs after the event that creates the liability being estimated and assessed. But in the case of the tips unreported by the employee, there would be no liability until notice and demand is made under Sec. 3121(q), and it is consequently at this point that the estimate is required. The upshot is that the estimate has to occur before the statute claimed to authorize it, Sec. 6201, is even applicable. That is, the IRS says it can estimate because it can assess, and it can assess because it can previously estimate. Reasoning this circular may warrant suspicion.

E

There is one more source of suspicion. In 1993, Congress enacted an income tax credit for certain employers in the amount of FICA taxes paid on tips in excess of the minimum wage. 26 U.S.C. Sec. 45B. The existence of the credit creates a peculiar scheme, for unless we are to assume that restaurateurs are constantly operating on the knife-edge of solvency, never able to use the credit (even with its 20-year carryforward, see 26 U.S.C. Sec. 39), the IRS has little reason to expect to gain much from the employer-taxpayer; the collection effort will probably result in no net benefit to the Government (except, perhaps, as an interest-free loan).[8] And because, as noted, the aggregate method chosen by the IRS will not affect individual employees' wage-earning records, the estimates do not even play much of a bookkeeping role. There is something suspect, then, in the IRS's insistence on conducting audits of employers, without corresponding audits of employees, for the purpose of collecting FICA taxes that will ultimately be refunded, that do not increase the accuracy of individual earnings records, and probably overestimate the true amount of taxable earnings.

In fact, the only real advantage to the IRS seems to be that the threat of audit, litigation, and immediate liability may well force employers to assume the job of monitoring their employees' tips to ensure accurate reporting. But if that explanation for the Government's practice makes sense of it, it also flips the Government from the frying pan into the fire. Congress has previously stymied every attempt the IRS has made to impose such a burden on employers. In the days when employers were responsible only for withholding the employee's share of the FICA tax, the IRS attempted to force employers to include tip income on W–2 forms; this effort was blocked when Congress modified 26 U.S.C. Sec. 6041 to exclude tip income expressly from the W–2 requirements. See Revenue Act of 1978, Sec. 501(b), 92 Stat. 2878. When the IRS interpreted the credit available under Sec. 45B to apply only to tips reported by the employee pursuant to 26 U.S.C. Sec. 6053(a), Congress overruled the IRS and clarified that the credit would apply to all FICA taxes paid on tips above those used to satisfy the employer's minimum wage obligations. See Small Business Job Protection Act of 1996, Pub. L. No. 104–188, Sec. 1112(a), 110 Stat. 1759. Finally, when the IRS developed its Tip Reporting Alternative Commitment (TRAC) program, *ante*, at 11–12, Congress forbade the IRS from "threaten[ing] to audit any taxpayer in an attempt to coerce the taxpayer" into participating. Internal Revenue Service Restructuring and Reform Act of 1998, Sec. 3414, 112 Stat. 755.[9] And although the use of a threatened aggregate estimate (after an audit) to induce monitoring of employee tips may not technically run afoul of that statute, it is difficult to imag-

[7] The majority takes note of this unusual scheme, but finds significance only in the fact that until notice issues (and liability arises), interest does not run. *Ante*, at 10–11. But to interpret the statute as nothing more than a method of preventing the running of interest avoids the significance of 3121(q), because there is already a statute that prevents interest running on unpaid FICA taxes. Sec. 6205(a)(1).

[8] At oral argument, the Government contended that the payment of the FICA tax, coupled with the Sec. 45B credit, benefited its accounting by permitting payments to be appropriately allocated between the Social Security trust fund and general revenue. See Tr. of Oral Arg. 20–21.

[9] To some extent, the modification of the Sec. 45B credit and TRAC may be taken as congressional awareness of the IRS's practice of making aggregate assessments. After all, there is no need to clarify that Sec. 45B is available for taxes on unreported tips unless such taxes are, in fact, being paid, and the TRAC program itself depends on the existence of aggregate assessments, because the "carrot" offered to employers to encourage participation is the IRS's promise to refrain from such assessments.

With respect to Sec. 45B, however, prior to Congress's modifications, the IRS regulations did not allow for the credit even when an individual employee was assessed and corresponding notice and demand issued to the employer. See 58 Fed. Reg. 68033 (1993) (temporary regulation Sec. 1.45B-1T). Thus, Congress's clarification did not depend on the existence of aggregate assessments. As for TRAC, at the time that Congress forbade the IRS from coercing participation, the IRS had actually halted the aggregate assessment practice. See Director, Office of Employment Tax Administration and Compliance, Memorandum for Regional Chief Compliance Officers (June 16, 1998), App. 106–107. Moreover, the simple (and realistic) answer is just that Congress did as asked; restaurateurs complained about a specific practice, *i.e.*, threatened audits, and Congress responded with a targeted statute.

ine that Congress would allow the aggregation practice as a lever on employers, when it forbade the use of an audit for the same purpose.

III

Consider an alternative. I have noted already that even the Government tacitly acknowledges the crucial role of Sec. 3121(q), the source of its authority to issue notice and demand, without which there is no liability on the employer's part for FICA taxes on unreported tips and thus no possibility of assessment under Sec. 6201. It makes sense, then, to understand the scope of authority to make the assessment as being limited by the scope of the authority to issue notice and demand, and it likewise makes sense to pay close attention to the text of that authorization.

The special provision in Sec. 3121(q) for notice and demand against an employer says nothing and suggests nothing about aggregate assessments. It reads that when an employer was furnished "no statement including such tips" or was given an "inaccurate or incomplete" one, the remuneration in the form of "such tips" shall be treated as if paid on the date notice and demand is made to the employer. 26 U.S.C. Sec. 3121(q). "[S]uch tips" are described as "tips received by an employee in the course of his employment." *Ibid.* Thus, by its terms, the statute provides for notice and demand for the tax on the tips of "an employee," not on the tips of "employees" or "all employees" aggregated together. And, of course, if notice and demand is limited to taxes on tips of "an employee," that is the end of aggregate estimates.

It is true that under the Dictionary Act, 1 U.S.C. Sec. 1, a statutory provision in the singular may include the plural where that would work in the context. *Ibid.* "[A]n employee" could cover "employees" and the notice and demand could cover tips received during "their employment," "unless the context indicates otherwise," *ibid*. But here, the context does indicate otherwise. The anomalies I have pointed out occur when the singular "employee" in Sec. 3121(q) is read to include the plural, which in turn is crucial to allowing aggregate notice, demand, and assessment; and it turns out that reading the statute to refer only to a particular employee's tips and limiting notice, demand, and assessment accordingly, goes far to abridge the catalog of oddities that come with the Government's position.

First, sticking to the singular means that the employer will not be assessed more tax than the employee himself should pay; whether or not the employee is sued for a like amount, the respective liabilities of employer and employee will be restored to parity. And by keying the employer's liability to a particular employee, the near-certainty of overassessment will be replaced with a likelihood of an accurate assessment taking into consideration the wage band of taxability under FICA.

Second, the fact that the employer has exercised his express, statutory option to decline to keep tipping records on his work force will no longer place him at such an immediate disadvantage. It will be relatively easy to discover the basis for the tax calculation in a particular instance.

Third, if indeed the Government first establishes the employee's liability for unreported tips, notice and demand under Sec. 3121(q) will then serve what on its face seems to be its obvious purpose, to provide the employer with reliable information, like the employee tip reports that similarly trigger liability, so that the employer will have no further need for keeping track of employee tips. Although this is not the time to decide whether the IRS must formally audit the employee's own tax liability first, there is at least one reason to think Congress assumed that it would. There is no statute of limitations on an employer's FICA tax liability for unreported tips (because the statute does not run until after liability attaches, and no time limits are imposed upon the issuance of the notice that triggers liability). But there is a statute of limitations for assessments against employees. 26 U.S.C. Sec. 6501. Conditioning the employer's liability on a parallel obligation of the employee would in effect place a limitation period on the employer's exposure.

Finally, of course, the tension with Congress's admonition that the IRS not "threaten to audit any taxpayer in an attempt to coerce the taxpayer" into participating in TRAC will be eliminated. If the employer is liable only after an individual employee's delinquency has been calculated, the use of mass assessments to force an employer, in self-defense, to institute TRAC will simply vanish.

Thus the context establishes that a singular reading is the one that makes sense by eliminating the eccentricities entailed by the aggregate reading, some of which seem unfair to employer taxpayers. Of course, this means that the problem of underreporting tips will be harder to solve, but it seems clear that Congress did not mean to solve it by allowing the IRS to use its assessment power to shift the problem to employers. I would therefore affirm the judgment of the Ninth Circuit.

Part III. Administrative, Procedural, and Miscellaneous

Weighted Average Interest Rate Update

Notice 2002–74

Sections 412(b)(5)(B) and 412(l)(7)(C)(i) of the Internal Revenue Code provide that the interest rates used to calculate current liability for purposes of determining the full funding limitation under § 412(c)(7) and the required contribution under § 412(l) must be within a permissible range around the weighted average of the rates of interest on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year.

Notice 88–73, 1988–2 C.B. 383, provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Code.

Section 417(e)(3)(A)(ii)(II) of the Code defines the applicable interest rate, which must be used for purposes of determining the minimum present value of a participant's benefit under § 417(e)(1) and (2), as the annual rate of interest on 30-year Treasury securities for the month before the date of distribution or such other time as the Secretary may by regulations prescribe. Section 1.417(e)–1(d)(3) of the Income Tax Regulations provides that the applicable interest rate for a month is the annual interest rate on 30-year Treasury securities as specified by the Commissioner for that month in revenue rulings, notices or other guidance published in the Internal Revenue Bulletin.

The rate of interest on 30-year Treasury Securities for October 2002 is 4.93 percent. Pursuant to Notice 2002–26, 2002–15 I.R.B. 743, the Service has determined this rate as the monthly average of the daily determination of yield on the 30-year Treasury bond maturing in February 2031.

Section 405 of the Job Creation and Worker Assistance Act of 2002 amended § 412(l)(7)(C) of the Code to provide that for plan years beginning in 2002 and 2003 the permissible range is extended to 120 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 110% Permissible Range	90% to 120% Permissible Range
November	2002	5.58	5.02 to 6.14	5.02 to 6.70

Drafting Information

The principal author of this notice is Todd Newman of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday. Mr. Newman may be reached at 1–202–283–9888 (not a toll-free number).

Changes in Accounting Periods

Notice 2002–75

This notice provides a proposed revenue procedure that, when finalized, will provide the exclusive procedures under § 442 of the Internal Revenue Code and the regulations thereunder for individuals filing federal income tax returns on a fiscal year basis to obtain automatic approval of the Commissioner to change their annual accounting periods to a calendar year.

In general, the proposed revenue procedure incorporates several rules that are similar to those of Rev. Proc. 2002–37, 2002–22 I.R.B. 1030, and Rev. Proc. 2002–38, 2002–22 I.R.B. 1037, which provide procedures for corporations and certain pass-through entities, respectively, to obtain automatic approval to change their annual accounting periods. For example, under the proposed revenue procedure, individuals with a majority interest or a *de minimis* interest in certain pass-through entities may qualify for automatic approval for their change.

The proposed revenue procedure would modify, amplify, and supersede Rev. Proc. 66–50, 1966–2 C.B. 1260. Rev. Proc. 66–50 provides an administrative procedure whereby certain individuals filing federal income tax returns on a fiscal year basis may expeditiously obtain approval of a change in their annual accounting periods to a calendar year. The proposed revenue procedure also would modify and supersede Rev. Proc. 81–40, 1981–2 C.B. 604, which modifies Rev. Proc. 66–50 with respect to the time and place for filing applications thereunder.

The Service welcomes comments on the proposed revenue procedure provided in this notice. Comments should be submitted by January 6, 2003, either to:

Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044
Attn: Associate Chief Counsel
(Income Tax & Accounting)
CC:ITA, Room 5026

or electronically via:

Notice.Comments@m1.irscounsel.treas.gov (the Service comments e-mail address).

Rev. Proc. 2003–AA

CONTENTS

SECTION 1. PURPOSE

This revenue procedure provides the exclusive procedures under § 442 of the Internal Revenue Code and § 1.442–1(b) of the Income Tax Regulations for individuals within its scope filing federal income tax returns on a fiscal year basis to obtain automatic approval to change their annual accounting periods to a calendar year. This revenue procedure modifies, amplifies, and supersedes Rev. Proc. 66–50, 1966–2 C.B. 1260, and modifies and supersedes Rev. Proc. 81–40, 1981–2 C.B. 604. An individual that complies with all of the applicable provisions of this revenue procedure will be deemed to have established a business purpose and to have obtained the approval of the Commissioner of the Internal Revenue Service to change the individual's annual accounting period to a calendar year under § 442 and the regulations thereunder.

SECTION 2. BACKGROUND

.01 *Taxable Year Defined.*

(1) *In general*. Section 441(b) and § 1.441–1(b)(1) provide that the term "taxable year" generally means the taxpayer's annual accounting period, if it is a calendar or fiscal year, or, if applicable, the taxpayer's required taxable year.

(2) *Annual accounting period*. Section 441(c) and § 1.441–1(b)(3) provide that the term "annual accounting period" means the annual period (calendar year or fiscal year) on the basis of which the taxpayer regularly computes its income in keeping its books.

.02 *Change in Taxable Year.*

(1) *In general.* Section 1.442–1(a)(1) generally provides that a taxpayer that wants to change its annual accounting period and use a new taxable year must obtain the approval of the Commissioner.

(2) *Annualization of short period income.* Section 443(b) and § 1.443–1(b)(1)(i) generally provide that if a return is made for a short period resulting from a change of an annual accounting period, the taxable income for the short period must be placed on an annual basis by multiplying the income by 12 and dividing the result by the number of months in the short period. Unless § 443(b)(2) and § 1.443–1(b)(2) apply, the tax for the short period generally is the same part of the tax computed on an annual basis as the number of months in the short period is of 12 months. Section 443(c) generally requires a similar adjustment to the deduction for personal exemptions.

(3) *No retroactive change in annual accounting period.* Unless specifically authorized by the Commissioner, a taxpayer may not request, or otherwise make, a retroactive change in annual accounting period.

.03 *Approval of a Change*. Section 1.442–1(b) provides, in part, that in order to secure the approval of the Commissioner to change an annual accounting period, a taxpayer must file an application, generally on Form 1128, *Application to Adopt, Change, or Retain a Tax Year*, with the Commissioner within such time and in such manner as is provided in administrative procedures published by the Commissioner. In general, a change in annual accounting period will be approved if the taxpayer establishes a business purpose for the requested annual accounting period and agrees to the Commissioner's prescribed terms, conditions, and adjustments for effecting the change.

.04 *Special Rule for Newly Married Couples.* Section 1.442–1(d) provides a special rule under which a newly married husband or wife may obtain automatic approval to change his or her annual accounting period in order to use the annual accounting period of the other spouse so that a joint return may be filed for the first or second taxable year of that spouse ending after the date of the marriage. Generally, this change is made by filing a federal income tax return for the short period, and not by filing a Form 1128.

SECTION 3. SIGNIFICANT CHANGES

Significant changes to Rev. Proc. 66–50, as modified by Rev. Proc. 81–40, include:

.01 Section 4.01 of this revenue procedure provides that this revenue procedure is the exclusive procedure for individuals within its scope to automatically change their annual accounting period to the calendar year;

.02 Section 4.02 of this revenue procedure does not limit the scope of this revenue procedure to individuals who receive only certain listed types of income;

.03 Section 4.02(2) of this revenue procedure retains the general rule of Rev. Proc. 66–50 that precluded the use of the automatic change procedures by individuals deriving income from interests in pass-through entities, but provides that interests in pass-through entities will be disregarded in certain circumstances;

.04 Section 6 of this revenue procedure imposes additional terms and conditions similar to those of Rev. Proc. 2002–37, Rev. Proc. 2002–38, and Rev. Proc. 2002–39. These terms and conditions include:

(1) a limitation on the carryback of net operating losses over $10,000 or general business credits that are generated in the short period; and

(2) a requirement that certain related entities concurrently change their annual accounting period to the new calendar taxable year of the individual owner.

.05 Section 7.02 of this revenue procedure extends the due date for filing a Form 1128 under this automatic revenue procedure to the due date of the individual's federal income tax return (including extensions) for the first effective year, as defined in section 5.03.

SECTION 4. SCOPE

.01 *Applicability.* Except as provided in section 4.02, this revenue procedure, which is the exclusive procedure for individuals within its scope, applies to an individual requesting automatic approval to change the individual's annual accounting period to a calendar year.

.02 *Inapplicability.* This revenue procedure does not apply to:

(1) *Newly married couples subject to § 1.442–1(d).* An individual that is permitted to change to the annual accounting period of the individual's spouse under § 1.442–1(d). See section 2.04 of this revenue procedure.

(2) *Interest in a pass-through entity.* An individual that has an interest in a pass-through entity as of the end of the short period. However, an interest in a pass-through entity will be disregarded for this purpose if any of the following conditions are met:

(a) the pass-through entity would be required under the Code or regulations to change its taxable year to the new calendar taxable year of the individual (or, if applicable in the case of a controlled foreign corporation (CFC) or foreign personal holding company (FPHC) to a taxable year that begins one month earlier than the new calendar taxable year of the individual). See section 6.07 of this revenue procedure for a special term and condition related to this exception;

(b) the pass-through entity is a fiscal year partnership that is owned equally (50-percent) by two partners, one or both of whom are individuals, and the individual and the partnership both want to change to the new calendar taxable year of the other 50-percent partner. See section 6.07 of this revenue procedure for a special term and condition related to this exception;

(c) the new calendar taxable year of the individual would result in no change in, or less deferral (as described in § 1.706–1(b)(3)) of income from the pass-through entity than the present taxable year of the individual. If the pass-through entity is a partnership, CFC, or FPHC, the individual should compare the existing deferral period (between the pass-through entity's and the individual's current taxable years) with the new deferral period (between the new required year of the pass-through entity and the individual's new calendar taxable year). See section 4.04 of this revenue procedure for an example of this rule; or

(d) for pass-through entities not qualifying for the exceptions in section 4.02(2)(a), (b), or (c) of this revenue procedure, the pass-through entity in which the individual has an interest has been in existence for at least three taxable years and the interest is *de minimis*. For this purpose, an interest in a pass-through entity is *de minimis* only if, for each of the prior three taxable years of the individual:

(i) the amount of income (including ordinary income or loss, capital gain or losses, rents, royalties, interest, dividends, and deduction equivalent of credits) from such pass-through entity is less than or equal to (A) 5 percent of the individual's gross income (without adjustments) from all sources for those taxable years, and (B) $10,000; and

(ii) the amount of the individual's gross income (without adjustments) from all such pass-through entities is, in the aggregate, less than or equal to the amounts described in (A) and (B) above. See section 4.04 of this revenue procedure for an example of this rule.

.03 *Nonautomatic Changes.* Individuals that are not eligible to obtain automatic approval for a change in accounting period under this revenue procedure, applicable regulations, or any other published administrative procedures, must secure prior approval from the Commissioner for a change in annual accounting period pursuant to § 442 and the regulations thereunder. *See* Rev. Proc. 2002–39, 2002–22 I.R.B. 1046.

.04 *Example.* (i) F, an individual having a taxable year ending June 30, wants to change F's taxable year to the calendar year. F has interests in the capital and profits of five partnerships, IJK, LMN, OPQ, RST, and UVW. All of the partnerships have been in existence for at least three taxable years. F's interest in IJK is greater than 50 percent. IJK uses a majority interest taxable year of June 30. F's interest in LMN is 50 percent; the other 50 percent interest is owned by G, an individual filing federal income tax returns on a calendar year basis. LMN also wants to change its taxable year to a calendar year. LMN uses a June 30 taxable year under the least aggregate deferral rules of § 1.706–1(b)(3). F's interests in OPQ, RST, and UVW are 15 percent, 10 percent, and 5 percent, respectively. OPQ uses its majority interest taxable year under § 706(b)(4), which ends May 31; RST and UVW each use their respective majority interest taxable years under § 706(b)(4), which end December 31. F's distributive share of income/(loss) from OPQ for each of the prior three taxable years is $5,000, $(1,000), and $2,000, respectively. F's gross income for each of those same taxable years from all sources was $150,000.

(ii) F's interests in F's pass-through entities will be disregarded only if each pass-through entity satisfies one of the exceptions enumerated under section 4.02(2) of this revenue procedure. F's interest in IJK may be disregarded under the exception in section 4.02(2)(a), because F is the majority interest partner in IJK. F's interest in LMN may be disregarded under the exception in section 4.02(2)(b), because both F and LMN are changing to the calendar taxable year, which is the taxable year of individual G, the other 50 percent partner. F's interests in RST and UVW may each be disregarded under the exception in section 4.02(2)(c), because F's new taxable year would result in less deferral than F's old taxable year (a new deferral period of 0 months as compared to the prior deferral period of 6 months from December 31 and June 30). Because F is not the majority interest partner in OPQ, and because F's new taxable year would not result in less deferral from this partnership, F's interest in OPQ may be disregarded only if the *de minimis* exception in section 4.02(2)(d) is satisfied. In this case, the income from OPQ for each of the prior three taxable years was less than 5 percent of F's total gross income from all sources, and less than $10,000. Consequently, F's interest in OPQ may be disregarded under the *de minimis* exception in section 4.02(2)(d). Because all of F's pass-through interests are disregarded under section 4.02(2), F is eligible to change under this revenue procedure.

SECTION 5. DEFINITIONS

The following definitions apply solely for the purpose of this revenue procedure:

.01 *Individual.* In the case of married individuals, for any year in which a husband and wife file separate federal income tax returns, the term "individual" includes only the husband or wife who is applying to change his or her annual accounting period under this revenue procedure. For any year in which a husband and wife file a joint federal income tax return, the term "individual" includes both spouses, even if only one spouse is applying to change an annual accounting period under this revenue procedure.

.02 *Pass-through Entity.* For purposes of this revenue procedure the term "pass-through entity" means a partnership; a trust; an estate; a common trust fund (as defined in § 584); a CFC (as defined in § 957), but only to the extent the individual is a U.S. shareholder (as defined in § 951(b)); an FPHC (as defined in § 552), but only to the extent the individual is a U.S. shareholder (as defined in § 551(a)); a passive foreign investment company (PFIC), but only if the individual has elected to treat such PFIC as a qualified electing fund (as defined in § 1295); and a closely-held real estate investment trust (as defined in § 6655(e)(5)(B)), but only to the extent the individual is described in § 6655(e)(5)(A).

.03 *First Effective Year.* The first effective year is the first taxable year for which a change in annual accounting period is effective. Thus, in the case of a change, the first effective year is the short period required to effect the change. The first effective year is also the first taxable year for complying with all the terms and conditions set forth in this revenue procedure necessary to effect the change in annual accounting period.

.04 *Short Period.* An individual's short period is the period beginning with the day following the last day of the old taxable year and ending with the day preceding the first day of the new taxable year.

SECTION 6. TERMS AND CONDITIONS OF CHANGE

.01 *In General.* A change in annual accounting period filed under this revenue procedure must be made pursuant to the terms and conditions provided in this revenue procedure.

.02 *Short Period Tax Return.* The individual must file a federal income tax return for the short period required to effect a change in annual accounting period by the due date of that return, including extensions pursuant to § 1.443–1(a). The individual's taxable income for the short period must be annualized and the tax must be computed in accordance with the provisions of §§ 443(b) and (c), and §§ 1.443–1(b) and (c).

.03 *Record Keeping.* The books of the individual (records reflecting income adequately and clearly on the basis of an annual accounting period) must be closed as of the last day of the first effective year.

.04 *Subsequent Year Tax Returns.* Returns for subsequent taxable years generally must be made on the basis of a full 12 months ending on the last day of the new calendar taxable year, unless the individual secures the approval of the Commissioner to change that taxable year.

.05 *Creation of Net Operating Loss.* If the individual generates a net operating loss (NOL) in the short period required to effect a change in annual accounting period, the individual may not carry the NOL back, but must carry it over in accordance with the provisions of § 172, beginning with the first taxable year after the short period. However, the short period NOL is carried back or carried over in accordance with § 172 if it is either: (a) $10,000 or less, or (b) results from a short period of 9 months or longer and is less than the NOL that would have resulted from a full 12-month period beginning with the first day of the short period.

.06 *Creation of General Business Credits.* If there is an unused general business credit or any other unused credit generated in the short period, the individual must carry that unused credit forward. An unused credit from the short period may not be carried back.

.07 *Concurrent Change for Related Entities.* If an individual's interest in a pass-through entity is disregarded pursuant to section 4.02(2) because the related entity will be required to change its taxable year to the individual's new calendar taxable year, the related entity must change its taxable year either under Rev. Proc. 2002–37 or Rev. Proc. 2002–38, whichever is applicable. The related party is required to change notwithstanding the testing date provisions in §§ 706(b)(4) or 898(c)(1)(C)(ii).

SECTION 7. GENERAL APPLICATION PROCEDURES

.01 *Approval.* Approval is hereby granted to any individual within the scope of this revenue procedure to change the individual's annual accounting period, provided the individual complies with all the applicable provisions of this revenue procedure. Approval is granted beginning with the first effective year. Individuals granted approval under this revenue procedure to change their annual accounting period are deemed to have established a business purpose for the change to the satisfaction of the Commissioner.

.02 *Filing Requirements.*

(1) *Where to file*. An individual who wants to change the individual's annual accounting period pursuant to the provisions of this revenue procedure must complete and file a Form 1128 with the Director, Internal Revenue Service Center, Attention: ENTITY CONTROL, where the individual files the individual's federal income tax return. No copies of Form 1128 are required to be sent to the national office. The individual also must attach a copy of the Form 1128 to the individual's federal income tax return filed for the short period required to effect the change.

(2) *When to file.* A Form 1128 filed pursuant to this revenue procedure will be considered timely filed for purposes of § 1.442–1(b)(1) only if it is filed on or before the due date (including extensions) for filing the federal income tax return for the short period required to effect such change.

(3) *Label.* In order to assist in the processing of the change in annual accounting period, reference to this revenue procedure must be made a part of the Form 1128 by either typing or legibly printing the following statement at the top of page 1 of the Form 1128: "FILED UNDER REV. PROC. 2003−AA."

(4) *Signature requirements.* The Form 1128 must be signed by the individual. If an individual is treated as including the husband and wife under section 5.01 of this revenue procedure, the Form 1128 must be signed by both the husband and the wife.

(5) *No user fee*. A user fee is not required for an application filed under this revenue procedure and, except as provided in section 8.01 of this revenue procedure, the receipt of an application filed under this revenue procedure generally will not be acknowledged.

SECTION 8. REVIEW OF APPLICATION

.01 *Service Center Review.* A Service Center may deny a change of annual accounting period under this revenue procedure only if: (a) the Form 1128 is not filed timely, or (b) the individual fails to meet the scope or any term and condition of this revenue procedure. If the change is denied, the Service Center will return the Form 1128 with an explanation of the reason for the denial.

.02 *Review of Director.* The appropriate director may ascertain if the change in annual accounting period was made in compliance with all the applicable provisions of this revenue procedure. Individuals changing their annual accounting period pursuant to this revenue procedure without complying with all the provisions (including the terms and conditions) of this revenue procedure ordinarily will be deemed to have initiated the change in annual accounting period without the approval of the Commissioner. Upon examination, an individual that has initiated an unauthorized change of annual accounting period may be denied the change. For example, an individual may be required to recompute the individual's taxable income or loss in accordance with the individual's former taxable year.

SECTION 9. EFFECTIVE DATE AND TRANSITION RULE

.01 *Effective Date.* This revenue procedure generally is effective for all changes in annual accounting periods for which the first effective year ends on or after [INSERT DATE THIS REVENUE PROCEDURE IS RELEASED TO THE TAX SERVICES]. However, if the time period for filing Form 1128 with respect to a taxable year set forth in section 7.02(2) of this revenue procedure has not yet expired, an individual within the scope of this revenue procedure may elect early application of the revenue procedure by providing the notification set forth in section 7.02(3) on the top of page 1 of Form 1128 and by satisfying the other procedural requirements of section 7.

.02 *Transition Rule.* If an individual within the scope of this revenue procedure filed an application with the national office and the application is pending with the national office on [INSERT DATE THIS REVENUE PROCEDURE IS RELEASED TO THE TAX SERVICES], the individual may obtain approval under this revenue procedure. However, the national office will process the application in accordance with the authority under which it was filed, unless by the later of [INSERT DATE THAT IS 45 DAYS FROM THE DATE THIS REVENUE PROCEDURE IS RELEASED TO THE TAX SERVICES] or the issuance of the letter ruling granting or denying approval for the change, the individual notifies the national office that the individual wants to use this revenue procedure. If the individual timely notifies the national office that the individual wants to use this revenue procedure, the national office may require the individual to make appropriate modifications to the application to comply with the applicable provisions of this revenue procedure. In addition, any user fee that was submitted with the application will be refunded to the individual.

SECTION 10. EFFECT ON OTHER DOCUMENTS

This revenue procedure modifies, amplifies, and supersedes Rev. Proc. 66–50, 1966–2 C.B. 1260, and modifies and supersedes Rev. Proc. 81–40, 1981–2 C.B. 604.

DRAFTING INFORMATION

The principal authors of this revenue procedure are Roy A. Hirshhorn and Michael Schmit of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Hirschhorn or Mr. Schmit at (202) 622–4960 (not a toll-free call).

Part IV. Items of General Interest

Withdrawal of Notice of Proposed Rulemaking

Requirement of Making Quarterly Payments of the Railroad Unemployment Repayment Tax

REG–209116–89

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Withdrawal of notice of proposed rulemaking.

SUMMARY: This document withdraws the notice of proposed rulemaking relating to the time and manner of making payments of the railroad unemployment repayment tax. The proposed regulations were published in the **Federal Register** on May 13, 1993. The railroad unemployment repayment tax provisions are no longer operative; therefore, these proposed regulations are obsolete.

FOR FURTHER INFORMATION CONTACT: Kyle Finizio at (202) 622–6040 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On May 13, 1993, the IRS published a notice of proposed rulemaking (EE−79–89, 1993–1 C.B. 635) in the **Federal Register** (58 FR 28374) that proposed amendments to the Employment Tax Regulations under sections 6011, 6157, and 6302 of the Internal Revenue Code (Code) of 1986. These proposed regulations stated the time and manner of making payments of the railroad unemployment repayment tax (sections 3321–3322 of the Code). Section 3321(c) of the Code provides for the termination of the tax when certain loans to the railroad unemployment fund are repaid. Because this repayment occurred on June 29, 1993, the railroad unemployment repayment tax provisions are no longer operative. Thus, no railroad unemployment repayment taxes are payable with respect to rail wages paid after July 1, 1993. See Announcement 93–128 (1993–30 I.R.B. 88). Therefore, proposed regulations §§ 31.6011(a)–3A, 31.6157–1, and 31.6302(c)–2A are hereby withdrawn.

* * * * *

Withdrawal of Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805 and 26 U.S.C. 6302, proposed regulations §§ 31.6011(a)–3A, 31.6157–1, and 31.6302(c)–2A published in the **Federal Register** on May 13, 1993 (58 FR 28374), are withdrawn.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on November 6, 2002, 8:45 a.m., and published in the issue of the Federal Register for November 7, 2002)

Notice of Proposed Rulemaking and Notice of Public Hearing

User Fees for Processing Offers to Compromise

REG–103777–02

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed amendments to the regulations relating to user fees to provide for the imposition of user fees for the processing of offers to compromise. The charging of user fees implements the Independent Offices Appropriations Act (IOAA), which is codified at 31 U.S.C. 9701. This document also contains a notice of public hearing on these proposed regulations.

DATES: Written and electronic comments must be received by Tuesday, February 4, 2003. Outlines of topics to be discussed at the public hearing scheduled for Thursday, February 13, 2003, must be received by Thursday, January 23, 2003.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–103777–02), 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:ITA:RU (REG–103777–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may send submissions electronically directly to the IRS Internet site at *www.irs.gov/regs*. The public hearing will be held in Room 4718 of the Internal Revenue Service Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning submissions and/or to be placed on the building access list to attend the hearing, Treena Garrett, 202–622–7180; concerning cost methodology, Eva Williams, 202–622–6400; concerning the regulations, G. William Beard, 202–622–3620 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Offers to Compromise

Section 7122 of the Internal Revenue Code gives the IRS the authority to compromise any civil or criminal case arising under the internal revenue laws, prior to the referral of that case to the Department of Justice. Section 7122 also directs the IRS to prescribe guidelines for officers and employees of the IRS to determine whether an offer to compromise is adequate and should be accepted. Guidelines are contained in § 301.7122–1. Pursuant to § 301.7122–1(b), an offer may be accepted if there is doubt as to liability, if there is doubt as to collectibility, or if acceptance will promote effective tax administration. Pursuant to § 301.7122–1(b)(3), offers may be accepted to promote effective tax administration if either: (1) the IRS determines that, although collection in full could be achieved, collection of the full liability would cause the taxpayer economic hardship within the meaning of § 301.6343–1, or (2) there are no other grounds for compromise and there are compelling public policy or equity considerations.

When an offer to compromise is received, an initial determination is made as to whether the offer is processable. Currently, an offer is returned as nonprocessable if the taxpayer is in bankruptcy, has not filed required tax returns, or has not perfected the offer by properly preparing the offer to compromise form and submitting other required documents. Absent these conditions, the offer is accepted for processing and cannot be rejected without an independent administrative review of the decision to reject and, if the taxpayer chooses to appeal the rejection, independent review by the Office of Appeals. Even though an offer accepted for processing may later be returned to the taxpayer if the taxpayer fails to provide requested information or the IRS determines that the offer was submitted solely to delay collection, such an offer may not be returned before a managerial review of the proposed return is completed pursuant to § 301.7122–1(f)(5)(ii).

When the IRS accepts an offer, the taxpayer receives the benefit of resolving its tax liabilities for a compromised amount, provided the taxpayer complies with the terms of the compromise agreement. To ensure that the taxpayer complies with the terms of the compromise agreement, the IRS must continue to monitor the taxpayer for a period of five years after the compromise is reached.

Even if an offer is rejected, the taxpayer receives the benefit of having the IRS process the offer and make an individualized determination as to the adequacy of the amount offered. In order to make that determination, the IRS must value assets, verify income-earning potential, and compute allowable expenses. The taxpayer also receives the benefit of certain deferred collection activities. The IRS generally does not make any levies to collect liabilities that are the subject of an offer during the period the IRS is evaluating whether the offer will be accepted or rejected, for 30 days immediately following the rejection of an offer, and during any period when a timely appeal from the rejection is being considered by the Office of Appeals.

Establishment of User Fees on Offers to Compromise

The IRS is proposing user fees for the processing of certain offers to compromise tax liabilities pursuant to § 301.7122–1.

For the IRS to process an offer, proposed section 300.3 establishes a $150 fee. The user fee would be paid out of the amount determined to be collectible from the taxpayer and would be taken into account when considering whether the amount offered is acceptable. Thus, imposition of the fee would not change the net amount paid by the taxpayer to compromise the liabilities.

The proposed user fee would not apply to offers based on doubt as to liability, offers made by certain low income taxpayers, offers accepted to promote effective tax administration, and offers accepted based on doubt as to collectibility where there has also been a determination that, although an amount greater than the amount offered could be collected, collection of more than the amount offered would create economic hardship within the meaning of § 301.6343–1 (currently referred to as "special circumstances" under IRS procedures). In most of these circumstances, the fees would be waived before being collected from the taxpayer. However, if the fee is collected from the taxpayer, but the offer is accepted to promote effective tax administration or based on considerations of economic hardship, the processing fee either would be refunded to the taxpayer or applied to the amount of the offer.

Offers based on doubt as to liability would be excepted from the user fee based on the inequity of the IRS charging a fee to compromise an uncertain liability when a compromise is based upon a reassessment of the taxpayer's liability for a tax (and the agreed upon amount may, in fact, provide for the full payment of the amount actually owed).

Offers made by low income taxpayers would be excepted from the user fee in light of section 7122(c)(3)(A), which prohibits the IRS from rejecting an offer from a low income taxpayer solely on the basis of the amount offered. Section 7122(c)(3)(A) literally applies to the rejection of an offer rather than the return of an offer for failure to pay a user fee. However, requiring payment of a user fee from a low income taxpayer would undermine section 7122(c)(3)(A) in cases where the taxpayer does not have the ability to pay the fee. Offers from low income taxpayers therefore would be excepted.

Offers accepted to promote effective tax administration would be excepted from the user fee because the collection of a fee in these circumstances would undermine the purposes of these programs. Offers accepted based on doubt as to collectibility and a determination that collecting more than the amount offered would create economic hardship within the meaning of § 301.6343–1 would also be excepted because the criteria for these offers is the same as offers accepted to promote effective tax administration based on economic hardship.

Authority

The IOAA authorizes agencies to prescribe regulations that establish charges for services provided by the agency (user fees). The charges must be fair and be based on the costs to the Government, the value of the service to the recipient, the public policy or interest served, and other relevant facts. The IOAA provides that regulations implementing user fees are subject to policies prescribed by the President, which are currently set forth in OMB Circular A–25, 58 F.R. 38142 (July 15, 1993) (the OMB Circular).

The OMB Circular encourages user fees for Government-provided services that confer benefits on identifiable recipients over and above those benefits received by the general public. Under the OMB Circular, an agency that seeks to impose a user fee for Government-provided services must calculate its full cost of providing those services. In general, the amount of a user fee should recover the cost of providing the special service, unless the Office of Management and Budget (OMB) grants an exception. Pursuant to the guidelines in the OMB Circular, the IRS has calculated its cost of providing services under the offer in compromise program. The IRS has determined that the full cost of investigating doubt as to collectibility and effective tax administration offers averages $471 when streamlined procedures are used to investigate the financial condition of the taxpayer, and $3,983 when more detailed investigations are used. The IRS estimates that 70 percent of offers are processed under streamlined procedures. OMB has granted an exception to the "full cost" requirement of the OMB Circular.

The Treasury, Postal Service, and General Government Appropriations Act of 1995, Public Law 103–329 (108 Stat. 2382) (the 1995 Appropriations Act) provides that the Secretary may establish new fees for services provided by the IRS where such fees are authorized by another law, such as the I0AA.

The proposed user fees will be implemented under the authority of the IOAA, the OMB Circular, and the 1995 Appropriations Act.

Effective Date

These regulations are proposed to be effective thirty days after the date of publication in the **Federal Register** of the final regulations.

Special Analysis

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 is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. This certification is based on the information that follows. The economic impact of these regulations on any small entity would result from the entity being required to pay a fee prescribed by these regulations in order to obtain a particular service. The dollar amount of the fee is not, however, substantial enough to have a significant economic impact on any entity subject to the fee. 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 (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department 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 Thursday, February 13, 2003, 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 Constitution Avenue entrance. 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 30 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 electronic or written comments and an outline of the comments to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by Thursday, January 23, 2003. 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 regulations is G. William Beard, Office of Associate Chief Counsel (Procedure and Adminstration), Collection, Bankruptcy and Summonses Division.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 300 is proposed to be amended as follows:

PART 300—USER FEES

Paragraph 1. The authority citation for part 300 continues to read as follows:

Authority: 31 U.S.C. 9701.

Par. 2. Section 300.0 is amended as follows:

1. Paragraphs (b)(3) is added.
2. Paragraph (c) is revised.

The addition and revision read as follows:

§ 300.0 User fees; in general.

* * * * *

(b) * * *

(3) Processing an offer to compromise.

(c) *Effective Date*. This part 300 is applicable March 16, 1995, except that the user fee for processing offers to compromise is applicable thirty days after the date of publication in the **Federal Register** of the final regulations.

Par. 3. Sections 300.3 is added to read as follows:

§ 300.3 Offer to compromise fee.

(a) *Applicability*. This section applies to the processing of offers to compromise tax liabilities pursuant to § 301.7122–1 of this chapter. Except as provided in this section, this fee applies to all offers to compromise accepted for processing.

(b) *Fee*. (1) The fee for processing an offer to compromise is $150.00, except that no fee will be charged if an offer is—

(i) Based on doubt as to liability as defined in § 301.7122–1(b)(1) of this chapter; or

(ii) Made by a low income taxpayer, that is, a taxpayer who falls at or below the dollar criteria established by the poverty guidelines updated annually in the **Federal Register** by the U.S. Department of Health and Human Services under authority of section 673(2) of the Omnibus Budget Reconciliation Act of 1981 (95 Stat. 357, 511) or such other measure that is adopted by the Secretary.

(2) The fee will, in the taxpayer's discretion, either be refunded to the taxpayer or applied against the amount of the offer if the offer is—

(i) Accepted to promote effective tax administration pursuant to § 301.7122–1(b)(3) of this chapter; or

(ii) Accepted based on doubt as to collectibility and a determination that collection of an amount greater than the amount offered would create economic hardship within the meaning of § 301.6343–1 of this chapter.

(3) Except as otherwise provided in this paragraph (b), the fee will not be refunded to the taxpayer if the offer is accepted, rejected, withdrawn, or returned as nonprocessable after acceptance for processing.

(c) *Person liable for the fee*. The person liable for the processing fee is the taxpayer whose tax liabilities are the subject of the offer.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on November 5, 2002, 8:45 a.m., and published in the issue of the Federal Register for November 6, 2002, 67 F.R. 67573)

Notice of Proposed Rulemaking and Notice of Public Hearing

Guidance Under Section 1502; Suspension of Losses on Certain Stock Dispositions

REG–131478–02

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations that redetermine the basis of stock of a subsidiary member of a consolidated group immediately prior to certain dispositions and deconsolidations of such stock. In addition, this document contains proposed regulations that suspend certain losses recognized on the disposition of such stock. The regulations apply to corporations filing consolidated returns. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by January 21, 2003. Outlines of topics to be discussed at the public hearing scheduled for January 15, 2003, at 10 a.m. must be received by December 27, 2002.

ADDRESSES: Send submissions to CC:ITA:RU (REG–131478–02), 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:ITA:RU (REG–131478–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at: *www.irs.gov/regs*. The public hearing will be held in room 6718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Aimee K. Meacham (202) 622−7530; concerning submissions, the hearing, and/or to be placed on the building access list to attend the hearing, Sonya M. Cruse (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget,** Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service,** Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S, Washington, DC 20224. Comments on the collection of information should be received by December 22, 2002. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in these proposed regulations is in § 1.1502–35(c) and § 1.1502–35(f). This information is required by the IRS to verify compliance with section 1502. This information will be used to determine whether the amount of tax has been calculated correctly. The collection of information is required to properly determine the amount permitted to be taken into account as a loss. The respondents are corporations filing consolidated returns. The collection of information is required to obtain a benefit.

Estimated total annual reporting and/or recordkeeping burden: 10,500 hours.

Estimated average annual burden per respondent: 2 hours.

Estimated number of respondents: 5,250.

Estimated annual frequency of responses: on occasion.

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

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

Background

Section 1502 of the Internal Revenue Code (Code) states that

> [t]he Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

The legislative history regarding that grant of authority states that "[a]mong the regulations which it is expected that the commissioner will prescribe are [regulations addressing the] extent to which gain or loss shall be recognized upon the sale by a member of the affiliated group of stock issued by any other member of the affiliated group [and] the basis of property . . . acquired, during the period of affiliation, by a member of the affiliated group, including the basis of such property after such period of affiliation." S. Rep. No. 960, 70th Cong., 1st Sess. 15 (1928).

In 1991, the IRS and Treasury Department promulgated § 1.1502–20, which set forth rules regarding the extent to which a loss recognized by a member of a consolidated group on the disposition of stock of a subsidiary member of the same group was allowed. Section 1.1502–20 provided that a loss recognized by a group member on the disposition of subsidiary member stock was allowable only to the extent it exceeded the sum of "extraordinary gain dispositions," "positive investment adjustments," and "duplicated loss." The rule not only implemented section 337(d), which directed the Secretary to promulgate regulations to prevent the circumvention of corporate tax on appreciated property through the filing of a consolidated return, but also was intended to further single entity principles by preventing the deduction of stock losses that reflected a subsidiary member's loss carryforwards, deferred deductions, and unrecognized losses inherent in its assets.

In *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), the United States Court of Appeals for the Federal Circuit considered the validity of the duplicated loss component of § 1.1502–20. The court held that the duplicated loss component of § 1.1502–20 was an invalid exercise of regulatory authority.

In response to the *Rite Aid* decision, the IRS and Treasury Department issued Notice 2002–11, 2002–7 I.R.B. 526, stating that the interests of sound tax administration would not be served by the continued litigation of the validity of the duplicated loss component of §1.1502–20. Notice 2002–11 announced that, because of the interrelationship in the operation of all of the loss disallowance factors of § 1.1502–20, the IRS and Treasury Department had decided that new rules governing loss disallowance on sales of subsidiary stock by members of consolidated groups should be implemented.

On March 7, 2002, the IRS and Treasury Department filed with the **Federal Register** temporary regulations (T.D. 8984, 2002–13 I.R.B. 668 [67 F.R. 11034]) under sections 337(d) and 1502 governing the determination of a consolidated group's allowable stock loss on a disposition of subsidiary member stock. Those regulations included § 1.337(d)–2T, which generally allows a loss on the disposition of subsidiary member stock only to the extent that a taxpayer can establish that the stock loss is not attributable to the recognition of built-in gain. Section 1.337(d)–2T does not disallow stock loss that reflects loss carryforwards, deferred deductions, or built-in asset losses of the subsidiary member.

Concurrently with the filing of § 1.337(d)–2T with the **Federal Register**, the IRS and Treasury Department issued Notice 2002–18, 2002–12 I.R.B. 644, which stated that regulations would be promulgated that would defer or otherwise limit the utilization of a loss on stock (or another asset that reflects the basis of stock) in transactions that facilitate the group's utilization of a single economic loss more than once. Notice 2002–18 is based on the principle that a consolidated group should not be able to obtain more than one tax benefit from a single economic loss. See *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934) (disallowing a worthless stock deduction recognized on a liquidation of a subsidiary member because the group had already obtained the tax benefit from the operating losses that gave rise to the deduction). The notice stated that the regulations would apply to dispositions occurring on or after March 7, 2002.

Explanation of Provisions

These proposed regulations reflect the principle set forth in Notice 2002–18 that a consolidated group should not be able to obtain more than one tax benefit from a single economic loss. The proposed regulations consist primarily of two rules: a basis redetermination rule and a loss suspension rule. The proposed regulations also include a basis reduction rule to address certain cases not within the scope of the loss suspension rule. Finally, the proposed regulations include certain antiavoidance rules to address certain transactions designed to avoid the application of the basis redetermination and loss suspension rules.

The rules in these proposed regulations are intended to address at least two types of transactions that may allow a group to obtain more than one tax benefit from a single economic loss. In the first type of transaction, a group absorbs an inside loss (*e.g.*, a loss carryforward, a deferred deduction, or a loss inherent in an asset) of a subsidiary member and then a member of the group recognizes a loss on a disposition of stock of that subsidiary member that is duplicative of the inside loss. For example, assume that in Year 1, P, a member of a group, forms S with a contribution of $80 in exchange for 80 shares of common stock of S (representing all of the outstanding stock of S). In Year 2, P contributes Asset A with a basis of $70 and a value of $20 to S in exchange for an additional 20 shares of S common stock. In Year 3, S sells Asset A and recognizes a $50 loss, which offsets income of P on the group's return. Under the investment adjustment rules of § 1.1502–32, P's basis in each share of S common stock it holds is reduced by a *pro rata* share of the $50 loss, with the result that the shares acquired in Year 1 have a basis of $40 and the shares acquired in Year 2 have a basis of $60. In Year 4, P sells the shares acquired in Year 2 for $20 and recognizes a $40 loss, which offsets income of P on the group's return. In this transaction, the group has obtained a total of $90 tax benefit from the single $50 loss.

Alternatively, assume that, in Year 1, P forms S with a contribution of $100 in exchange for all of the common stock of S. In Year 2, P contributes Asset A with a basis of $50 and a value of $20 to S in exchange for all of the preferred stock of S. In Year 3, S sells Asset A and recognizes a $30 loss, which offsets income of P on the group's return. Under the investment adjustment rules of § 1.1502–32, P's basis in each share of S common stock it holds is reduced by a *pro rata* share of the $30 loss. P's basis in its preferred shares, however, is not reduced. In Year 4, P sells the preferred stock of S for $20 and recognizes a $30 loss, which offsets income of P on the group's return. In this transaction, the group has obtained a $60 tax benefit from the single $30 economic loss in Asset A.

Although, in both cases, a taxable disposition of the S common stock acquired in Year 1 would offset the excess tax benefit, the group has various non-taxable alternatives by which to ensure that the excess tax benefit is not reduced, including retention of the remaining shares of S or the liquidation of S in a transaction described in section 332.

In the second type of transaction, a member of the group recognizes a loss on a disposition of subsidiary member stock that is duplicative of an inside loss of the subsidiary member, the subsidiary remains a member of the group, and the group subsequently recognizes the inside loss of that subsidiary member. For example, assume that in Year 1, P forms S with a contribution of $80 in exchange for 80 shares of the common stock of S. In Year 2, P contributes Asset A with a basis of $50 and a value of $20 to S in exchange for an additional 20 shares of S common stock. In Year 3, P sells the 20 shares of S common stock that it acquired in Year 2 for $20 and recognizes a $30 loss, which offsets income of P on the group's return. The sale of the 20 shares of S common stock does not result in the deconsolidation of S. In Year 4, S sells Asset A and recognizes a $30 loss, which also offsets income of P on the group's return. In this transaction, the group has obtained the use of two losses from the single economic loss in Asset A. Again, although a taxable disposition by P of its remaining S common stock would offset the tax benefit of one of the losses, the group has various non-taxable alternatives by which to ensure that the excess tax benefit is not reduced, including retention of the remaining shares of S or the liquidation of S in a transaction described in section 332.

A. *Basis Redetermination Rule*

The investment adjustment rules of § 1.1502–32 are premised on certain assumptions regarding the shareholders' interests in the subsidiary. One assumption is that the subsidiary's losses are borne by the holders of the common stock before the holders of the preferred stock. Another assumption is that each share within a class is entitled to an equal portion of the subsidiary's items of income and gain, and, in the case of common stock, of deduction and loss. The investment adjustment rules, therefore, generally allocate basis adjustments without regard to differences in members' bases in their shares of the stock of the subsidiary member and without regard to whether a basis adjustment reflects an item of income, gain, deduction, or loss that was built-in with respect to contributed property. These assumptions can give rise to the results illustrated in the transactions described above.

The basis redetermination rule attempts to mitigate the effect of the assumptions underlying the investment adjustment rules by reversing certain investment adjustments to take into account the source of certain items of deduction and loss. In addition, where the subsidiary member remains a member of the group, the basis redetermination rule equalizes members' bases in subsidiary stock such that the loss suspension rule, described below, need not include inordinately complex rules to address the method by which inside losses reduce stock basis under § 1.1502–32.

The proposed regulations require the redetermination of the basis of subsidiary member stock held by members of the group immediately before a disposition or deconsolidation of a share of subsidiary member stock when the basis of such stock exceeds its value. The rule applies differently when the subsidiary remains a member of the group after its stock is disposed of or deconsolidated from when the subsidiary does not remain a member of the group.

If a subsidiary remains a member of the group, the basis redetermination rule requires that all members of the group aggregate their bases in all shares of the subsidiary member. That basis is then allocated first to the shares of the subsidiary member's preferred stock that are owned by the members of the group in proportion to, but not in excess of, their value on the date of the disposition or deconsolidation. After the allocation of the aggregated basis to all shares of the preferred stock of the subsidiary member held by members of the group, any remaining basis is allocated among all common shares of subsidiary member stock held by members of the group in proportion to their value on the date of the disposition or deconsolidation. This rule reallocates past adjustments to reflect an economic allocation of the built-in items of deduction and loss with respect to contributed property. The rule also reallocates stock basis that arose from capital contributions of property and stock basis that arose as a result of positive investment adjustments. The reallocation of basis obviates the need for complex rules addressing basis adjustments resulting from an inside loss that was reflected in a stock loss that is suspended pursuant to the loss suspension rule described below.

If the subsidiary is no longer a member of the group immediately after the disposition or deconsolidation of its stock, the basis redetermination rule requires a reallocation of a certain amount of the basis of the stock of the subsidiary member owned by group members. In particular, the amount of basis subject to reallocation is equal to the lesser of (1) the loss inherent in the stock disposed of or deconsolidated, and (2) the subsidiary member's items of deduction and loss that were taken into account in computing the adjustment to the basis of any share of stock of the subsidiary member, other than the shares disposed of or deconsolidated, during the time such subsidiary member was a member of the group. However, only those items of deduction and loss that are attributable to formerly unrecognized or unabsorbed items reflected in the basis of the subsidiary member stock disposed of or deconsolidated are included in the computation of the amount of basis subject to reallocation. For example, if a share of stock has a basis in excess of value because the stock was acquired in exchange for a built-in loss asset, the stock's basis reflects that unrecognized loss. If that loss is later recognized, the basis adjustment resulting from that recognition is an item of loss attributable to a formerly unrecognized item reflected in the basis of such stock. The proposed regulations contain a presumption that all items of deduction and loss included in the computation of prior investment adjustments to the basis of members' shares of the subsidiary member are attributable to the recognition and absorption of a deduction or loss reflected in the basis of the shares that are disposed of or deconsolidated. The regulations do, however, permit groups to establish that particular items of deduction and loss are not reflected in the basis of the shares disposed of or deconsolidated, and, therefore, are not reallocated to other shares.

If the subsidiary is no longer a member of the group immediately after the disposition or deconsolidation of its stock, the basis in the shares of subsidiary member stock disposed of or deconsolidated is reduced by the amount of basis subject to reallocation. Then, to the extent of the amount of basis subject to reallocation, the basis of all preferred shares of stock of the subsidiary member that are held by members of the group immediately after the disposition or deconsolidation is increased such that the basis of each such share equals, but does not exceed, its value immediately before the disposition or deconsolidation. Finally, to the extent that the amount of basis subject to reallocation does not increase the basis of such preferred shares of the subsidiary member, such amount increases the basis of all common shares of stock of the subsidiary member held by members of the group immediately after the disposition or deconsolidation in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of each such share to be the same.

The basis redetermination rule does not apply if the group disposes of all its stock of the subsidiary member within a single taxable year, in one or more fully taxable transactions, or is allowed a worthless stock deduction with respect to all of the subsidiary member stock owned by the members. Under those circumstances, if a second tax benefit has been derived from an economic loss, the second tax benefit will be recaptured in the taxable year in which it was obtained.

The proposed regulations also include a look-through rule that applies the basis redetermination rule to stock of lower-tier subsidiary members when there is a disposition or deconsolidation of stock of a higher-tier member. In addition, the proposed regulations provide that basis adjustments made pursuant to the basis redetermination rule result in basis adjustments to higher-tier member stock.

While the basis redetermination rule may prevent the recognition of a current loss on a particular share of subsidiary member stock, it does not prevent a group from obtaining a benefit from its investment in the subsidiary member. The basis redetermination rule affects only the timing of the group's loss and, in so doing, prevents the group from inappropriately duplicating a single economic loss.

B. *Loss Suspension Rule*

The loss suspension rule prevents duplication of an economic loss by effectively disallowing a stock loss if the economic loss giving rise to that stock loss is later reflected on the group's return as in the second type of transaction described above.

1. *Suspension of Stock Loss*

Under the loss suspension rule, if, after application of the basis redetermination rule, a member of a consolidated group recognizes a loss on the disposition of stock of a subsidiary member of the same group, and the subsidiary member is a member of the same group immediately after the disposition, then the selling member's stock loss is suspended to the extent of the duplicated loss with respect to such stock. The proposed regulations also include a special rule that applies the loss suspension rule in cases of a disposition of stock of a subsidiary member that leaves the group where the subsidiary owns stock of another subsidiary that remains a member of the group. In addition, the proposed regulations include a substitute asset rule that suspends a member's loss recognized on a disposition of an asset other than stock of a subsidiary member where such member's basis in the asset disposed of was determined, directly or indirectly, in whole or in part, by reference to the basis of stock of a subsidiary member with respect to which there was a duplicated loss, and immediately after the disposition, the subsidiary member is a member of such group.

The amount of duplicated loss is the excess of (1) the sum of the aggregate basis of the subsidiary member's assets (excluding stock in other subsidiary members of the group), the subsidiary member's losses that are carried to its first taxable year after the disposition, and the subsidiary member's deductions that have been recognized but deferred under another provision, over (2) the sum of the value of stock of the subsidiary member and the subsidiary member's liabilities that have been taken into account for tax purposes. Each of these items in the computation (except stock value) includes the subsidiary member's allocable share of the same items of any lower-tier subsidiary. This definition of duplicated loss is substantially identical to the one in former § 1.1502–20, except that securities of other members of the group are not excluded from the computation of the subsidiary's aggregate asset basis.

The application of the loss suspension rule can be illustrated as follows. Assume P, the common parent of a consolidated group, forms S in Year 1 by contributing $100 to S in exchange for all 10 shares of S's outstanding stock. Immediately after the contribution, S purchases a building for $100. In Year 2, the value of the building declines to $10. At the end of Year 2, P sells one share of S stock for $1 and recognizes a $9 loss. (Because the basis of P's shares of S stock is uniform at the time of the disposition, the basis redetermination rule does not alter P's basis in the share sold.) Immediately after the sale, S is still a member of the P group because P continues to own 90% of the S stock. On the date of the stock sale, S's duplicated loss is $90, the excess of its asset basis ($100) over the value of the assets (deemed to be equal to the aggregate stock value, $10). Of the total duplicated loss, 10%, or $9, is allocable to the share sold. Thus, under the loss suspension rule the $9 stock loss is suspended.

2. *Reduction of Suspended Stock Loss*

Because a suspended stock loss reflects the subsidiary member's unrecognized or unabsorbed deductions and losses, the suspended loss is reduced, with the result that it will not later be allowed, as the subsidiary member's deductions and losses are taken into account (*i.e.*, absorbed) in determining the group's consolidated taxable income (or loss). The reduction of suspended loss is appropriate because, once the group takes the inside loss into account in determining consolidated taxable income (or loss), the group should not be able to take such loss (in the form of the stock loss or otherwise) into account again in determining consolidated taxable income or loss. Using the facts of the above example, assume that, in Year 3, S sells its building for $10 and recognizes a $90 loss. The P group uses the entire $90 loss to offset income of another member of the group. Under these proposed regulations, the absorbed loss ($90) reduces the suspended loss amount ($9), but not below zero. Thus, P will benefit from the economic loss once on its return, no suspended stock loss will remain, and P's basis in its remaining S stock will be reduced by its allocable share of the loss ($81).

The proposed regulations generally presume that all deductions and losses are attributable first to the duplicated loss that gave rise to a suspended stock loss. The presumption, however, is rebuttable. If a taxpayer can establish that an item of deduction or loss was not part of the duplicated loss that gave rise to a suspended stock loss, the taxpayer will not be required to reduce its suspended stock loss. To illustrate, assume that, instead of selling the building, S retained the building and, in Year 3, earned $50 which it then used to purchase a truck. In Year 4, S sells the truck, recognizing a $25 loss. That loss offsets income of another member of the P group. Assuming that P and S have kept adequate records, P should be able to establish that the loss on the truck was not reflected in the stock loss (because it was attributable to an asset that was acquired after the disposition of stock that gave rise to the suspended stock loss). In that case, P would not be required to reduce its suspended stock loss. The IRS and Treasury Department are concerned about, and specifically request comments regarding, the administrability aspects of this exception.

3. *Allowance of Suspended Stock Loss*

The proposed regulations provide that any suspended stock loss remaining at the time the subsidiary member leaves the group is allowed, to the extent otherwise allowable under applicable provisions of the Code and regulations thereunder. The loss is allowed on a return filed for the taxable year that includes the last day that the subsidiary member is a member of the group. Once the subsidiary member is no longer a member of the group, the group will not typically be able to use the subsidiary member's deductions or losses on the group's return. Accordingly, it is appropriate to allow any suspended stock loss remaining at the time the subsidiary member leaves the group.

The proposed regulations also provide that any suspended stock loss remaining is allowed at the time the group is allowed a worthless stock deduction with respect to all of the subsidiary member stock owned by members. In such cases, the basis reduction rule, described below, may reduce a worthless stock deduction effectively to prevent any second tax benefit that could be derived from the economic loss that gave rise to the suspended stock loss.

The proposed regulations require that in order for a group to be allowed a loss that was recognized on the disposition of a subsidiary member and that was suspended, the group must file a statement of allowable loss with the consolidated return for the year in which the loss is allowable.

C. *Application of the Basis Redetermination and Loss Suspension Rules Generally*

The IRS and Treasury Department do not expect that the basis redetermination and the loss suspension rules will apply frequently. This expectation is based on the assumption that, when a group seeks to raise capital, the common parent will typically issue stock directly or sell all of the stock of a subsidiary member. Alternatively, groups sometimes seek to raise capital by creating minority interests in a subsidiary member. In such cases, however, the group will typically cause the subsidiary member to issue shares directly to the nonmember. Thus, the IRS and Treasury Department believe that a member's sale of less than all of the stock of a subsidiary member to a nonmember, which may trigger application of the basis redetermination and loss suspension rules, is not a common transaction in the absence of tax incentives.

D. *Basis Reduction Rule*

The loss suspension rule apples only if there has been a disposition of subsidiary member stock and the subsidiary member is a member of the group immediately after the disposition. The IRS and Treasury Department, however, are concerned that a group may obtain more than one tax benefit from a single economic loss in certain cases in which a group member recognizes a loss with respect to subsidiary member stock and, in connection with such recognition event, the subsidiary member ceases to exist. For example, suppose P owns all of the stock of S. P's basis in its S stock is $100 and the value of the S stock is $0 because S is insolvent. S liquidates into P. In that case, P will recognize a loss of $100 on the disposition of the S stock. Because S is not a member of the P group immediately after the disposition of S stock, the loss suspension rule will not apply. The portion of the group's consolidated net operating and net capital loss carryforwards attributable to S, however, may remain with the P group. Therefore, to that extent, any loss on the stock of the subsidiary duplicates those losses. To address this case, these proposed regulations provide that if a member disposes of subsidiary member stock and on the following day the subsidiary is not a member of the group and does not have a separate return year, then the basis of the subsidiary member stock is reduced to the extent of the consolidated net operating loss and net capital loss carryforwards attributable to such subsidiary member, as though they were absorbed immediately prior to the disposition.

Similarly, where the subsidiary becomes worthless under the standards of § 1.1502–80(c), the group may be allowed a worthless stock loss while consolidated net operating and net capital loss carryforwards attributable to the worthless subsidiary member remain unabsorbed. Although the subsidiary may be viewed as remaining in the group, rather than rely on existing rules, including the excess loss account recapture rules, to prevent the possible duplication of the unabsorbed losses, these proposed regulations provide for a negative stock basis adjustment similar to that described above in such cases.

E. *Anti-avoidance Rules*

The IRS and Treasury Department are concerned that, in certain cases, taxpayers may structure transactions to avoid the application of the basis redetermination and loss suspension rules in a manner that is not consistent with the purpose of the proposed regulations to prevent a consolidated group from obtaining more than one tax benefit from a single economic loss. In particular, suppose P acquires 80 shares of S common stock in exchange for $80. In a later year, P contributes an asset with a basis of $50 and a value of $20 to S in exchange for 20 shares of S preferred stock. The following year, S sells the contributed asset, recognizing a loss of $30. As a result of the sale of the asset, P's basis in the S common stock is reduced by $30 from $80 to $50. In contemplation of the sale of the S preferred stock, P contributes the 80 shares of S common stock to PS, a partnership, in a transaction described in section 721. Because P's basis in the S common stock does not exceed the value of such stock, the deconsolidation of the S common stock does not trigger the application of the basis redetermination rule. In the same year, but after the contribution of the S common stock to PS, P sells the S preferred stock, recognizing $30 of loss. Absent the application of an anti-avoidance rule, the P group will have obtained more than one tax benefit from the single economic loss inherent in the contributed asset. Accordingly, the proposed regulations provide that if a share of subsidiary member stock is deconsolidated and such deconsolidation is with a view to avoiding application of the basis redetermination rule prior to the disposition of loss stock of the subsidiary member, then the basis redetermination rule will apply immediately prior to the deconsolidation.

In addition, suppose in Year 1, P forms S with a contribution of $100 in exchange for 100 shares of common stock of S which at that time represents all of the outstanding stock of S. In Year 2, P contributes 20 shares of common stock of S to PS, a partnership, in a transaction described in section 721. In Year 3, P contributes an asset with a basis of $50 and a value of $20 to PS in a transaction described in section 721. Also in Year 3, PS contributes the built-in loss asset to S and P contributes an additional $80 to S in transfers to which section 351 applies. In Year 4, S sells the built-in loss asset for $20, recognizing a loss of $30. The P group uses that loss to offset income of P. Also in Year 4, P sells its entire interest in PS for $40, recognizing a loss of $30, or PS sells its S stock for $20, recognizing a loss of $30. In either case, the P group would obtain more than one tax benefit from the single economic loss in the contributed asset. Accordingly, the proposed regulations provide that where a member of a consolidated group contributes a built-in loss asset to a partnership or a deconsolidated corporation, that partnership or deconsolidated corporation subsequently contributes the built-in loss asset to a subsidiary member of the group, and those contributions are with a view to avoiding the application of the basis redetermination rule or the loss suspension rule, adjustments must be made to prevent the consolidated group from obtaining more than one tax benefit from a single economic loss in the case.

The IRS and Treasury Department are also concerned that it may be possible to avoid the loss suspension rule by disposing of a sufficient amount of subsidiary member stock to cause a deconsolidation of the subsidiary member, but then engage in a transaction that has the effect of re-importing to the group losses of that subsidiary member. To address this concern, the proposed regulations include an anti-avoidance rule that prevents the group from obtaining the tax benefit of the re-imported loss. The rule applies whenever (1) a group recognizes and is allowed a loss on the disposition of subsidiary member stock with respect to which there is a duplicated loss, (2) as a result of that disposition or another disposition, the subsidiary member leaves the group, and (3) within ten (10) years after the date the subsidiary member leaves the group, a loss of the subsidiary member is re-imported into the group. A loss of a subsidiary may be re-imported into the group when the subsidiary member rejoins the group at a time when it has losses or deferred deductions that it had on the date of the disposition or has losses or deferred deductions that are attributable to built-in loss assets held by the subsidiary member on the date of the disposition, or has built-in loss assets that were built-in loss assets of the subsidiary member on the date of the disposition. A loss of a subsidiary member may also be re-imported into the group when a member of the group succeeds to losses or deferred deductions of the subsidiary member that were losses or deferred deductions of the subsidiary member on the date of the disposition, or losses or deferred deductions that are attributable to assets that were built-in loss assets of the subsidiary member on the date of the disposition, or acquires built-in loss assets that were built-in loss assets of the subsidiary member on the date of the disposition. If the anti-avoidance rule applies, then these proposed regulations generally prohibit the use of the re-imported item of deduction or loss to offset income of the group.

F. *Application of Anti-Abuse Rules*

Finally, the proposed regulations make clear that the proposed rules do not preclude the application of anti-abuse rules of the Code and regulations thereunder, including to a transaction entered into to invoke the basis redetermination rule to avoid the effect of any other provision of the Code or regulations.

G. *Request for Comments*

The IRS and Treasury Department are considering alternative approaches to the basis redetermination rule that would mitigate basis disparities in stock of a subsidiary member. In this regard, the IRS and Treasury Department are considering an approach that would adjust the bases of all shares of subsidiary member stock held by group members upon any acquisition of subsidiary member stock. Comments are requested regarding the appropriateness and desirability of such an approach as well as suggestions for alternative approaches.

In addition, under the proposed regulations, the basis redetermination and loss suspension rules apply only to certain events involving stock that has a basis in excess of value. The IRS and Treasury Department, however, are considering the appropriateness and feasibility of a rule that applies the principles of the basis redetermination and loss suspension rules to certain events involving stock that has a value in excess of basis. With respect to the application of the principles of the loss suspension rule to dispositions of stock that has a value in excess of basis and that reflects duplicated gain, a rule might require taking into account the stock gain upon the disposition of the stock but would eliminate gain recognized on the disposition of assets that had a built-in gain at the time of the stock transaction. The IRS and Treasury Department request comments on appropriate and administrable applications of the principles of the basis redetermination and loss suspension rules to dispositions and deconsolidations of stock that has a built-in gain.

Finally, as an alternative or supplement to the rule providing for basis reduction for unabsorbed losses in certain cases where the subsidiary member ceases to exist or the group is allowed a worthless stock deduction with respect to the stock of such subsidiary member, the IRS and Treasury Department are considering whether it would be more appropriate to restrict the losses pursuant to the approach set forth in section 382(g)(4)(D). Comments are requested regarding whether such an approach would be appropriate, desirable and administrable, as well as the application of such an approach in the context of consolidated attributes.

Proposed Effective Date

These regulations, other than the anti-avoidance rule that relates to the re-importing of losses, are proposed to apply to transactions that occur on or after March 7, 2002, but only if such transactions occur during a taxable year the original return for which is due (without regard to extensions) after the date these regulations are published as temporary or final regulations in the **Federal Register**. The anti-avoidance rule that relates to the re-importing of loss is proposed to apply to losses re-imported as a result of an event that occurs on or after October 18, 2002, that triggers the application of such rule, but only if such event occurs during a taxable year the original return for which is due (without regard to extensions) after the date these regulations are published as temporary or 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 is hereby certified that these regulations do not have a significant impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect affiliated groups of corporations, which tend to be larger businesses. Moreover, the number of taxpayers affected and the average burden are minimal. 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 these regulations do not impose a collection requirement 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, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small businesses.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department 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 January 15, 2003, beginning at 10 a.m. in room 6718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. 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 30 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" portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by December 27, 2002. 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 regulations is Aimee K. Meacham of the Office of the Associate Chief Counsel (Corporate), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.1502–32 is amended by:

1. Revising paragraph (a)(2).

2. Adding paragraphs (b)(3)(iii)(C), (b)(3)(iii)(D), and (b)(3)(vi).

The revision and additions read as follows:

§ 1.1502–32 Investment adjustments.

(a) * * *

(1) * * *

(2) *Application of other rules of law.* The rules of this section are in addition to other rules of law. See, *e.g.*, section 358 (basis determinations for distributees), section 1016 (adjustments to basis), § 1.1502–11(b) (limitations on the use of losses), § 1.1502–19 (treatment of excess loss accounts), § 1.1502–31 (basis after a group structure change), and § 1.1502–35 (additional rules relating to stock loss). P's basis in S's stock must not be adjusted under this section and other rules of law in a manner that has the effect of duplicating an adjustment. For example, if pursuant to § 1.1502–35(c)(3) and paragraph (b)(3)(iii)(C) of this section the basis in stock is reduced to take into account a loss suspended under § 1.1502–35(c)(1), such basis shall not be further reduced to take into account such loss, or a portion of such loss, if any, that is later allowed pursuant to § 1.1502–35(c)(5). See also paragraph (h)(5) of this section for basis reductions applicable to certain former subsidiaries.

* * * * *

(b) * * *

(3) * * *

(iii) * * *

(C) *Loss suspended under § 1.1502–35(c)*. Any loss suspended pursuant to § 1.1502–35(c) is treated as a noncapital, nondeductible expense incurred during the tax year that includes the date of the disposition to which such section applies. See § 1.1502–35(c)(3). Consequently, the basis of a higher-tier member's stock of P is reduced by the suspended loss in the year it is suspended.

(D) *Loss disallowed under § 1.1502–35(g)(3)(iii).* Any loss the use of which is disallowed pursuant to § 1.1502–35(g)(3)(iii)(A) or (B) is treated as a noncapital, nondeductible expense incurred during the taxable year that includes the date on which such loss is recognized. Any loss the use of which is disallowed pursuant to § 1.1502–35(g)(3)(iii)(C) and with respect to which no waiver described in paragraph (b)(4) of this section is filed is treated as a noncapital, nondeductible expense incurred during the taxable year that includes the day after the event described in § 1.1502–35(g)(3)(iii)(C) that gives rise to the application of § 1.1502–35(g)(3). See § 1.1502–35(g)(3)(iv).

* * * * *

(vi) *Special rules in the case of certain transactions subject to § 1.1502–35.* If a member of a group disposes of a share of subsidiary member stock or a share of subsidiary member stock is deconsolidated, and, at the time of such disposition or deconsolidation, the basis of such share exceeds its value, all members of the group are subject to the provisions of § 1.1502–35, which generally require a redetermination of members' basis in all shares of subsidiary stock.

Par. 3. Section 1.1502–35 is added to read as follows:

§ 1.1502–35 Disposition or deconsolidation of subsidiary member stock.

(a) *Purpose*. The purpose of this section is to prevent a group from obtaining more than one tax benefit from a single economic loss. The provisions of this section shall be construed in a manner consistent with that purpose and in a manner that reasonably carries out that purpose.

(b) *Redetermination of basis on disposition or deconsolidation of subsidiary member stock*—(1) *Application*. Except as provided in paragraph (b)(4) of this section, this paragraph (b) applies if a member of a consolidated group disposes of stock of a subsidiary member or a share of subsidiary member stock is deconsolidated, and such disposed of or deconsolidated stock has a basis that exceeds it value immediately prior to such disposition or deconsolidation. If, immediately after such disposition or deconsolidation, the subsidiary member remains a member of the group, then, immediately before such disposition or deconsolidation, the basis in each share of subsidiary member stock owned by each member of the group shall be redetermined in accordance with the provisions of paragraph (b)(2) of this section. If, immediately after such disposition or deconsolidation, the subsidiary is not a member of the group, then immediately before such disposition or deconsolidation, the basis in each share of subsidiary member stock owned by each member of the group shall be redetermined in accordance with the provisions of paragraph (b)(3) of this section.

(2) *Redetermination of subsidiary member stock basis if subsidiary member remains a member of the same group*. If the subsidiary member the stock of which is disposed of or deconsolidated remains a member of the group, all of the members' basis in the shares of subsidiary member stock shall be aggregated. Such aggregated basis shall be allocated first to the shares of the subsidiary member's preferred stock that are owned by the members of the group, in proportion to, but not in excess of, the value of those shares on the date of the disposition or deconsolidation that gave rise to the application of this paragraph (b). After allocation of the aggregated basis to all shares of the preferred stock of the subsidiary member held by members of the group, any remaining basis shall be allocated among all common shares of subsidiary member stock held by members of the group in proportion to the value of such shares on the date of the disposition or deconsolidation that gave rise to the application of this paragraph (b).

(3) *Redetermination of subsidiary member stock basis if subsidiary member does not remain a member of the group*—(i) *Calculation of Reallocable Basis Amount*. The reallocable basis amount shall equal the lesser of—

(A) The amount by which the basis of the disposed of or deconsolidated stock exceeds the value of such stock immediately prior to the disposition or deconsolidation that gave rise to the application of this paragraph (b); and

(B) The total of the subsidiary member's (and any predecessor's) items of deduction and loss, and the subsidiary member's (and any predecessor's) allocable share of items of deduction and loss of all lower-tier subsidiary members, that were taken into account in computing the adjustment to the basis of any share of stock of the subsidiary member (and any predecessor) under § 1.1502–32 other than the stock of the subsidiary member the disposition or deconsolidation of which gave rise to the application of this paragraph (b), during the time such subsidiary member (or any predecessor) was a member of the group, except to the extent the group can establish that all or a portion of such items would not have been reflected in a computation of the duplicated loss with respect to the disposed of or deconsolidated stock of the subsidiary member (or any predecessor) at any time prior to such disposition or deconsolidation.

(ii) *Allocation of reallocable basis amount*. If the subsidiary member the stock of which is disposed of or deconsolidated does not remain a member of the group, the basis in the shares of subsidiary member stock that were disposed of or deconsolidated shall be reduced by the reallocable basis amount. Then, to the extent of the reallocable basis amount, the basis of all the preferred shares of stock of the subsidiary member that are held by members of the group immediately after the disposition or deconsolidation shall be increased such that the basis of each such share shall equal, but not exceed, its value immediately before the disposition or deconsolidation. If the reallocable basis amount is not sufficient to increase the basis of each such share of preferred stock to its value immediately before the disposition or deconsolidation, the basis of each such share shall be increased in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of each such share to be the same. Then, to the extent the reallocable basis amount does not increase the basis of shares of subsidiary member preferred stock pursuant to the second sentence of this paragraph (b)(3)(ii), such amount shall increase the basis of all common shares of subsidiary member stock held by members of the group immediately after the disposition or deconsolidation in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of each such other share to be the same.

(4) *Exception to application of redetermination rules*. This paragraph (b) shall not apply to a disposition of subsidiary member stock if, within the taxable year of such disposition, in one or more fully taxable transactions, the group disposes of its entire equity interest in the subsidiary member or is allowed a worthless stock loss under section 165(g) (taking into account the provisions of § 1.1502–80(c)) with respect to all of the subsidiary member stock owned by members.

(5) *Special rule for lower-tier subsidiaries*. If—

(i) A member of a consolidated group disposes of stock of a subsidiary member of the same group or a share of subsidiary member stock is deconsolidated, and, immediately before the disposition or deconsolidation, the member's basis in the disposed of or deconsolidated share of subsidiary member stock exceeds its value;

(ii) The subsidiary member owns stock of another subsidiary member of the same group and, immediately before the disposition or deconsolidation, the basis of some or all of such stock exceeds its value; and

(iii) Immediately after the disposition or deconsolidation, another member of the same group owns stock of such other subsidiary member, then the basis in each share of such other subsidiary member shall be redetermined pursuant to this paragraph (b) as if the stock of such other subsidiary member owned by the subsidiary member had been disposed of or deconsolidated. This paragraph (b)(5) shall not apply in the case of a disposition of subsidiary member stock if, within the taxable year of the disposition of subsidiary member stock, in one or more fully taxable transactions, the group disposes of its remaining equity interests in the other subsidiary member or is allowed a worthless stock loss under section 165(g) (taking into account the provisions of § 1.1502–80(c)) with respect to such other subsidiary member. These same principles shall apply to stock of subsidiary members of the same group that are owned by such other subsidiary member.

(6) *Stock basis adjustments for higher-tier stock*. The basis adjustments required under this paragraph (b) result in basis adjustments to higher-tier member stock. The adjustments are applied in the order of the tiers, from the lowest to highest. For example, if a common parent owns stock of a subsidiary member that owns stock of a lower-tier subsidiary member and the subsidiary member recognizes a loss on the disposition of a portion of its shares of the lower-tier subsidiary member stock, the common parent must adjust its basis in its subsidiary member stock under the principles of § 1.1502–32 to reflect the adjustments that the subsidiary member must make to its basis in its stock of the lower-tier subsidiary member.

(7) *Ordering rule.* The rules of this paragraph (b) apply after the rules of § 1.1502–32 are applied. Paragraph (b)(5) of this section (and any resulting basis adjustments to higher-tier member stock made pursuant to paragraph (b)(6) of this section) applies prior to paragraph (b)(2) or (b)(3) of this section (and any resulting basis adjustments to higher-tier member stock made pursuant to paragraph (b)(6) of this section).

(c) *Loss suspension*—(1) *General rule*. Any loss recognized by a member of a consolidated group with respect to the disposition of a share of subsidiary member stock shall be suspended to the extent of the duplicated loss with respect to such share of stock if, immediately after the disposition, the subsidiary is a member of the consolidated group of which it was a member immediately prior to the disposition (or any successor group).

(2) *Special rule for lower-tier subsidiaries.* This paragraph (c)(2) applies if neither paragraph (c)(1) nor (f) of this section applies to a member's disposition of a share of stock of a subsidiary member (the departing member), a loss is recognized on the disposition of such share, and the departing member owns stock of one or more other subsidiary members (a remaining member) that is a member of such group immediately after the disposition. In that case, such loss shall be suspended to the extent the duplicated loss with respect to the departing member stock disposed of is attributable to the remaining member or members.

(3) *Treatment of suspended loss.* For purposes of the rules of § 1.1502–32(b)(3)(iii), any loss suspended pursuant to paragraph (c)(1) or (c)(2) of this section is treated as a noncapital, nondeductible expense of the member that disposes of subsidiary member stock incurred during the taxable year that includes the date of the disposition of stock to which paragraph (c)(1) or (c)(2) of this section applies. See § 1.1502–32(b)(3)(iii)(C). Consequently, the basis of a higher-tier member's stock of the member that disposes of subsidiary member stock is reduced by the suspended loss in the year it is suspended.

(4) *Reduction of suspended loss*—(i) *General rule*. The amount of any loss suspended pursuant to paragraphs (c)(1) and (c)(2) of this section shall be reduced, but not below zero, by the subsidiary member's (and any successor's) items of deduction and loss, and the subsidiary member's (and any successor's) allocable share of items of deduction and loss of all lower-tier subsidiary members, that are allocable to the period beginning on the date of the disposition that gave rise to the suspended loss and ending on the day before the first date on which the subsidiary member (or any successor) is not a member of the group of which it was a member immediately prior to the disposition (or any successor group), and that are taken into account in determining consolidated taxable income (or loss) of such group for any taxable year that includes any date on or after the date of the disposition and before the first date on which the subsidiary member (or any successor) is not a member of such group. The preceding sentence shall not apply to items of deduction and loss to the extent that the group can establish that all or a portion of such items was not reflected in the computation of the duplicated loss with respect to the subsidiary member stock on the date of the disposition of such stock.

(ii) *Operating rules*—(A) *Year in which deduction or loss is taken into account.* For purposes of paragraph (c)(4)(i) of this section, a subsidiary member's (or any successor's) deductions and losses are treated as taken into account when and to the extent they are absorbed by the subsidiary member (or any successor) or any other member. To the extent that the subsidiary member's (or any successor's) deduction or loss is absorbed in the year it arises or is carried forward and absorbed in a subsequent year (*e.g.*, under section 172, 465, or 1212), the deduction is treated as taken into account in the year in which it is absorbed. To the extent that a subsidiary member's (or any successor's) deduction or loss is carried back and absorbed in a prior year (whether consolidated or separate), the deduction or loss is treated as taken into account in the year in which it arises and not in the year in which it is absorbed.

(B) *Determination of items that are allocable to the post-disposition, predeconsolidation period.* For purposes of paragraph (c)(4)(i) of this section, the determination of whether a subsidiary member's (or any successor's) items of deduction and loss and allocable share of items of deduction and loss of all lower-tier subsidiary members are allocable to the period beginning on the date of the disposition of subsidiary stock that gave rise to the suspended loss and ending on the day before the first date on which the subsidiary member (or any successor) is not a member of the consolidated group of which it was a member immediately prior to the disposition (or any successor group) is determined pursuant to the rules of § 1.1502–76(b)(2), without regard to § 1.1502–76(b)(2)(ii)(D), as if the subsidiary member ceased to be a member of the group at the end of the day before the disposition and filed separate returns for the period beginning on the date of the disposition and ending on the day before the first date on which it is not a member of such group.

(5) *Allowable loss*—(i) *General rule*. To the extent not reduced under paragraph (c)(4) of this section, any loss suspended pursuant to paragraph (c)(1) or (c)(2) of this section shall be allowed, to the extent otherwise allowable under applicable provisions of the Internal Revenue Code and

regulations thereunder, on a return filed by the group of which the subsidiary was a member on the date of the disposition of subsidiary stock that gave rise to the suspended loss (or any successor group) for the taxable year that includes the day before the first date on which the subsidiary (or any successor) is not a member of such group or the date the group is allowed a worthless stock loss under section 165(g) (taking into account the provisions of § 1.1502–80(c)) with respect to all of the subsidiary member stock owned by members.

(ii) *No tiering up of certain adjustments.* No adjustments shall be made to a member's basis of stock of a subsidiary member (or any successor) for a suspended loss that is taken into account under paragraph (c)(5)(i) of this section. See § 1.1502–32(a)(2).

(iii) *Statement of allowed loss*. Paragraph (c)(5)(i) of this section applies only if the separate statement required under this paragraph (c)(5)(iii) is filed with, or as part of, the taxpayer's return for the year in which the loss is allowable. The statement must be entitled "ALLOWED LOSS UNDER § 1.1502–35(c)(5)" and must contain the name and employer identification number of the subsidiary the stock of which gave rise to the loss.

(6) *Special rule for dispositions of certain carryover basis assets.* If—

(i) A member of a group recognizes a loss on the disposition of an asset other than stock of a subsidiary member;

(ii) Such member's basis in the asset disposed of was determined, directly or indirectly, in whole or in part, by reference to the basis of stock of a subsidiary member and, at the time of the determination of the member's basis in the assets disposed of, there was a duplicated loss with respect such stock of the subsidiary member; and

(iii) Immediately after the disposition, the subsidiary member is a member of such group, then such loss shall be suspended pursuant to the principles of paragraphs (c)(1) and (c)(2) of this section to the extent of the duplicated loss with respect to such stock at the time of the determination of basis of the asset disposed of. Principles similar to those set forth in paragraphs (c)(3), (4), and (5) of this section shall apply to a loss suspended pursuant to this paragraph (c)(6).

(7) *Coordination with loss deferral, loss disallowance, and other rules*—(i) *In general.* Loss recognized on the disposition of subsidiary member stock or another asset is subject to redetermination, deferral, or disallowance under other applicable provisions of the Internal Revenue Code and regulations thereunder, including sections 267(f) and 482. Paragraphs (c)(1), (c)(2), and (c)(6) of this section do not apply to a loss that is disallowed under any other provision. If loss is deferred under any other provision, paragraphs (c)(1), (c)(2), and (c)(6) of this section apply when the loss would otherwise be taken into account under such other provision. However, if an overriding event described in paragraph (c)(7)(ii) of this section occurs before the deferred loss is taken into account, paragraphs (c)(1), (c)(2), and (c)(6) of this section apply to the loss immediately before the event occurs, even though the loss may not be taken into account until a later time.

(ii) *Overriding events.* For purposes of paragraph (c)(7)(i) of this section, the following are overriding events—

(A) The stock ceases to be owned by a member of the consolidated group;

(B) The stock is canceled or redeemed (regardless of whether it is retired or held as treasury stock); or

(C) The stock is treated as disposed of under § 1.1502–19(c)(1)(ii)(B) or (c)(1)(iii).

(d) *Definitions*—(1) *Disposition. Disposition* means any event in which gain or loss is recognized, in whole or in part.

(2) *Deconsolidation. Deconsolidation* means any event that causes a share of stock of a subsidiary member that remains outstanding to be no longer owned by a member of any consolidated group of which the subsidiary is also a member.

(3) *Value. Value* means fair market value.

(4) *Duplicated loss*—(i) *In general.* Duplicated loss is determined immediately after a disposition and equals the excess, if any, of—

(A) The sum of—

(*1*) The aggregate adjusted basis of the subsidiary member's assets other than any stock that subsidiary member owns in another subsidiary member; and

(*2*) Any losses attributable to the subsidiary member and carried to the subsidiary member's first taxable year following the disposition; and

(*3*) Any deductions of the subsidiary member that have been recognized but are deferred under a provision of the Internal Revenue Code (such as deductions deferred under section 469); over

(B) The sum of—

(*1*) The value of the subsidiary member's stock; and

(*2*) Any liabilities of the subsidiary member that have been taken account for tax purposes.

(ii) *Special rules.* (A) The amounts determined under paragraph (d)(4)(i) of this section with respect to a subsidiary member include its allocable share of corresponding amounts with respect to all lower-tier subsidiary members. If 80 percent or more in value of the stock of a subsidiary member is acquired by purchase in a single transaction (or in a series of related transactions during any 12-month period), the value of the subsidiary member's stock may not exceed the purchase price of the stock divided by the percentage of the stock (by value) so purchased. For this purpose, stock is acquired by purchase if the transferee is not related to the transferor within the meaning of sections 267(b) and 707(b)(1), using the language "10 percent" instead of "50 percent" each place that it appears, and the transferee's basis in the stock is determined wholly by reference to the consideration paid for such stock.

(B) The amounts determined under paragraph (d)(4)(i) of this section are not applied more than once to suspend a loss under this section.

(5) *Predecessor and Successor.* A predecessor is a transferor of assets to a transferee (the successor) in a transaction—

(i) To which section 381(a) applies;

(ii) In which substantially all of the assets of the transferor are transferred to members in a complete liquidation;

(iii) In which the successor's basis in assets is determined (directly or indirectly, in whole or in part) by reference to the transferor's basis in such assets, but the transferee is a successor only with respect to the assets the basis of which is so determined; or

(iv) Which is an intercompany transaction, but only with respect to assets that are being accounted for by the transferor in a prior intercompany transaction.

(6) *Successor group.* A surviving group is treated as a successor group of a consolidated group (the terminating group) that ceases to exist as a result of—

(i) The acquisition by a member of another consolidated group of either the assets of the common parent of the terminating group in a reorganization described in section 381(a)(2), or the stock of the common parent of the terminating group; or

(ii) The application of the principles of § 1.1502–75(d)(2) or (3).

(7) *Preferred stock, common stock. Preferred stock* and *common stock* shall have the meanings set forth in § 1.1502–32(d)(2) and (3), respectively.

(8) *Lower-tier.* A subsidiary member is *lower-tier* with respect to a member if or to the extent investment basis adjustments under § 1.1502–32 with respect to the stock of the former member would affect investment basis adjustments with respect to the stock of the latter.

(e) *Examples.* For purposes of the examples in this section, unless otherwise stated, all groups file consolidated returns on a calendar-year basis, the facts set forth the only corporate activity, all transactions are between unrelated persons, and tax liabilities are disregarded. The principles of paragraphs (a) through (d) of this section are illustrated by the following examples:

Example 1. (i) P owns 100 percent of the common stock of each of S1 and S2. S1 and S2 each have only one class of stock outstanding. P's basis in the stock of S1 is $100 and in the stock of S2 is $120. P, S1, and S2 are all members of the P group. S1 and S2 form S3. In Year 1, in transfers to which section 351 applies, S1 contributes $100 to S3 in exchange for all of the common stock of S3 and S2 contributes an asset with a basis of $50 and a value of $20 to S3 in exchange for all of the preferred stock of S3. S3 becomes a member of the P group. In Year 3, in a transaction that is not part of the plan that includes the formation of S3, S2 sells the preferred stock of S3 for $20. Immediately after the sale, S3 is a member of the P group.

(ii) Under paragraph (b)(1) of this section, because S2's basis in the preferred stock of S exceeds the value of such shares immediately prior to the sale and S is a member of the P group immediately after the sale, all of the P group members' bases in the stock of S3 is redetermined pursuant to paragraph (b)(2) of this section. Of the group members' total basis of $150 in the S3 stock, $20 is allocated to the preferred stock, the fair market value of the preferred stock on the date of the sale, and $130 is allocated to the common stock. S2's sale of the preferred stock results in the recognition of $0 of gain/loss. Pursuant to paragraph (b)(6) of this section, the redetermination of S1's and S2's bases in the stock of S3 results in adjustments to P's basis in the stock of S1 and S2. In particular, P's basis in the stock of S1 is increased by $30 to $130 and its basis in the stock of S2 is decreased by $30 to $90.

Example 2. (i) P owns 75 shares of common stock of S each with a basis and value equal to $1. S is a member of the P group. On January 1st of Year 1, in a transfer to which section 351 applies, P contributes Asset A, which has a basis of $100 and value of $25, to S in exchange for 25 shares of common stock of S. In Year 1, S incurs $40 of ordinary operating expenses and takes a depreciation deduction in the amount of $10 with respect to Asset A. Those deductions offset income of P in Year 1. Pursuant to § 1.1502–32, the negative investment adjustment of $50 with respect to the stock of S reduces the basis of each share of S common stock by $0.50. Therefore, P's original 75 shares of S common stock each has a basis of $0.50 and each of the 25 shares of S common stock that P acquired in Year 1 has a basis of $3.50. In Year 3 in a transaction that is not part of a plan that includes the Year 1 contribution, P sells the 25 shares of common stock it acquired in Year 1 for $12.50. As a result of that sale, S ceases to be a member of the P group.

(ii) Under paragraph (b)(1) of this section, because P's basis in the 25 shares of common stock it acquired in Year 1 exceeds its value immediately prior to the sale and S is not a member of the P group immediately after the disposition, P's basis in its shares of S common stock is redetermined pursuant to paragraph (b)(3) of this section. Pursuant to paragraph (b)(3)(i) of this section, the reallocable basis amount is $37.50 (the lesser of the amount by which P's basis in the S common stock sold exceeds the value of such stock immediately prior to the sale ($87.50 minus $12.50, or $75) and the aggregate amount of S's items of deduction and loss that were previously taken into account in the computation of the adjustment to the basis of the S common stock other than the stock disposed of, under § 1.1502–32, during the time that S was a member of the P group ($37.50)). P, however, may be able to establish that $30 of the $37.50 of items of deduction and loss taken into account in computing the adjustment to the basis of the S common stock (other than the S common stock disposed of) in Year 1 was not attributable to a loss that was already reflected in P's basis in its shares of S common stock disposed of. Assuming that P can establish this fact, pursuant to paragraph (b)(3)(i) of this section, the reallocable basis amount would be $7.50. In that case, P's basis in the 25 shares of S common stock sold would be reduced from $87.50 to $80 pursuant to paragraph (b)(3)(ii) of this section. Accordingly, P would recognize a loss of $67.50 on the sale of the 25 shares of S common stock for $12.50. In addition, the basis of each remaining share of S common stock would be increased in an aggregate amount of $7.50 in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of each such other share to be equal. In this case, the basis of each of the 75 shares of S common stock retained would be increased by $0.10 to $0.60.

Example 3. (i) In Year 1, P forms S by contributing Asset A with a basis of $90 and a value of $10 in exchange for one share of S common stock (CS1) in a transfer to which section 351 applies. In Years 2 and 3, in successive but unrelated transfers to which section 351 applies, P transfers $10 to S in exchange for one share of S common stock (CS2), Asset B with a basis of $2 and a value of $10 in exchange for one share of S common stock (CS3), and Asset C with a basis of $100 and a value of $10 in exchange for one share of S common stock (CS4). In Year 4, S sells Asset A, recognizing $80 of loss that is used to offset income of P recognized during Year 4. As a result of the sale of Asset C, the basis of each of P's four shares of S common stock is reduced by $20. Therefore, the basis of CS1 is $70. CS2 has an excess loss account of $10. CS3 has an excess loss account of $18. CS4 has a basis of $80. In Year 5 in a transaction that is not part of a plan that includes the Year 1 contribution, P sells CS1 for $10. Immediately after the sale of CS1, S is not a member of the P group.

(ii) Under paragraph (b)(1) of this section, because P's basis in CS1 exceeds its value immediately prior to the sale and S is not a member of the P group immediately after the disposition, P's basis in its shares of S common stock is redetermined pursuant to paragraph (b)(3) of this section. Pursuant to paragraph (b)(3)(i) of this section, the reallocable basis amount is $60 (the lesser of the amount by which P's basis in the S common stock sold exceeds the value of such stock immediately prior to the sale ($60) and the aggregate amount of S's items of deduction and loss that were previously taken into account in the computation of the adjustment to the basis of the S common stock other than the stock disposed of, under § 1.1502–32, during the time that S was a member of the P group ($60)). Pursuant to paragraph (b)(3)(ii) of this section, P's basis in CS1 is reduced from $70 to $10. On the sale of CS1, therefore, P recognizes $0 gain/loss. Then, P's basis in the remaining S common stock is increased in an aggregate amount of $60 in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of each such share to be same. In this case, $20 of the reallocable basis amount is allocated to CS2 and $28 of the reallocable basis amount is allocated to CS3 so as to increase the basis of such shares to $10, the basis of CS1. The remaining $12 of the reallocable basis amount is allocated equally to CS2 and CS3 so as to increase the basis of each such share from $10 to $16.

Example 4. (i) In Year 1, P forms S with a contribution of $80 in exchange for 80 shares of the common stock of S, which at that time represents all of the outstanding stock of S. S becomes a member of the P group. In Year 2, P contributes Asset A with a basis of $50 and a value of $20 in exchange for 20 shares of the common stock of S in a transfer to which section 351 applies. In Year 3, in a transaction that is not part of the plan that includes the Year 2 contribution, P sells the 20 shares of the common stock of S that it acquired in Year 2 for $20. At that time, S has $80 and Asset A, the basis and value of which have not changed. In Year 4, S sells Asset A for $20, recognizing a $30 loss. That $30 loss is used on the P group return to offset income of P. In Year 5, P sells its remaining S common stock for $80.

(ii) Under paragraph (b)(1) of this section, because P's basis in the common stock sold exceeds its value immediately prior to the sale and S is a member of the P group immediately after the sale, P's basis in all of the stock of S is redetermined pursuant to paragraph (b)(2) of this section. Of P's total basis of $130 in the S common stock, a proportionate amount is allocated to each of the 100 shares of S common stock. Accordingly, $26 is allocated to the common stock of S that is sold and $104 is allocated to the common stock of S that is retained. On P's sale of the 20 shares of the common stock of S for $20, P recognizes a loss of $6. Because the sale of the 20 shares of common stock of S does not result in the deconsolidation of S, under paragraph (c)(1) of this section, that loss is suspended to the extent of the duplicated loss with respect to the shares sold. The duplicated loss with respect to the shares sold is $6. Therefore, the entire $6 loss is suspended. Pursuant to paragraph (c)(4) of this section, the amount of the suspended loss is reduced, but not below zero, by S's items of deduction and loss that are allocable to the period beginning on the date of the Year 2 disposition of the S stock and ending on the day before the first date on which S is not a member of the P group and that are taken into account in determining consolidated taxable income (or loss) of the P group for any taxable year that includes any date on or after the date of the Year 2 disposition and before the first date on which S is not a member of the P group, except to the extent the P group can establish that all or a portion of such items was not included in the calculation of the duplicated loss with respect to the shares of S sold on the date of the Year 2 disposition. Because the loss recognized on the sale of Asset A was included in the calculation of the duplicated loss with respect to the S common stock sold on the date of the sale and is absorbed by the P group, the suspended loss is reduced to zero pursuant to paragraph (c)(4) of this section. Accordingly, no amount of suspended loss is allowed under paragraph (c)(5) of this section. Under § 1.1502–32, P's basis in its S stock is reduced by $24. Accordingly, such basis is reduced from $104 to $80. P recognizes $0 gain/loss on the Year 5 sale of its remaining S common stock.

Example 5. (i) The facts are the same as in *Example 4*, except that instead of selling Asset A for $20, S sells Asset A for $45, recognizing a $5 loss. In addition in Year 5, P sells its remaining S common stock for $100.

(ii) As in *Example 4*, P recognizes a loss of $6 on the sale of the 20 shares of the common stock of S and that loss is suspended under paragraph (c)(1) of this section. Pursuant to paragraph (c)(4) of this section, assuming the P group cannot establish that only a portion of the loss recognized on the sale Asset A was reflected in the computation of the duplicated loss with respect to the 20 shares of S common stock sold, the amount of the suspended loss is reduced by the $5 loss recognized on the sale of Asset A to $1. Under § 1.1502–32, P's basis in its S stock is reduced by $4 from $104 to $100. In Year 5, when P sells its remaining S common stock for $100, it recognizes $0 gain/loss. Pursuant to paragraph (c)(5) of this section, the remaining $1 of the suspended loss is allowed on the P group's return for Year 5.

Example 6. (i) The facts are the same as in *Example 4*, except that S does not sell Asset A prior to the sale of its remaining S common stock.

(ii) As in *Example 4*, P recognizes a loss of $6 on the sale of the 20 shares of the common stock of S and that loss is suspended under paragraph (c)(1) of this section. In Year 5 when P sells its remaining S common stock for $80, it recognizes a loss of $24. Pursuant to paragraph (c)(5) of this section, for the year that includes the date of the deconsolidation of S, the suspended loss attributable to its Year 2 sale of S common stock is allowed to the extent it has not been reduced pursuant to paragraph (c)(4) of this section. Because S had no items of loss and deduction that are allocable to the period beginning on the date of the Year 2 disposition of the S stock and ending on the day before the first date on which S is not a member of the of the P group, the suspended loss is not reduced pursuant to paragraph (c)(4) of this section. Accordingly, pursuant to paragraph (c)(5) of this section, the entire $6 suspended loss is allowed on the P group's return for Year 5.

Example 7. (i) In Year 1, P forms S1 with a contribution of $200 in exchange for all of the common stock of S1, which represents all of the outstanding stock of S1. In the same year, S1 forms S2 with a contribution of $80 in exchange for 80 shares of the common stock of S2, which at that time represents all of the outstanding stock of S2. S1 and S2 become members of the P group. In the same year, S2 purchases Asset A for $80. In Year 2, S1 contributes Asset B with a basis of $50 and a value of $20 in exchange for 20 shares of the common stock of S2 in a transfer to which section 351 applies. In Year 3, S1 sells the 20 shares of the common stock of S2 that it acquired in Year 2 for $20. At that time, the bases and values of Asset A and Asset B are unchanged. In Year 4, S2 sells Asset A for $50, recognizing a $30 loss. That $30 loss is used on the P group return to offset income of P. In Year 5, S1 sells its remaining S2 common stock for $56.

(ii) Under paragraph (b)(1) of this section, because S1's basis in the S2 common stock sold exceeds its value immediately prior to the sale and S2 is a member of the P group immediately after the sale, S1's basis in all of the stock of S2 is redetermined pursuant to paragraph (b)(2) of this section. Of S1's total basis of $130 in the S2 common stock, a proportionate amount is allocated to each of the 100 shares of S2 common stock. Accordingly, a total of $26 is allocated to the common stock of S2 that is sold and $104 is allocated to the common stock of S2 that is retained. On S1's sale of the 20 shares of the common stock of S2 for $20, S1 recognizes a loss of $6. Because the sale of the 20 shares of common stock of S2 does not result in the deconsolidation of S2, under paragraph (c)(1) of this section, that loss is suspended to the extent of the duplicated loss with respect to the shares sold. The duplicated loss with respect to the shares sold is $6. Therefore, the entire $6 loss is suspended. Pursuant to paragraph (c)(3) of this section and § 1.1502–32(b)(3)(iii)(C), the suspended loss is treated as a noncapital, nondeductible expense incurred by S1 during the tax year that includes the date of the disposition of stock to which paragraph (c)(1) of this section applies. Accordingly, P's basis in its S1 stock is reduced from $200 to $194. Pursuant to paragraph (c)(4) of this section, the amount of the suspended loss is reduced, but not below zero, by S2's items of deduction and loss that are allocable to the period beginning on the date of the Year 3 disposition of the S2 stock and ending on the day before the first date on which S2 is not a member of the P group, and that are taken into account in determining consolidated taxable income (or loss) of the P group for any taxable year that includes any date on or after the date of the Year 3 disposition and before the first date on which S2 is not a member of the P group, except to the extent the P group can establish that all or a portion of such items was not included in the calculation of the duplicated loss with respect to the S2 stock sold on the date of the disposition. Assuming the P group can establish that the $30 loss generated by S2 on the sale of Asset A was not included in the calculation of the duplicated loss with respect to the S2 stock sold on the date of the disposition, such loss does not reduce the suspended loss. In that case, for the taxable year that includes the day before the first date in Year 5 on which S is not a member of the P group, the P group is allowed to take into account the $6 suspended loss. On the other hand, if the P group cannot establish that the $30 loss generated by S2 on the sale of Asset A was not included in the calculation of the duplicated loss with respect to the S2 stock sold on the date of the disposition, pursuant to paragraph (c)(4) of this section, such loss reduces the suspended loss to zero, and no amount of suspended loss is allowed under paragraph (c)(5) of this section. In either case, under § 1.1502–32, S1's basis in its remaining S2 stock is reduced by $24 from $80 to $56. S1 recognizes $0 gain/loss on the sale of its remaining S2 stock.

Example 8. (i) In Year 1, P forms S1 with a contribution of Asset A with a basis of $50 and a value of $20 in exchange for 100 shares of common stock of S1 in a transfer to which section 351 applies. Also in Year 1, P and S1 form S2. P contributes $80 to S2 in exchange for 80 shares of common stock of S2. S1 contributes Asset A to S2 in exchange for 20 shares of common stock of S2 in a transfer to which section 351 applies. In Year 3, in a transaction that is not part of a plan that includes the Year 1 contributions, P sells its 100 shares of S1 common stock for $20. At that time, S1 owns 20 shares of common stock of S2 and S2 has $80 and Asset A, the basis and value of which have not changed. In Year 4, S2 sells Asset A for $20, recognizing a $30 loss. That $30 loss is used on the P group return to offset income of P. In Year 5, P sells its S2 common stock for $80.

(ii) Because the P group disposes of its entire equity interest in S1 within a single taxable year, pursuant to paragraph (b)(4) of this section, paragraph (b) of this section does not apply immediately prior to the disposition to cause a redetermination of P's basis in its S1 common stock. Pursuant to paragraph (b)(5) of this section, however, because, immediately prior to the disposition of the S1 stock, P's basis in such stock exceeds its value, S1 owns stock of S2 (another subsidiary member of the same group) and, immediately prior to the disposition of the S1 stock, such S2 stock has a basis that exceeds its value, and, immediately after the disposition of the S1 stock, P owns stock of S2, the basis in each share of S2 that is owned by members of the P group must be redetermined as provided in paragraph (b) of this section as if S1's S2 stock had been disposed of or deconsolidated. Because S2 is a member of the group immediately after the disposition of the S1 stock, the group member's basis in the S2 stock is redetermined pursuant to paragraph (b)(2) of this section immediately prior to the sale of the S1 stock. Of the group members' total basis of $130 in the S2 stock, $26 is allocated to S1's 20 shares of S2 common stock and $104 is allocated to P's 80 shares of S2 common stock. Pursuant to paragraph (b)(6) of this section, the redetermination of S1's basis in the stock of S2 results in an adjustment to P's basis in the stock of S1. In particular, P's basis in the stock of S1 is decreased by $24 to $26. On P's sale of its 100 shares of S1 common stock for $20, S1 recognizes a loss of $6. Because S1 is not a member of the P group immediately after S1's disposition of the S2 stock, paragraph (c)(1) of this section does not apply to suspend such loss. Pursuant to paragraph (c)(2) of this section, however, because P recognizes a loss with respect to the disposition of the S1 stock and S1 owns stock of S2 (which is a member of the P group immediately after the disposition), such loss is suspended up to $6, an amount equal to the amount by which the duplicated loss with respect to the stock of S1 sold is attributable to S2's adjusted basis in its assets, loss carryforwards and deferred deductions. Pursuant to paragraph (c)(4) of this section, the amount of the suspended loss is reduced, but not below zero, by S2's items of deduction and loss that are allocable to the period beginning on the date of the Year 3 disposition of the S1 stock and ending on the day before the first date on which S2 is not a member of the P group and that are taken into account in determining the consolidated taxable income (or loss) of the P group for any taxable year that includes any date on or after the date of the Year 3 disposition and before the first date on which S2 is not a member of the P group, except to the extent the P group can establish all or a portion of such items were not included in the calculation of the duplicated loss with respect to the S1 stock sold or were not attributable to S2's adjusted basis in its assets, loss carryforwards, or deferred deductions. Because the loss recognized on the sale of Asset A was included in the calculation of the duplicated loss with respect to the S1 stock on the date of the sale of the S1 stock and is absorbed by the P group, the suspended loss is reduced to zero pursuant to paragraph (c)(4) of this section. Accordingly, no amount of suspended loss is allowed under paragraph (c)(5) of this section. Under § 1.1502–32, P's basis in its S2 stock is reduced by $24 from $104 to $80. P recognizes $0 gain/loss on the sale of its S2 common stock.

Example 9. (i) In Year 1, P forms S with a contribution of $80 in exchange for 80 shares of common stock of S which at that time represents all of the outstanding stock of S. S becomes a member of the P group. In Year 2, P contributes Asset A with a basis of $50 and a value of $20 in exchange for 20 shares of common stock of S in a transfer to which section 351 applies. In Year 3, in a transaction that is not part of a plan that includes the Year 1 and Year 2 contributions, P contributes the 20 shares of S common stock it acquired in Year 2 to PS, a partnership, in exchange for a 20 percent capital and profits interest in a transaction described in section 721. In Year 4, P sells its interest in PS for $20, recognizing a $30 loss.

(ii) Under paragraph (b)(1) of this section, because P's basis in the S common stock contributed to PS exceeds its value immediately prior to its deconsolidation and S is a member of the P group immediately after the deconsolidation, P's basis in all of the S stock is redetermined pursuant to paragraph (b)(2) of this section. Of P's total basis of $130 in the common stock of S, a proportionate amount is allocated to each share of S common stock. Accordingly, $26 is allocated to the S common stock that is contributed to PS and, under section 722, P's basis in its interest in PS is $26. P recognizes a $6 loss on its disposition of its interest in PS. Because P's basis in its interest in PS was determined by reference to the basis of S stock and at the time of the determination of P's basis in its interest in PS such S stock had a duplicated loss of $6, and, immediately after the disposition, S is a member of the P group, such loss is suspended to the extent of such duplicated loss. Principles similar to those of paragraphs (c)(3), (4), and (5) of this section shall apply to such suspended loss.

(f) *Basic reduction on worthlessness and certain dispositions not followed by separate return years.* If a member of a group disposes of subsidiary member stock and on the following day the subsidiary is not a member of the group and does not have a separate return year, then, immediately prior to the recognition of any gain or loss with respect thereto, and immediately after all other adjustments under § 1.1502–32 with respect thereto, the basis of upper-tier members in the stock of the subsidiary member shall be reduced to the extent of the consolidated net operating losses and net capital losses that would be treated as attributable to such subsidiary member (and lower-tier members) under the principles of § 1.1502–21(b)(2)(iv), as though such losses were absorbed by the group. In addition, if, taking into account the provisions of § 1.1502–80(c), stock of a subsidiary member is treated as worthless under section 165, then, immediately prior to the allowance of any loss or inclusion of an excess loss account with respect thereto, and immediately after all other adjustments under § 1.1502–32 with respect thereto, the basis of upper-tier members in the stock of the worthless member shall be reduced to the extent of the consolidated net operating losses and net capital losses that would be treated as attributable to such subsidiary member (and lower-tier members) under the principles of § 1.1502–21(b)(2)(iv), as though such losses were absorbed by the group.

(g) *Anti-avoidance rules*. (1) *Disposition or deconsolidation of gain share in avoidance.* If a share of subsidiary member stock has a basis that does not exceed its value and the share is deconsolidated with a view to avoiding application of the rules of paragraph (b) of this section prior to the disposition of a share of subsidiary member stock that has a basis that does exceed its value, the rules of paragraph (b) of this section shall apply immediately prior to the deconsolidation.

(2) *Transfers of loss property in avoidance.* If a member of a consolidated group contributes an asset with a basis that exceeds its value to a partnership in a transaction described in section 721 or a corporation that is not a member of such group in a transfer described in section 351, such partnership or corporation contributes such asset to a subsidiary member in a transfer described in section 351, and such contributions are undertaken with a view to avoiding the rules of paragraph (b) or (c) of this section, adjustments must be made to carry out the purposes of this section.

(3) *Anti-loss reimportation*—(i) *Application.* This paragraph (g)(3) applies if—

(A) A member of a group recognizes and is allowed a loss on the disposition of a share of stock of a subsidiary member with respect to which there is a duplicated loss;

(B) As a result of that disposition or another disposition, the subsidiary member ceases to be a member of such group; and

(C) Within the 10-year period beginning on the date the subsidiary member ceases to be a member of such group—

(*1*) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) owns any asset that has a basis in excess of value at such time and that was owned by the subsidiary member on the date of the disposition and that had a basis in excess of value on such date;

(*2*) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) owns any asset that has a basis in excess of value at such time and that has a basis that reflects, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary member on the date of the disposition and that had a basis in excess of value on such date;

(*3*) In a transaction described in section 381 or section 351, any member of such group (or any successor group) acquires any asset of the subsidiary member (or any successor) that was owned by the subsidiary member on the date of the disposition and that had a basis in excess of its value on such date, or any asset that has a basis that reflects, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary member on the date of the disposition and that had a basis in excess of its value on such date, and, immediately after the acquisition of such asset, such asset has a basis in excess of its value;

(*4*) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) has any losses or deferred deductions that were losses or deferred deductions of the subsidiary member on the date of the disposition;

(*5*) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) has any losses or deferred deductions that are attributable to any asset that was owned by the subsidiary member on the date of the disposition and that had a basis in excess of value on such date;

(*6*) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) has any losses or deferred deductions that are attributable to any asset that had a basis that reflected, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary member on the date of the disposition and that had a basis in excess of value on such date; or

(*7*) Any member of such group (or any successor group) succeeds to any losses or deferred deductions of the subsidiary member (or any successor) that were losses or deferred deductions of the subsidiary member on the date of the disposition, that are attributable to any asset that was owned by the subsidiary member on the date of the disposition and that had a basis in excess of value on such date, or that are attributable to any asset that had a basis that reflected, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary member on the date of the disposition and that had a basis in excess of value on such date.

(ii) *Operating rules*—(A) For purposes of paragraph (g)(3)(i)(C) of this section, assets shall include stock and securities and the subsidiary member (or any successor) shall be treated as having its allocable share of losses and deferred deductions of all lower-tier subsidiary members and as owning its allocable share of each asset of all lower-tier subsidiary members.

(B) For purposes of paragraphs (g)(3)(i)(C)(*4*), (*5*), and (*6*) of this section, unless the group can establish otherwise, if the subsidiary member (or any successor) again becomes a member of such group (or any successor group) at a time when the subsidiary member (or any successor) has any losses or deferred deductions, such losses and deferred deductions shall be treated as losses or deferred deductions that were losses or deferred deductions of the subsidiary member on the date of the disposition, losses or deferred deductions that are attributable to assets that were owned by the subsidiary member on the date of the disposition and that had bases in excess of value on such date, or losses or deferred deductions that are attributable to assets that had bases that reflected, directly or indirectly, in whole or in part, the bases of assets that were owned by the subsidiary member on the date of the disposition and that had bases in excess of value on such date.

(C) For purposes of paragraph (g)(3)(i)(C)(*7*) of this section, unless the group can establish otherwise, if a member of such group (or any successor group) succeeds to any losses or deferred deductions of the subsidiary member (or any successor), such losses and deferred deductions shall be treated as losses or deferred deductions that were losses or deferred deductions of the subsidiary member on the date of the disposition, losses or deferred deductions that are attributable to assets that were owned by the subsidiary member on the date of the disposition and that had bases in excess of value on such date, or losses or deferred deductions that are attributable to assets that had bases that reflected, directly or indirectly, in whole or in part, the bases of assets that were owned by the subsidiary member on the date of the disposition and that had bases in excess of value on such date.

(iii) *Loss disallowance*. If paragraph (g)(3) of this section applies, then, to the extent that the aggregate amount of loss recognized by members of the group (and any successor group) on dispositions of the subsidiary member stock was attributable to a duplicated loss of such subsidiary member, and such loss was allowed, such group (or any successor group) will be denied the use of—

(A) Any loss recognized that is attributable to, directly or indirectly, an asset that was owned by the subsidiary member on the date of the disposition and that had a basis in excess of value on such date, to the extent of the lesser of the loss inherent in such asset on the date of the disposition of the subsidiary member stock and the loss inherent in such asset on the date of the event described in paragraph (g)(3)(i)(C) of this section that gives rise to the application of this paragraph (g)(3); and

(B) Any loss recognized that is attributable to, directly or indirectly, an asset that has a basis that reflects, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary on the date of the disposition and that had a basis in excess of its value on such date, to the extent of the lesser of the loss inherent in the asset that was owned by the subsidiary on the date of the disposition the basis of which is reflected, directly or indirectly, in whole or in part, in the basis of such asset on the date of the disposition and the loss inherent in such asset on the date of the event described in paragraph (g)(3)(i)(C) of this section that gives rise to the application of this paragraph (g)(3); and

(C) Any loss or deferred deduction described in paragraph (g)(3)(i)(C)(*4*), (*5*), (*6*), or (*7*) of this section.

(iv) *Treatment of disallowed loss.* For purposes of § 1.1502–32(b)(3)(iii), any loss the use of which is disallowed pursuant to paragraph (g)(3)(iii)(A) or (B) of this section is treated as a noncapital, nondeductible expense incurred during the taxable year that includes the date on which such loss is recognized. See § 1.1502–32(b)(3)(iii)(D). In addition, any loss or deferred deduction the use of which is disallowed pursuant to paragraph (g)(3)(iii)(C) of this section and with respect to which no waiver described in § 1.1502–32(b)(4) is filed is treated as a noncapital, nondeductible expense incurred during the taxable year that includes the day after the event described in paragraph (g)(3)(iii) of this section that gives rise to the application of this paragraph (g)(3).

(4) *Examples.* The principles of this paragraph (g) are illustrated by the following examples.

Example 1. (i) In Year 1, P forms S with a contribution of $80 in exchange for 80 shares of common stock of S which at that time represents all of the outstanding stock of S. S becomes a member of the P group. In Year 2, P contributes Asset A with a basis of $50 and a value of $20 in exchange for 20 shares of preferred stock of S in a transfer to which section 351 applies. In Year 3, S sells Asset A for $20, recognizing a loss of $30. Under § 1.1502–32, P's basis in its common stock of S is reduced from $80 to $50. With a view to avoiding the application of the basis redetermination rule prior to a sale of the S preferred stock, in Year 4, P contributes the 80 shares of S common stock it acquired in Year 1 to PS, a partnership, in exchange for a 20 percent capital and profits interest in a transaction described in section 721. Also in Year 4, P sells its preferred stock of S for $20, recognizing a $30 loss.

(ii) Under paragraph (g)(1) of this section, the rules of paragraph (b) of this section shall apply immediately prior to the deconsolidation of the S common stock.

Example 2. (i) In Year 1, P forms S with a contribution of $100 in exchange for 100 shares of common stock of S which at that time represents all of the outstanding stock of S. S becomes a member of the P group. In Year 2, P contributes 20 shares of common stock of S to PS, a partnership, in exchange for a 20 percent capital and profits interest in a transaction described in section 721. In Year 3, P contributes Asset A with a basis of $50 and a value of $20 to PS in exchange for an additional capital and profits interest in PS in a transaction described in section 721. Also in Year 3, PS contributes Asset A to S and P contributes an additional $80 to S in transfers to which section 351 applies. In Year 4, S sells Asset A for $20, recognizing a loss of $30. The P group uses that loss to offset income of P. Also in Year 4, P sells its entire interest in PS for $40, recognizing a loss of $30.

(ii) Pursuant to paragraph (g)(2) of this section, if P's contributions of S stock and Asset A to PS were undertaken with a view to avoiding the basis redetermination or the loss suspension rule, adjustments must be made such that the group does not obtain more than one tax benefit from the $30 loss inherent in Asset A.

Example 3. (i) In Year 1, P forms S with a contribution of Asset A with a value of $100 and a basis of $120, Asset B with a value of $50 and a basis of $70, Asset C with a value of $90 and a basis of $100 in exchange for all of the common stock of S and S becomes a member of the P group. In Year 2, in a transaction that is not part of a plan that includes the contribution, P sells the stock of S for $240, recognizing a loss of $50. At such time, the bases and values of Assets A, B, and C have not changed since their contribution to S. In Year 3, S sells Asset A, recognizing a $20 loss. In Year 3, S merges into M in a reorganization described in section 368(a)(1)(A). In Year 4, P purchases all of the stock of M for $300. At that time, M has a $10 net operating loss. In addition, M owns Asset D, which was acquired in an exchange described in section 1031 in connection with the surrender of Asset B. Asset C has a value of $80 and a basis of $100. Asset D has a value of $60 and a basis of $70. In Year 5, P has operating income of $100 and M recognizes $20 of loss on the sale of Asset C. In Year 6, P has operating income of $50 and M recognizes $50 of loss on the sale of Asset D.

(ii) P's $50 loss on the sale of S stock is entirely attributable to duplicated loss. Therefore, pursuant to this paragraph (g)(3), assuming the P group cannot establish otherwise, M's $10 net operating loss is treated as attributable to assets that were owned by S on the date of the disposition and that had bases in excess of value on such date. Without regard to any other limitations on the group's use of M's net operating loss, the P group cannot use M's $10 net operating loss pursuant to paragraph (g)(3)(iii)(C) of this section. Pursuant to paragraph (g)(3)(iv) of this section and § 1.1502–32(b)(3)(iii)(D), such loss is treated as a noncapital, nondeductible expense of M incurred during the taxable year that includes the day after the reorganization. In addition, the P group is denied the use of $10 of the loss recognized on the sale of Asset C. Finally, the P group is denied the use of $10 of the loss recognized on the sale of Asset D. Pursuant to paragraph (g)(3)(iv) of this section and § 1.1502–32(b)(3)(iii)(D), each such disallowed loss is treated as a noncapital, nondeductible expense of M incurred during the taxable year that includes the date of the disposition of the asset with respect to which such loss was recognized.

(h) *Application of anti-abuse rules.* The rules of this section do not preclude the application of anti-abuse rules under other provisions of the Internal Revenue Code and regulations thereunder, including to a transaction that is entered into to invoke the basis redetermination rule to avoid the effect of any provision of the Internal Revenue Code or regulations thereunder.

(i) [Reserved].

(j) *Effective date*. This section, except for paragraph (g)(3) of this section, applies with respect to dispositions and deconsolidations occurring on or after March 7, 2002, but only if such transactions occur during a taxable year the original return for which is due (without regard to extensions) after the date these regulations are published as temporary or final regulations in the **Federal Register**. Paragraph (g)(3) of this section applies to events described in paragraph (g)(3)(iii) of this section occurring on or after October 18, 2002, but only if such events occur during a taxable year the original return for which is due (without regard to extensions) after the date these regulations are published as temporary or final regulations in the **Federal Register**.

Robert E. Wenzel,
Deputy Commissioner
of Internal Revenue.

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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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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2002–1 through 2002–25 is in Internal Revenue Bulletin 2002–26, dated July 1, 2002.

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[1] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2002–1 through 2002–25 is in Internal Revenue Bulletin 2002–26, dated July 1, 2002.

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