Internal Revenue
bulletin

Bulletin No. 2013–44
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HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

T.D. 9637, page 427

These final regulations remove any reference to, or requirement of reliance on, credit ratings in regulations under the Internal Revenue Code and provide substitute standards of credit-worthiness where appropriate, pursuant to the Dodd-Frank Act.

REG–124148–05, page 444

Research expenditures under Section 174. Theses proposed regulations provide guidance on the treatment of amounts paid or incurred in connection with the development of tangible property, including pilot models. Comments requested by December 5, 2013. A public hearing is scheduled for January 8, 2014.

REG–161948–05, page 449

These proposed regulations apply when a corporation that is subject to U.S. income tax acquires loss property tax-free from a liquidating subsidiary, from shareholders or others in a capital contribution, or from another corporation or person in a reorganization, and the loss in the acquired property accrued outside the U.S. tax system. The proposed regulations provide guidance for preventing the importation of loss in such cases by requiring the bases of the assets received to be equal to value.

Notice 2013–60, page 431

Clarification of Notice 2013–29. Notice 2013–29 provided two methods to determine when construction has begun on a qualified energy facility. This notice clarifies Notice 2013–29 regarding (i) the determination of whether a taxpayer satisfies either of those methods with respect to a facility, (ii) the applicability of the "master contract" provision in that notice, and (iii) the effect of a transfer of a facility after construction has begun.

Notice 2013–63, page 436

In order to provide emergency housing relief needed as a result of the devastation caused by severe storms, flooding, landslides, and mudslides in Colorado, this notice temporarily suspends certain requirements under § 142(d) for qualified residential rental projects financed with exempt facility bonds issued by state and local governments under § 142. To that end, this Notice suspends the income requirements during a temporary housing period that ends September 30, 2014, for units of a Project within which units are occupied by displaced individuals. It also provides certain modifications to the beginning and ending dates of the qualified project period for a Project occupied by displaced individuals, provides that displaced persons are not to be considered transient, and provides 60 days for correcting non-compliant Projects at the end of the temporary housing period.

Notice 2013–64, page 438

The Internal Revenue Service is suspending certain requirements under § 42 of the Code for low-income housing credit projects to provide emergency housing relief needed as a result of the devastation caused by recent weather-related disasters in the State of Colorado.

(Continued on the next page)

Finding Lists begin on page ii.
Index for July through October begins on page iv.

Department of the Treasury
Internal Revenue Service

EXEMPT ORGANIZATIONS

Announcement 2013–42, page 464

The IRS has revoked its determination that the following organizations qualify as organizations described in sections 501(c)(3) and 170(c)(2) of the Code: American College of Forensic Examiners International, Inc. of Springfield, MO., B & L Grace Foundation of Fresno, CA., Big Apple Day School of Brooklyn, NY., BuildClean of Houston, TX., Foster Care Network, Inc. of Goodyear, AZ., Generational Arts Limited of New York, NY., Help End Hunger Now Foundation of Troy, MI., IDA Foundation for Autism and Alzheimer's Research and Solution, Inc. of Homestead, FL., J. D. Davis Community Service, Inc., of Inglewood, CA., Joy Center, Inc. of Stuart, FL., Lifeskills 411 of Richmond, CA., The Music Box Lurrine Burgess of Los Angeles, CA., and One World Hunger of Union Center, CA.

EMPLOYMENT TAX

Notice 2013–61, page 432

This notice provides guidance for employers and employees to make claims for refund or adjustments of overpayments of Federal Insurance Contributions Act (FICA) taxes and Federal income tax withholding resulting from the Supreme Court decision in *United States v. Windsor,* 570 U.S. ___ , 133 S.Ct. 2675 (2013) decision and Revenue Ruling 2013–17, 2013–38 I.R.B. 201.

EXCISE TAX

T.D. 9637, page 427

These final regulations remove any reference to, or requirement of reliance on, credit ratings in regulations under the Internal Revenue Code and provide substitute standards of credit-worthiness where appropriate, pursuant to the Dodd-Frank Act.

ADMINISTRATIVE

Notice 2013–65, page 440

Optional special per diem rates. This notice provides the 2013–2014 special per diem rates for taxpayers to use in substantiating the amount of ordinary and necessary business expenses incurred while traveling away from home. The notice includes (1) the special transportation industry rate, (2) the rate for the incidental expenses only deduction, and (3) the rates and list of high-cost localities for the high-low substantiation method.

The IRS Mission

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the 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.

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 last 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 last Bulletin of each semiannual period.

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

Section 150.—Definitions and Special Rules

T.D. 9637

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 48

Modification of Treasury Regulations Pursuant to Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations that remove any reference to, or requirement of reliance on, "credit ratings" in regulations under the Internal Revenue Code (Code) and provides substitute standards of credit-worthiness where appropriate. This action is required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. These regulations affect persons subject to various provisions of the Code.

DATES: *Effective Date:* These regulations are effective on September 6, 2013.

Applicability Dates: For dates of applicability, see §§1.150–1(a)(4), 1.171–1 (f), 1.197–2(b)(7), 1.249–1(f)(3), 1.475(a)–4(d)(4), 1.860G–2(g)(3), 1.1001–3(d), (e), and (g), and 48.4101–1(l)(5).

FOR FURTHER INFORMATION CONTACT: Arturo Estrada, (202) 622-3900 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Section 939A(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203 (124 Stat. 1376 (2010)) (the "Dodd-Frank Act"), requires each Federal agency to review its regulations that require the use of an assessment of credit-worthiness of a security or money market instrument, and to review any references or requirements in its regulations regarding credit ratings. Section 939A(b) directs each agency to modify any regulation identified in the review required under section 939A(a) by removing any reference to, or requirement of reliance on, credit ratings and substituting a standard of credit-worthiness that the agency deems appropriate. Numerous provisions under the Internal Revenue Code (Code) are affected.

These regulations amend the Income Tax Regulations (26 CFR part 1) under sections 150, 171, 197, 249, 475, 860G, and 1001 of the Code (the existing regulations). These sections were added to the Code during different years to serve different purposes. These regulations also amend the Manufacturers and Retailers Excise Tax Regulations (26 CFR part 48) under section 4101, which provides registration requirements related to Federal fuel taxes.

On July 6, 2011, temporary regulations (TD 9533) under sections 150, 171, 197, 249, 475, 860G, and 1001 of the Code were published in the **Federal Register** (76 FR 39278) that modify or eliminate the reference to credit ratings in the relevant regulations. Additional temporary regulations (26 CFR part 48) under section 4101 were published as part of TD 9533. A notice of proposed rulemaking (REG–118809–11) cross-referencing the temporary regulations was published in the **Federal Register** the same day (76 FR 39341). No written comments responding to the notice of proposed rulemaking were received. No public hearing was requested or held. The regulations are adopted as proposed without substantive changes.

Explanation of Provisions

These regulations remove references to "credit ratings" and "credit agencies" or functionally similar terms in the existing regulations. Some changes involve simple word deletions or substitutions. Others reflect the revision of one or more sentences to remove the credit rating references. Where appropriate, substitute standards of credit-worthiness replace the prior references to credit ratings, credit agencies, or functionally similar terms. Language revisions serve solely to remove the references prohibited by section 939A of the Dodd-Frank Act and no additional changes to the existing regulations are intended.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business. No comments were received.

Drafting Information

These regulations were drafted by personnel in the Office of Associate Chief Counsel (Financial Institutions and Products), the Office of Associate Chief Counsel (Income Tax and Accounting), the Office of the Associate Chief Counsel (International) and the Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and the Treasury Department participated in the development of the regulations.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 48 are 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 1.150–1 is amended as follows:

1. Paragraph heading (a)(2) is revised.

2. Paragraph (a)(4) is revised.

3. In paragraph (b), the definition of *Issuance costs* is revised.

The revisions read as follows:

§1.150–1 Definitions.

(a) * * *

(2) *Effective/applicability date* * * *

* * * * *

(4) *Additional exception to the general applicability date.* Section 1.150–1(b), *Issuance costs*, applies on and after July 6, 2011.

(b) * * *

Issuance costs means costs to the extent incurred in connection with, and allocable to, the issuance of an issue within the meaning of section 147(g). For example, issuance costs include the following costs but only to the extent incurred in connection with, and allocable to, the borrowing: underwriters' spread; counsel fees; financial advisory fees; fees paid to an organization to evaluate the credit quality of an issue; trustee fees; paying agent fees; bond registrar, certification, and authentication fees; accounting fees; printing costs for bonds and offering documents; public approval process costs; engineering and feasibility study costs; guarantee fees, other than for qualified guarantees (as defined in §1.148–4(f)); and similar costs.

* * * * *

§1.150–1T [Removed]

Par. 3. Section 1.150–1T is removed.

Par. 4. Section 1.171–1(f) *Example 2* is revised to read as follows:

§1.171–1 Bond premium.

* * * * *

(f) * * *

Example 2. Convertible bond—(i) *Facts.* On January 1, A purchases for $1,100 B corporation's bond maturing in three years from the purchase date, with a stated principal amount of $1,000, payable at maturity. The bond provides for unconditional payments of interest of $30 on January 1 and July 1 of each year. In addition, the bond is convertible into 15 shares of B corporation stock at the option of the holder. On the purchase date, B corporation's nonconvertible, publicly-traded, three-year debt of comparable credit quality trades at a price that reflects a yield of 6.75 percent, compounded semiannually.

(ii) *Determination of basis.* A's basis for determining loss on the sale or exchange of the bond is $1,100. As of the purchase date, discounting the remaining payments on the bond at the yield at which B's similar nonconvertible bonds trade (6.75 percent, compounded semiannually) results in a present value of $980. Thus, the value of the conversion option is $120. Under paragraph (e)(1)(iii)(A) of this section, A's basis is $980 ($1,100–$120) for purposes of this section and §§1.171–2 through 1.171–5. The sum of all amounts payable on the bond other than qualified stated interest is $1,000. Because A's basis (as determined under paragraph (e)(1)(iii)(A) of this section) does not exceed $1,000, A does not acquire the bond at a premium.

(iii) *Applicability date.* Notwithstanding §1.171–5(a)(1), this Example 2 applies to bonds acquired on or after July 6, 2011.

§1.171–1T [Removed]

Par. 5. Section 1.171–1T is removed.

Par. 6. Section 1.197–2 is amended by revising paragraph (b)(7) to read as follows:

§1.197–2 Amortization of goodwill and certain other intangibles.

* * * * *

(b) * * *

(7) *Supplier-based intangibles*—(i) *In general*. Section 197 intangibles include any supplier-based intangible. A *supplier-based intangible* is the value resulting from the future acquisition, pursuant to contractual or other relationships with suppliers in the ordinary course of business, of goods or services that will be sold or used by the taxpayer. Thus, the amount paid or incurred for supplier-based intangibles includes, for example, any portion of the purchase price of an acquired trade or business attributable to the existence of a favorable relationship with persons providing distribution services (such as favorable shelf or display space at a retail outlet), or the existence of favorable supply contracts. The amount paid or incurred for supplier-based intangibles does not include any amount required to be paid for the goods or services themselves pursuant to the terms of the agreement or other relationship. In addition, see the exceptions in paragraph 2(c) of this section, including the exception in paragraph 2(c)(6) of this section for certain rights to receive tangible property or services from another person.

(ii) *Applicability date.* This section applies to supplier-based intangibles acquired after July 6, 2011.

* * * * *

§1.197–2T [Removed]

Par. 7. Section 1.197–2T is removed.

Par. 8. Section 1.249–1 is amended by revising paragraphs (e)(2)(ii) and (f)(3) to read as follows:

§1.249–1 Limitation on deduction of bond premium on repurchase.

* * * * *

(e) * * *

(2) * * *

(ii) In determining the amount under paragraph (e)(2)(i) of this section, appropriate consideration shall be given to all factors affecting the selling price or yields of comparable nonconvertible obligations. Such factors include general changes in prevailing yields of comparable obligations between the dates the convertible obligation was issued and repurchased and the amount (if any) by which the selling price of the nonconvertible obligation was affected by reason of any change in the issuing corporation's credit quality or the credit quality of the obligation during such period (determined on the basis of widely published financial information or on the basis of other relevant facts and circumstances which reflect the relative credit quality of the corporation or the comparable obligation).

* * * * *

(f) * * *

(3) *Portion of repurchase premium attributable to cost of borrowing.* Paragraph (e)(2)(ii) of this section applies to any repurchase of a convertible obligation occurring on or after July 6, 2011.

* * * * *

§1.249–1T [Removed]

Par. 9. Section 1.249–1T is removed.

Par. 10. Section 1.475(a)–4 is amended by revising paragraph (d)(4) *Example 1*, *Example 2*, and *Example 3* to read as follows:

§1.475(a)–4 Valuation safe harbor.

* * * * *

(d) * * *

(4) * * *

Example 1. (i) X, a calendar year taxpayer, is a dealer in securities within the meaning of section 475(c)(1). X generally maintains a balanced portfolio of interest rate swaps and other interest rate derivatives, capturing bid-ask spreads and keeping its market exposure within desired limits (using, if necessary, additional derivatives for this purpose). X uses a mark-to-market method on a statement that it is required to file with the United States Securities and Exchange Commission and that satisfies paragraph (d)(2) of this section with respect to both the contracts with customers and the additional derivatives. When determining the amount of any gain or loss realized on a sale, exchange, or termination of a position, X makes a proper adjustment for amounts taken into account respecting payments or receipts. X and all of its counterparties on the derivatives have the same general credit quality as each other.

(ii) Under X's valuation method, as of each valuation date, X determines a mid-market probability distribution of future cash flows under the derivatives and computes the present values of these cash flows. In computing these present values, X uses an industry standard yield curve that is appropriate for obligations by persons with this same general credit quality. In addition, based on information that includes its own knowledge about the counterparties, X adjusts some of these present values either upward or downward to reflect X's reasonable judgment about the extent to which the true credit status of each counterparty's obligation, taking credit enhancements into account, differs from the general credit quality used in the yield curve to present value the derivatives.

(iii) X's methodology does not violate the requirement in paragraph (d)(3)(iii) of this section that the same cost or risk not be taken into account, directly or indirectly, more than once.

(iv) Applicability date. This Example 1 applies to valuations of securities on or after July 6, 2011.

Example 2. (i) The facts are the same as in *Example 1*, except that X uses a better credit quality in determining the yield curve to discount the payments to be received under the derivatives. Based on information that includes its own knowledge about the counterparties, X adjusts these present values to reflect X's reasonable judgment about the extent to which the true credit status of each counterparty's obligation, taking credit enhancements into account, differs from this better credit quality obligation.

(ii) X's methodology does not violate the requirement in paragraph (d)(3)(iii) of this section that the same cost or risk not be taken into account, directly or indirectly, more than once.

(iii) *Applicability date*. This *Example 2* applies to valuations of securities on or after July 6, 2011.

Example 3. (i) The facts are the same as in Example 1, except that, after computing present values using the discount rates that are appropriate for obligors with the same general credit quality, and based on information that includes X's own knowledge about the counterparties, X adjusts some of these present values either upward or downward to reflect X's reasonable judgment about the extent to which the true credit status of each counterparty's obligation, taking credit enhancements into account, differs from a better credit quality.

(ii) X's methodology violates the requirement in paragraph (d)(3)(iii) of this section that the same cost or risk not be taken into account, directly or indirectly, more than once. By using the same general credit quality discount rate, X's method takes into account the difference between risk-free obligations and obligations with that lower credit quality. By adjusting values for the difference between a higher credit quality and that lower credit quality, X takes into account risks that it had already accounted for through the discount rates that it used. The same result would occur if X judged some of its counterparties' obligations to be of a higher credit quality but X failed to adjust the values of those obligations to reflect the difference between a higher credit quality and the lower credit quality.

(iii) *Applicability date*. This *Example 3* applies to valuations of securities on or after July 6, 2011.

* * * * *

§1.475(a)–4T [Removed]

Par. 11. Section 1.475(a)–4T is removed.

Par. 12. Section 1.860G–2 is amended by revising paragraphs (g)(3)(ii)(B), (g)(3)(ii)(C) and (g)(3)(ii)(D) to read as follows:

§1.860G–2 Other rules.

* * * * *

(g) * * *

(3) * * *

(ii) * * *

(B) *Presumption that a reserve is reasonably required*. The amount of a reserve fund is presumed to be reasonable (and an excessive reserve is presumed to have been promptly and appropriately reduced) if it does not exceed the amount required by a third party insurer or guarantor, who does not own directly or indirectly (within the meaning of section 267(c)) an interest in the REMIC (as defined in §1.860D–1(b)(1)), as a condition of providing credit enhancement.

(C) *Presumption may be rebutted*. The presumption in paragraph (g)(3)(ii)(B) of this section may be rebutted if the amounts required by the third party insurer are not commercially reasonable considering the factors described in paragraph (g)(3)(ii)(A) of this section.

(D) *Applicability date*. Paragraphs (g)(3)(ii)(B) and (g)(3)(ii)(C) of this section apply on and after July 6, 2011.

* * * * *

§1.860G–2T [Removed]

Par. 13. Section 1.860G–2T is removed.

Par. 14. Section 1.1001–3 is amended as follows:

1. Paragraph (d) *Example 9* is revised.
2. Paragraph (e)(4)(iv)(B) is revised.
3. Paragraph (e)(5)(ii)(B)(*2*) is revised.
4. Paragraph (g) *Examples 1*, *5* and *8* are revised.

The revisions read as follows:

§1.1001–3 Modifications of debt instruments.

* * * * *

(d) * * *

Example 9. Holder's option to increase interest rate. (i) A corporation issues an 8-year note to a bank in exchange for cash. Under the terms of the note, the bank has the option to increase the rate of interest by a specified amount if certain covenants in the note are breached. The bank's right to increase the interest rate is a unilateral option as described in paragraph (c)(3) of this section.

(ii) A covenant in the note is breached. The bank exercises its option to increase the rate of interest. The increase in the rate of interest occurs by operation of the terms of the note and does not result in a deferral or a reduction in the scheduled payments or any other alteration described in paragraph (c)(2) of this section. Thus, the change in interest rate is not a modification.

(iii) *Applicability date*. This *Example 9* applies to modifications occurring on or after July 6, 2011.

* * * * *

(e) * * *

(4) * * *

(iv) * * *

(B) *Nonrecourse debt instruments* (*1*) A modification that releases, substitutes, adds or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for a nonrecourse debt instrument is a significant modification. A substitution of collateral is not a significant modification, however, if the collateral is fungible or otherwise of a type where the particular units pledged are unimportant (for example, government securities or financial instruments of a particular type and credit quality). In addition, the substitution of a similar commercially available credit enhancement contract is not a significant modification, and an improvement to the property securing a nonrecourse debt instrument does not result in a significant modification.

(*2*) *Applicability date*. Paragraph (e)(4)(iv)(B)(*1*) of this section applies to modifications occurring on or after July 6, 2011.

* * * * *

(5) * * *

(ii) * * *

(B) * * *

(*2*) *Original collateral* (*i*) A modification that changes a recourse debt instrument to a nonrecourse debt instrument is not a significant modification if the instrument continues to be secured only by the original collateral and the modification does not result in a change in payment expectations. For this purpose, if the original collateral is fungible or otherwise of a type where the particular units pledged are unimportant (for example, government securities or financial instruments of a particular type and credit quality), replacement of some or all units of the original collateral with other units of the same or similar type and aggregate value is not considered a change in the original collateral.

(*ii*) *Applicability date*. Paragraph (e)(5)(ii)(B)(*2*)(*i*) of this section applies to modifications occurring on or after July 6, 2011.

* * * * *

(g) * * *

Example 1. Modification of call right. (i) Under the terms of a 30-year, fixed-rate bond, the issuer can call the bond for 102 percent of par at the end of ten years or for 101 percent of par at the end of 20 years. At the end of the eighth year, the holder of the bond pays the issuer to waive the issuer's right to call the bond at the end of the tenth year. On the date of the modification, the issuer's credit quality is approximately the same as when the bond was issued, but market rates of interest have declined from that date.

(ii) The holder's payment to the issuer changes the yield on the bond. Whether the change in yield is a significant modification depends on whether the yield on the modified bond varies from the yield on the original bond by more than the change in yield as described in paragraph (e)(2)(ii) of this section.

(iii) If the change in yield is not a significant modification, the elimination of the issuer's call right must also be tested for significance. Because the specific rules of paragraphs (e)(2) through (e)(6) of this section do not address this modification, the significance of the modification must be determined under the general rule of paragraph (e)(1) of this section.

(iv) *Applicability date*. This *Example 1* applies to modifications occurring on or after July 6, 2011.

* * * * *

Example 5. Assumption of mortgage with increase in interest rate. (i) A recourse debt instrument with a 9 percent annual yield is secured by an office building. Under the terms of the instrument, a purchaser of the building may assume the debt and be substituted for the original obligor if the purchaser is equally or more creditworthy than the original obligor and if the interest rate on the instrument is increased by one-half percent (50 basis points). The building is sold, the purchaser assumes the debt, and the interest rate increases by 50 basis points.

(ii) If the purchaser's acquisition of the building does not satisfy the requirements of paragraph (e)(4)(i)(B) or paragraph (e)(4)(i)(C) of this section, the substitution of the purchaser as the obligor is a significant modification under paragraph (e)(4)(i)(A) of this section.

(iii) If the purchaser acquires substantially all of the assets of the original obligor, the assumption of the debt instrument will not result in a significant modification if there is not a change in payment expectations and the assumption does not result in a significant alteration.

(iv) The change in the interest rate, if tested under the rules of paragraph (e)(2) of this section, would result in a significant modification. The change in interest rate that results from the transaction is a significant alteration. Thus, the transaction does not meet the requirements of paragraph (e)(4)(i)(C) of this section and is a significant modification under paragraph (e)(4)(i)(A) of this section.

(v) Applicability date. This Example 5 applies to modifications occurring on or after July 6, 2011.

* * * * *

Example 8. Substitution of credit enhancement contract. (i) Under the terms of a recourse debt instrument, the issuer's obligations are secured by a letter of credit from a specified bank. The debt instrument does not contain any provision allowing a substitution of a letter of credit from a different bank. The specified bank, however, encounters financial difficulty. The issuer and holder agree that the issuer will substitute a letter of credit from another bank.

(ii) Under paragraph (e)(4)(iv)(A) of this section, the substitution of a different credit enhancement contract is not a significant modification of a recourse debt instrument unless the substitution results in a change in payment expectations. While the substitution of a new letter of credit by a different bank does not itself result in a change in payment expectations, such a substitution may result in a change in payment expectations under certain circumstances (for example, if the obligor's capacity to meet payment obligations is dependent on the letter of credit and the substitution substantially enhances that capacity from primarily speculative to adequate).

(iii) *Applicability date*. This *Example 8* applies to modifications occurring on or after July 6, 2011.

* * * * *

§1.1001–3T [Removed]

Par. 15. Section 1.1001–3T is removed.

PART 48—MANUFACTURERS AND RETAILERS EXCISE TAXES

Par. 16. The authority citation for part 48 continues to read in part as follows:

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

Par. 17. Section 48.4101–1 is amended as follows:

1. Paragraph (f)(4)(ii)(B) is revised.

2. Paragraph (l)(5) is revised.

The revisions read as follows:

§48.4101–1 Taxable fuel; registration.

* * * * *

(f) * * *

(4) * * *

(ii) * * *

(B) *Basis for determination*. The determination under §48.4101–1(f)(4)(ii) must be based on all information relevant to the applicant's financial status.

* * * * *

(l) * * *

(5) *Applicability date*. Paragraph (f)(4)(ii)(B) of this section applies on and after July 6, 2011.

§48.4101–1T [Removed]

Par. 18. Section 48.4101–1T is removed.

Beth Tucker,
Deputy Commissioner for Operations Support.

Approved August 14, 2013.

Mark J. Mazur,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on September 5, 2013, 8:45 a.m., and published in the issue of the Federal Register for September 6, 2013, 78 F.R. 54758)

Section 6402.—Authority to Make Credits or Refunds

Special administrative procedures for making adjustments or claiming refunds of overpayments of FICA taxes and income tax withholding resulting from *United States v. Windsor* and Rev. Rul. 2013–17, are set forth in Notice 2013–61. See page 432.

Part III. Administrative, Procedural, and Miscellaneous

Clarification of Notice 2013–29

Notice 2013–60

SECTION 1. PURPOSE

The American Taxpayer Relief Act of 2012, Pub. L. No. 112–240, 126 Stat. 2313 (ATRA), modified the definition of a qualified facility under section 45(d) of the Internal Revenue Code by replacing the placed in service requirement with a begin construction requirement. A taxpayer will be eligible to receive the renewable electricity production tax credit (PTC) under section 45, or the energy investment tax credit (ITC) under section 48 in lieu of the PTC, with respect to a facility if construction of such facility begins before January 1, 2014. Notice 2013–29, 2013–20 I.R.B. 1085, provides two methods to determine when construction has begun on such a facility. This notice clarifies Notice 2013–29 regarding (i) the determination of whether a taxpayer satisfies either of those methods with respect to a facility, (ii) the applicability of the "master contract" provision in that notice, and (iii) the effect of a transfer of a facility after construction has begun.

SECTION 2. BACKGROUND

Notice 2013–29 provides two methods that a taxpayer may use to establish that construction of a qualified facility has begun. A taxpayer may establish the beginning of construction by starting physical work of a significant nature as described in section 4 of the notice (Physical Work Test). Alternatively, a taxpayer may establish the beginning of construction by meeting the safe harbor provided in section 5 of the notice (Safe Harbor). These methods require that a taxpayer make continuous progress towards completion once construction has begun (as set forth in sections 4.06 (Continuous Construction Test) and 5.02 (Continuous Efforts Test) of Notice 2013–29, respectively). Notice 2013–29 provides that a taxpayer may enter into a master contract for purposes of the Physical Work Test in section 4.03(2). Notice 2013–29 does not address the effect of a transfer of a facility after construction has begun.

The Treasury Department and the Internal Revenue Service have received a significant number of questions regarding the application of the Continuous Construction and Continuous Efforts Tests in Notice 2013–29, the applicability of the master contract provision for purposes of the Safe Harbor, and the effect that a transfer of a facility after construction has begun will have on its ability to qualify for the PTC or ITC. In response to these questions, this notice provides a method that will allow taxpayers to be deemed to satisfy both the Continuous Construction and Continuous Efforts Tests. In addition, this notice provides that the master contract provision in Notice 2013–29 also applies for purposes of the Safe Harbor, and that the transfer of a facility after construction has begun will not prevent a facility from qualifying for the PTC or ITC.

SECTION 3. CONTINUOUS CONSTRUCTION/CONTINUOUS EFFORTS TESTS

.01 *In general*. Section 4.01 of Notice 2013–29, setting forth the Physical Work Test, provides:

> The Internal Revenue Service will closely scrutinize, and may determine that construction has not begun on a facility before January 1, 2014, if a taxpayer does not maintain a continuous program of construction as determined under section 4.06.

Section 4.06(1) provides that whether a taxpayer maintains a continuous program of construction will be determined by the relevant facts and circumstances. Section 4.06(2) provides that certain disruptions in the taxpayer's construction of a facility that are beyond the taxpayer's control will not be considered to indicate that a taxpayer has failed to maintain a continuous program of construction, and sets forth a non-exclusive list of examples of such disruptions.

Section 5.01 of Notice 2013–29, setting forth the Safe Harbor, provides:

> Construction of a facility will be considered as having begun before January 1, 2014, if (1) a taxpayer pays or incurs (within the meaning of Treas. Reg. § 1.461–1(a)(1) and (2)) five percent or more of the total cost of the facility, except as provided in section 5.01(2), before January 1, 2014, and (2) thereafter, the taxpayer maintains continuous efforts to advance towards completion of the facility (as determined under section 5.02).

The exception in section 5.01(2) deals with costs incurred by a person other than the taxpayer under a binding written contract with the taxpayer. Section 5.02(1) provides that whether a taxpayer maintains continuous efforts to advance towards completion of the facility will be determined by the relevant facts and circumstances. Section 5.02(2) provides that certain disruptions in the taxpayer's continuous efforts to advance towards completion of the facility that are beyond the taxpayer's control will not be considered as indicating that a taxpayer has failed to maintain continuous efforts to advance towards completion of the facility, and sets forth a non-exclusive list of examples of such disruptions.

.02 *Deemed satisfaction of Continuous Construction/Continuous Efforts Tests.* If a facility is placed in service before January 1, 2016, the facility will be considered to satisfy the Continuous Construction Test (for purposes of satisfying the Physical Work Test) or the Continuous Efforts Test (for purposes of satisfying the Safe Harbor). If a facility is not placed in service before January 1, 2016, whether the facility satisfies the Continuous Construction or Continuous Efforts Tests will be determined by the relevant facts and circumstances, as described in section 4.06 and section 5.02 in Notice 2013–29.

SECTION 4. MASTER CONTRACT

.01 *In general*. Section 4.03(2) of Notice 2013–29, setting forth the Physical Work Test, provides:

> If a taxpayer enters into a binding written contract for a specific number of components to be manufactured, constructed, or produced for the taxpayer by another person under a binding written contract (a "master contract"), and then through a new binding written contract (a "project contract") the taxpayer assigns its rights to certain components to an affiliated special purpose vehicle that will own the

facility for which such property is to be used, work performed with respect to the master contract may be taken into account in determining when physical work of a significant nature begins with respect to the facility.

.02 *Master contract for Safe Harbor*. The master contract provision, as described in section 4.03(2) of Notice 2013–29 under the Physical Work Test, also applies for purposes of the Safe Harbor.

SECTION 5. TRANSFER OF A FACILITY

.01 *In general*. Notice 2013–29 did not address the effect of a transfer of a facility after construction has begun. Section 45(d)(1), as amended by ATRA, provides:

> In the case of a facility using wind to produce electricity, the term 'qualified facility' means any facility owned by the taxpayer which is originally placed in service after December 31, 1993, and the construction of which begins before January 1, 2014.

The statutory language requires only that construction of a facility begin before January 1, 2014. It does not require the construction to be begun by the taxpayer claiming the credit. If a qualified facility satisfies either the Physical Work Test or the Safe Harbor, a taxpayer that owns the facility during the 10-year period beginning on the date the facility was originally placed in service may claim the PTC with respect to that facility even if the taxpayer did not own the facility at the time construction began. Alternatively, a taxpayer that owns the facility on the date it is originally placed in service may elect to claim the ITC in lieu of the PTC with respect to that facility even if the taxpayer did not own the facility at the time construction began. Any ITC claimed on a facility will be limited to the taxpayer's basis in qualified property (as defined in section 48(a)(5)(D)).

.02 *Example*. In August 2013, Developer acquires a parcel of land on which it intends to build and operate a wind farm (Facility). Developer contributes the land to its wholly-owned limited liability company (LLC), which is disregarded as an entity separate from its owner for federal tax purposes, to hold and develop Facility. In November 2013, Developer incurs 5 percent of the cost of Facility and thereafter maintains continuous efforts to advance towards the completion of Facility. In April 2014, to finance the development of the project, Developer sells 95 percent of the interests in LLC to a group of investors (Investors) who are not related to Developer, and Developer does not contribute sales proceeds to LLC. Under Rev. Rul. 99–5, 1999–1 C.B. 434, Developer is treated as selling 95 percent of each of the assets of LLC to Investors, and immediately thereafter Developer and Investors are treated as contributing their respective 5 percent and 95 percent interests in those assets to LLC, which is now a partnership and the owner of Facility for federal tax purposes. In October 2015, LLC places Facility in service. Because Facility satisfies the Safe Harbor and assuming Facility is otherwise a qualified facility under section 45(d), LLC is eligible to claim the PTC with respect to electricity generated by Facility and sold to an unrelated party. Alternatively, LLC may elect to claim the ITC in lieu of the PTC.

SECTION 6. EFFECT ON OTHER DOCUMENTS

Notice 2013–29 is clarified.

SECTION 7. DRAFTING INFORMATION

The principal author of this notice is Brian J. Americus of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this notice, contact Brian J. Americus on (202) 622-3110 (not a toll-free call).

Application of *Windsor* Decision and Revenue Ruling 2013–17 to Employment Taxes and Special Administrative Procedures for Employers to Make Adjustments or Claims for Refund or Credit

Notice 2013–61

PURPOSE

This notice provides guidance for employers and employees to make claims for refund or adjustments (referred to in this notice as corrections) of overpayments of Federal Insurance Contributions Act (FICA) taxes and Federal income tax withholding (employment taxes) with respect to certain benefits provided to same-sex spouses and remuneration paid to same-sex spouses resulting from the United States Supreme Court decision in *United States v. Windsor*, 570 U.S. ___, 133 S.Ct. 2675 (2013) and the holdings of Rev. Rul. 2013–17, 2013–38 I.R.B. 201.

To reduce filing and reporting burdens associated with the optional retroactive application of the holdings of Rev. Rul. 2013–17, the Internal Revenue Service (IRS) is providing special administrative procedures for employers to correct overpayments of employment taxes for 2013 and prior years with respect to certain same-sex spouse benefits and certain remuneration paid to same-sex spouses, including overpayments that result from a taxpayer's retroactive application of the holdings of Rev. Rul. 2013–17. With respect to these overpayments for 2013, this notice provides two alternative special administrative procedures. Under the first alternative, employers may use the fourth quarter 2013 Form 941, *Employer's QUARTERLY Federal Tax Return*, to correct these overpayments of employment taxes for the first three quarters of 2013. Under the second alternative, employers may file one Form 941–X, *Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund*, for the fourth quarter of 2013 to correct these overpayments of FICA taxes for all quarters of 2013.

With respect to these overpayments of FICA taxes for years before 2013, employers can make a claim or adjustment for all four calendar quarters of a calendar year on one Form 941–X filed for the fourth quarter of such year if the period of limitations on refunds under section 6511 of the Internal Revenue Code (Code) has not expired and, in the case of adjustments, the period of limitations will not expire within 90 days of filing the adjusted return. Under normal procedures, employers are required to file a Form 941–X for each calendar quarter for which a refund claim or adjustment is made.

The special administrative procedures provided in this notice are optional. Employers that prefer to use the regular procedures for correcting employment tax overpayments related to same-sex spouse benefits and remuneration paid to same-sex spouses, instead of the special administrative procedures, may do so.

BACKGROUND

Effect of Windsor and Revenue Ruling 2013–17

A number of income tax and employment tax provisions provide for exclusions from gross income and wages, respectively, for certain benefits provided to the spouse of an employee. In addition, services performed by an individual in the employ of the individual's spouse that are not in the course of the employer's trade or business or that are domestic services in the employer's private home are excepted from FICA tax under section 3121(b)(3)(B).[1] Until the recent decision of the Supreme Court in *Windsor*, the IRS interpreted section 3 of the Defense of Marriage Act (DOMA) as prohibiting it from recognizing same-sex marriages for purposes of these provisions. Section 3 of DOMA provided that:

> In determining the meaning of any Act of Congress, or of any ruling, regulation or interpretation of the various administrative bureaus and agencies of the United States, the word 'marriage' means only a legal union between one man and one woman as husband and wife, and the word 'spouse' refers only to a person of the opposite sex who is a husband or a wife.

1 U.S.C. § 7.

As a result, employers withheld and paid employment taxes with respect to certain benefits provided to the same-sex spouse of an employee because the marriage was not recognized for purposes of the Code, and the benefits were not treated as excludable from gross income or wages for Federal income or employment tax purposes, respectively. Employers may also have withheld and paid employment taxes on amounts paid for services performed by an individual in the employ of the individual's same-sex spouse without applying the employment tax exceptions for certain remuneration paid to spouses.

In *Windsor*, the Court held that section 3 of DOMA is unconstitutional because it violates the principles of equal protection, and on August 29, 2013, the IRS announced the publication of Rev. Rul. 2013–17, which held:

1. for Federal tax purposes, the terms "spouse," "husband and wife," "husband," and "wife" include an individual married to a person of the same sex if the individuals are lawfully married under state law, and the term "marriage" includes such a marriage between individuals of the same sex;
2. for Federal tax purposes, the IRS adopts a general rule recognizing a marriage of same-sex individuals that was validly entered into in a state whose laws authorize the marriage of two individuals of the same sex even if the married couple is domiciled in a state that does not recognize the validity of same-sex marriages; and
3. for Federal tax purposes, the terms "spouse," "husband and wife," "husband," and "wife" do not include individuals (whether of the opposite sex or the same sex) who have entered into a registered domestic partnership, civil union, or other similar formal relationship recognized under state law that is not denominated as a marriage under the laws of that state, and the term "marriage" does not include such formal relationships.

Rev. Rul. 2013–17 provides that its holdings will be applied prospectively as of September 16, 2013, which is the date of publication of the ruling in the Internal Revenue Bulletin. Except as otherwise provided in Rev. Rul. 2013–17, taxpayers also may rely on Rev. Rul. 2013–17 for the purpose of filing original returns, amended returns, adjusted returns, or claims for credit or refund for any overpayment of tax resulting from these holdings, provided the applicable limitations period for filing such claim under section 6511 has not expired. Rev. Rul. 2013–17 also provides that if an affected taxpayer files an original return, amended return, adjusted return, or claim for credit or refund in reliance on Rev. Rul. 2013–17, all items required to be reported on the return or claim that are affected by the marital status of the taxpayer must be adjusted to be consistent with the marital status reported on the return or claim.

Rev. Rul. 2013–17 also provides that taxpayers may rely (subject to the conditions in the preceding paragraph regarding the applicable limitations period and consistency within the return or claim) on Rev. Rul. 2013–17 retroactively with respect to any employee benefit plan or arrangement or any benefit provided thereunder only for purposes of filing original returns, amended returns, adjusted returns, or claims for credit or refund of an overpayment of tax concerning employment tax and income tax with respect to employer-provided health coverage benefits or fringe benefits that were provided by the employer and are excludable from income under sections 106, 117(d), 119, 129, or 132 based on an individual's marital status. For purposes of the preceding sentence, if an employee made a pre-tax salary-reduction election for health coverage under a section 125 cafeteria plan sponsored by an employer and also elected to provide health coverage for a same-sex spouse on an after-tax basis under a group health plan sponsored by that employer, an affected taxpayer may treat the amounts that were paid by the employee for the coverage of the same-sex spouse on an after-tax basis as pre-tax salary reduction amounts.

Employers may also rely (subject to the previously noted conditions regarding the applicable limitations period and the consistency requirement) on the holdings in Rev. Rul. 2013–17 for purposes of recognizing same-sex spouses as spouses in applying exceptions from the definition of "employment" for employment tax purposes.

[1]The Railroad Retirement Tax Act (RRTA) and the Federal Unemployment Tax Act (FUTA) also provide exceptions that can apply for same-sex spouse benefits and remuneration paid to same-sex spouses. RRTA taxes are generally paid on Form CT–1, *Employer's Annual Railroad Retirement Tax Act Return*, and FUTA taxes are paid on Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*, which are both annual returns. No special administrative procedures are needed to correct overpayments of taxes on same-sex spouse benefits and remuneration paid to same-sex spouses reported on those returns. However, some RRTA taxes are paid on Form CT–2, *Employee Representative's Quarterly Railroad Tax Return*, which is a quarterly return, and the special administrative procedures in this notice can be used with respect to overpayments of RRTA tax on same-sex spouse benefits reported on Form CT–2.

General Procedures for Corrections of Overpayments of Employment Taxes

Generally, corrections of overpayments of FICA tax are made after an error has been ascertained using the adjustment process under section 6413 or using the refund claim process under section 6402. An error is ascertained when the employer has sufficient knowledge of the error to be able to correct it.

Under section 31.6413(a)–1(a) and section 31.6413(a)–2(b) of the Employment Tax Regulations, before making an adjustment of an overpayment of FICA tax with respect to an employee, an employer generally must repay or reimburse the employee in the amount of the overcollection prior to the expiration of the period of limitations on credit or refund, and, for FICA tax overcollected in a prior year, must also secure the employee's written statement confirming that the employee has not made any previous claims (or the claims were rejected) and will not make any future claims for refund or credit of the amount of the overcollected FICA tax. An employer repays the employee by direct payment to the employee; an employer reimburses an employee by applying the amount of the overcollection against the employee FICA tax which attaches to wages paid by the employer to the employee. Section 31.6413(a)–2(c)(2) provides that employers cannot adjust overpayments of withheld income tax after the end of the calendar year, except in the case of administrative errors. (An administrative error occurs if the amount the employer entered on Form 941 is not the amount the employer actually withheld.) Section 31.6413(a)–2(d)(2) provides that no adjustment in respect of an overpayment may be made if the overpayment relates to a return period for which the period of limitations on credit or refund of such overpayment will expire within 90 days of filing the adjusted return.

Section 31.6402(a)–2 provides rules under which a refund claim for an overpayment of FICA tax may be made. Pursuant to § 31.6402(a)–2(a), no refund or credit for FICA employer tax will be allowed unless the employer has first repaid or reimbursed its employee for the employee FICA tax or has secured the employee's consent to the allowance of the claim for refund and includes a claim for the refund of such employee tax. However, this requirement does not apply to the extent that the employee FICA taxes were not withheld from the employee or, after the employer makes reasonable efforts to repay or reimburse the employee or secure the employee's consent, the employer cannot locate the employee or the employee will not provide consent. Under section 6414 and § 31.6414–1, no refund to the employer is allowed for the overpayment of withheld income tax which the employer deducted or withheld from an employee.

To make employment tax corrections for overpayments (that is, to make adjustments or to claim refunds), an employer uses the "X" form that corresponds to the return being corrected. Thus, an employer corrects overreported taxes on a previously filed Form 941 by filing Form 941–X. Generally, a separate X form must be filed for each taxable period.

In determining whether there has been an overpayment of employment taxes and the amount of any refund, credit, or adjustment, employers are required to take into account the applicable wage base under the social security tax portion of the FICA tax, and the tax rates in effect for the particular year.

Section 31.6051–1(c) requires an employer adjusting a return filed for a prior year, or claiming a refund or credit of FICA taxes for a prior year, to file Forms W-2c, *Corrected Wage and Tax Statement*, for such year. Section 31.6051–1(c) provides that the employer must file Forms W-2c correcting Forms W-2, *Wage and Tax Statement*, if an amount of employee social security or Medicare tax shown on the Form W-2 is incorrect and is adjusted or refunded; the amount of social security wages or Medicare wages shown on the Form W-2 is incorrect; the amount shown in Box 1, Wages, tips, other compensation, is incorrect; or the amount of income tax actually withheld from the employee is incorrectly reported in Box 2, Federal income tax withheld.

SPECIAL ADMINISTRATIVE PROCEDURES FOR EMPLOYMENT TAX ADJUSTMENTS AND CLAIMS FOR REFUND

To reduce administrative burden, this notice provides special administrative procedures for adjustments and claims for refunds or credits for overpayments of employment taxes attributable to same-sex spouse benefits, including overpayments that result from a taxpayer's retroactive application of the holdings in Rev. Rul. 2013–17. For purposes of this notice, "same-sex spouse benefits" refers to the benefits specified in Rev. Rul. 2013–17 for which amended income tax returns and adjusted employment tax returns or claims for refund or credit may be filed. These benefits are same-sex spouse employer-provided health coverage and fringe benefits that were provided by an employer to a same-sex spouse and are excludable from income under section 106, 117(d), 119, 129, or 132 based on an individual's marital status. For purposes of the preceding sentence, if an employee made a pre-tax salary-reduction election for health coverage under a section 125 cafeteria plan sponsored by an employer and also elected to provide health coverage for a same-sex spouse on an after-tax basis under a group health plan sponsored by that employer, an affected taxpayer may treat the amounts that were paid by the employee for the coverage of the same-sex spouse on an after-tax basis as pre-tax salary reductions amounts. Thus, for purposes of this notice, employment taxes paid on after-tax amounts that were used to purchase health coverage for an employee's same-sex spouse under the circumstances described in the preceding sentence are treated as overpayments of employment taxes.

In addition, for purposes of this notice, "same-sex spouse benefits" includes remuneration for services that is excepted from the definition of employment for FICA purposes under the holdings in Rev. Rul. 2013–17 because the services are within the exception of section 3121(b)(3)(B).

Employment Tax Returns for Third Quarter 2013 (July, August, September)

If an employer withholds employment taxes with respect to same-sex spouse benefits paid to or on behalf of an employee in the third quarter of 2013, ascertains the amount withheld on such benefits, and repays or reimburses the employee for the amount of such taxes before filing the third quarter 2013 Form 941, the employer will not report the wages and withholding on the third quarter 2013 Form 941. If the employer does not repay or reimburse the employee for the amount of the overcollection before filing the third quarter 2013 Form 941, the employer must report the amount of the overcollection on that return and can use one of the special administrative procedures for 2013 described below to make an adjustment or claim a refund for the overpayment.

Special Administrative Procedures for Adjustments for 2013 on Fourth Quarter 2013 Form 941 or Fourth Quarter 2013 Form 941-X

The IRS is providing two alternative special administrative procedures for employers that treated the value of same-sex spouse benefits as wages on Forms 941 for the first three quarters of 2013 and that seek to correct overpayments of employment taxes attributable to the benefits.[2]

(1) Under the first alternative, an employer must repay or reimburse its employees for the amount of the overcollected FICA tax and the overcollected income tax withholding with respect to the same-sex spouse benefits for the first three quarters of 2013 on or before December 31, 2013. After repaying or reimbursing the employees, the employer, in reporting amounts on its fourth quarter 2013 Form 941, may reduce the fourth quarter wages, tips, and other compensation reported on line 2, taxable social security wages reported on line 5a (subject to the wage base limitation discussed below), and taxable Medicare wages and tips reported on line 5c, by the amount of the same-sex spouse benefits treated as wages for the first three quarters of 2013. Also, the income tax withheld from wages, tips, and other compensation reported on line 3 of Form 941 should be reduced by the amount of income tax withholding with respect to the same-sex spouse benefits that has been repaid or reimbursed to the employees by the end of the calendar year. In addition, if the value of any same-sex spouse benefits were included in taxable wages subject to Additional Medicare Tax withholding on line 5d, the amount of taxable wages subject to Additional Medicare Tax withholding on the fourth quarter 2013 Form 941 should be reduced. By taking advantage of this special administrative procedure, the employer will not have to file separate Forms 941-X to correct each of the first three quarters of 2013.

Under this special administrative procedure, the employer may only correct the employer share of FICA tax that corresponds to the employee share of FICA tax that has been repaid or reimbursed to the employees on or before December 31, 2013.

For the repayment or reimbursement of overwithheld social security tax and the corresponding reduction for taxable social security wages reported on Form 941, line 5a, the employer must take into account that adjustments of social security tax are limited to the tax paid on that portion of the value of the same-sex spouse benefits that, when added to other social security wages and tips for the year, does not exceed the social security wage base for 2013 ($113,700). Accordingly, if for a particular employee the value of same-sex spouse benefits was included in social security wages and, after the exclusion of the value of the same-sex spouse benefits from wages for 2013, the remaining social security wages of the employee are equal to or greater than $113,700, then no refund, credit, or adjustment of social security tax can be made for 2013 for that employee.

To ensure that use of this special administrative procedure for the 2013 fourth quarter Form 941 does not result in a mismatch between total taxes reported on line 10 (total taxes after adjustments) and total liability for the quarter reported on line 16 for a monthly schedule depositor or on Schedule B (Form 941) for a semiweekly schedule depositor, the employer should use the following procedures.

If the employer repays or reimburses the employee share of FICA taxes or income tax withholding to employees before the fourth quarter (*i.e.*, before October 1, 2013), the repayment or reimbursement and the corresponding reduction of the employer portion of FICA tax should be reflected by reductions in the amount reported by a monthly schedule depositor on line 16 (Tax liability: Month 1 (October)) or by a semiweekly schedule depositor on Schedule B (Form 941), Day 1 (October 1) of the Tax liability for Month 1. Negative numbers must not be entered on Line 16 or Schedule B (Form 941). If the amount of the adjustment for repayments and reimbursements exceeds the liability of the quarter reported for Month 1 or Day 1, the employer should apply the amount of the remaining adjustment to reduce liabilities in calendar order until the amount of the remaining adjustment is completely used. For example, if the employer's tax liability for October on line 16 would be negative (due to the adjustment for repayments and reimbursements made before or during the fourth quarter), the employer should not enter a negative amount for the month. Instead, the employer should enter zero for October and subtract the negative amount from the tax liability for November.

If the employer repays or reimburses the employee share of FICA taxes or income tax withholding to employees during the fourth quarter (*i.e.*, after September 30, 2013 and on or before December 31, 2013), the repayment or reimbursement and the corresponding reduction of the employer portion of FICA tax should be reflected by reductions in the amount reported on line 16 of the fourth quarter Form 941 or Schedule B (Form 941) on the date of the repayment or reimbursement or on the next date after the date of the repayment or reimbursement such that it will not reduce any amount on line 16 or Schedule B (Form 941) below zero.

(2) Under the second alternative, an employer that does not repay or reimburse employees for the amount of withheld FICA and income taxes with respect to same-sex spouse benefits provided in 2013 on or before December 31, 2013, and thus, files the 2013 fourth quarter Form 941 without making the adjustment,

[2]The same procedures are available to filers of Form 941-SS, *Employer's QUARTERLY Federal Tax Return (American Samoa, Guam, the Commonwealth of Northern Mariana Islands, and the U.S. Virgin Islands)*, Form 941-PR, *Planilla para la Declaración Federal TRIMESTRAL del Patrono*, and Form CT-2, *Employee Representative's Quarterly Railroad Tax Return* (different lines are applicable on Form CT-2). The special procedures are not needed for filers of Form CT-1, *Employer's Annual Railroad Retirement Tax Return*, and Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*, which are annual returns.

may correct overpayments of FICA taxes with respect to same-sex spouse benefits paid in 2013 using Form 941-X. Under this option, an employer may file one Form 941-X for the fourth quarter of 2013 to make adjustments or claim refunds or credits of overpayments of FICA taxes with respect to same-sex spouse benefits paid in all quarters of 2013, provided the employer has satisfied the usual requirements for filing Form 941-X, including repaying or reimbursing the overcollected employee FICA tax to employees (or, for refund claims, securing consents from employees), and obtaining the required written statements from employees. The employer should write "WINDSOR" in dark, bold letters across the top margin of page 1 of Form 941-X. Only corrections made under this special administrative procedure may be shown on this Form 941-X.

An employer may not make an adjustment for an overpayment of income tax withholding for a prior calendar year unless the overpayment is attributable to an administrative error. An employer may not claim a refund or credit for an overpayment of income tax withholding if the tax was deducted and withheld from the employee. Accordingly, this second special administrative procedure for 2013 cannot be used with regard to income tax withheld from employees with respect to same-sex spouse benefits in 2013 because an employer can use this Form 941-X procedure only if the employer did not repay or reimburse employees for the amount of withheld taxes with respect to same-sex spouse benefits provided in 2013 on or before December 31, 2013. In such case, employees will receive credit for the income tax withheld for purposes of determining any entitlement to a refund of income tax paid with respect to same-sex spouse benefits provided in 2013 when they file Form 1040, *U.S. Individual Income Tax Return*.

Special Administrative Procedure for Adjustments or Claims for Refund for Years Before 2013

The IRS is also providing a special administrative procedure for employers to make adjustments or claims for refund or credit of overpayments of FICA taxes paid with respect to same-sex spouse benefits for any year before 2013 for which the applicable period of limitations on credit or refund has not expired. Under this procedure, the employer must take into account the applicable social security wage base in determining the overpayment of FICA taxes for the prior year being corrected. Under this procedure, the employer may file one Form 941-X for the fourth quarter of the prior year. This fourth quarter Form 941-X would include the adjustments or refunds for all overpayments of employment taxes with respect to same-sex spouse benefits provided during such prior year, including overpayments reflected in the Forms 941 for the first three quarters of the year. The employer should write "WINDSOR" in dark, bold letters across the top margin of page 1 of Form 941-X. Only corrections made under this special administrative procedure may be shown on this Form 941-X.

Although the employer may file for all four quarters of a prior year on the fourth quarter Form 941-X, this special administrative procedure is subject to the usual requirements that apply in the case of corrections of overpayments for prior years, including the filing of Forms W-2c, repaying or reimbursing employees for the overwithheld taxes, and obtaining the required written statements (and consents if applicable) from employees.

An employer may not make an adjustment for an overpayment of income tax withholding for a prior calendar year unless the overpayment is attributable to an administrative error. An employer may not claim a refund or credit for an overpayment of income tax withholding if the tax was deducted and withheld from the employee. Accordingly, this special administrative procedure for prior years cannot be used with regard to income tax withheld from employees with respect to same-sex spouse benefits in prior years. Employees may receive refunds of income tax paid with respect to same-sex spouse benefits in prior years by filing Form 1040X, *Amended U.S. Individual Income Tax Return*. As indicated above, an employer filing a claim for refund or credit or making adjustments for prior years must file Forms W-2c for the prior years. Forms W-2c will assist employees in claiming a refund of income tax.

DRAFTING INFORMATION

The principal author of this notice is Alfred G. Kelley of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt & Government Entities). For further information regarding this notice, contact Mr. Kelley at (202) 622-6040 (not a toll-free call).

Temporary Shelter for Individuals Displaced by Severe Storms, Flooding, Landslides, and Mudslides in Colorado

Notice 2013–63

The Internal Revenue Service is suspending certain requirements under § 142(d) of the Internal Revenue Code for qualified residential rental projects financed with exempt facility bonds under § 142 to provide emergency housing relief needed as a result of the devastation caused by recent weather-related disasters in the State of Colorado (the Disaster). The Disaster includes severe storms, flooding, landslides, and mudslides and is more fully described in the Federal Emergency Management Agency's (FEMA) Notice of a Major Disaster Declaration for the State of Colorado (Internal Agency Docket No. FEMA-4145-DR) and all amendments thereto.

This Notice provides relief for all qualified residential rental projects described herein. For those projects that are also low-income housing tax credit (LIHTC) projects, this Notice should be read with Notice 2013–64, I.R.B. 2013–44 (October 28, 2013), which suspends certain low-income and non-transient requirements under § 42 to allow low-income housing credit projects to provide emergency housing needed because of the Disaster.

BACKGROUND

On September 14, 2013, the President issued a major disaster declaration for the State of Colorado because of the devastation caused by the Disaster. The President issued the declaration under the Robert T. Stafford Disaster Relief and Emergency Assistance Act, 42 U.S.C. 5121 *et seq*. Subsequently, FEMA designated some jurisdictions in

Colorado as eligible for Individual Assistance (as FEMA uses that term). Because of the widespread damage to housing caused by the Disaster, the Service has determined that issuers may approve the use of qualified residential rental projects described in § 142(d) to temporarily house displaced individuals, as defined below, regardless of their income, in accordance with this Notice. The Service has determined that the projects to which this approval may be given can be located in any State, regardless of whether a major disaster declaration with Individual Assistance has been issued for that State.

Consistent with Notice 2013–64, the term "displaced individual" means, for purposes of this Notice, an individual who resided in a jurisdiction designated for Individual Assistance and who has been displaced because his or her residence was destroyed or damaged as a result of the devastation caused by the Disaster.

SECTION 1. SUSPENSION OF INCOME LIMITATIONS

The Service has determined that it is appropriate to temporarily suspend certain income limitation requirements under § 142(d) that apply to qualified residential rental projects financed with tax-exempt bonds issued by a qualified issuer under § 103 (Issuer). The suspension, described in Section 3 below, is available to both qualified residential rental projects under § 142(d) that are not subject to any LIHTC-related requirements (Bond Projects) and to qualified residential rental projects under § 142(d) that are also subject to LIHTC-related requirements (Bond/LIHTC Projects). For purposes of this Notice, the term "Project" refers to either a Bond Project or a Bond/LIHTC Project.

SECTION 2. GENERAL REQUIREMENTS

.01 *Issuer Approval for Relief*. If an Issuer that issued exempt facility bonds for a Project desires to allow the use of the Project to temporarily house displaced individuals, the Issuer must approve that use and must determine an appropriate period for the temporary housing, not to extend beyond September 30, 2014 (Temporary Housing Period). If a Bond/LIHTC Project subject to both Notice 2013–64 and this Notice receives approval, for purposes of § 42, for a temporary housing period and for the suspension of income limitations from a State housing agency (as contemplated in Section IV(2) of Notice 2013–64) and that agency is not the Issuer, then the income limitations under § 142(d) for that Bond/LIHTC Project are suspended only if the project also receives the Issuer's consent for a suspension. An Issuer that chooses to provide that consent must adopt for purposes of § 142(d) the same temporary housing period that the agency adopted for purposes of § 42.

.02 *Protection of Tenants*. Existing tenants in a Project whose income is at or below an applicable income limitation under § 142(d) cannot be evicted or have their tenancy terminated as a result of efforts to provide temporary housing for displaced individuals.

.03 *Certification and Recordkeeping Requirements*. The Project operator must comply with the certification and recordkeeping requirements in Section 4 of this Notice. For certification and recordkeeping requirements under § 42, see Notice 2013–64.

.04 *Rent Restrictions*. To the extent such rent restrictions are applicable, rents for the low-income units that house displaced individuals must not exceed the lesser of–

(1) the maximum gross rent for that unit under § 142(d)(4)(B); or

(2) the maximum gross rent for that unit under § 42(g)(2).

.05 *Project Must Meet All Remaining Requirements*. Except as expressly provided in this Notice, a Project continues to be subject to all other rules and requirements of § 142(d) and § 103.

SECTION 3. RELIEF FROM SECTION 142 REQUIREMENTS

.01 *Qualified Project Period*. Only a unit in a Project occupied by a non-displaced individual counts for purposes of determining the beginning of the qualified project period under § 142(d)(2)(A). Thus, only non-displaced individuals are counted for determining the 1st day on which 10 percent of the residential units in a Project are occupied under § 142(d)(2)(A). However, occupancy of a unit by any tenant (whether a displaced individual or a non-displaced individual) in a Project counts for purposes of determining the end of the qualified project period under § 142(d)(2)(A)(i). If occupancy by a displaced individual in a Project causes any termination of assistance with respect to the Project under section 8 of the United States Housing Act of 1937, then that termination is disregarded for determining when the qualified project period ends under § 142(d)(2)(A)(iii).

.02 *Satisfaction of the Non-Transient Use Requirement*. The occupancy of a unit in a Project by a displaced individual during the Temporary Housing Period is treated as satisfying the non-transient use requirement applicable to qualified residential rental projects described in § 142(d). *See* § 1.103–8(b)(4); *see also* Notice 2013–64 for suspension of the non-transient use requirement under § 42(i)(3)(B)(i).

.03 *Income Qualification of Units in Bond Projects during Temporary Housing Period*. A unit in a Bond Project occupied by a displaced individual during the Temporary Housing Period retains the income status it had immediately before that occupancy, regardless of whether the unit was a market-rate unit, a unit occupied by a tenant who met an applicable income limit, a designated low-income unit, or a never previously occupied unit. *See* Rev. Proc. 2004–39, 2004–2 C.B. 49 (treating never previously occupied units as unavailable). This means, for example, that if a unit in a Bond Project had been designated as a low-income unit or rented to an individual whose income was at or below an applicable income limit or was a market-rate unit or an unavailable unit, then the unit remains as such while occupied by a displaced individual during the Temporary Housing Period regardless of the occupancy by, or income of, the displaced individual. Thus, the fact that a unit becomes occupied by a displaced individual does not affect compliance with the 20–50 test or 40–60 test of § 142(d)(1)(A) and (B) (or the 25–60 test under the special rule in § 142(d)(6)).

Under § 142(d)(3)(B), if the income of a low-income resident of a Project rises above a specified percentage of the applicable income limit, then, for that resident's income to continue to be treated as not exceeding the applicable income limit, the next residential unit meeting certain criteria to become available in the same Project must be occupied by a new resident whose income does not exceed the applicable income limit (the next available unit rule). For purposes of determining compliance with the next available unit rule, an operator of a Bond Project may disregard the new occupancy of units during the Temporary Housing Period by displaced individuals, and apply the rule solely based on new occupancy by persons who are not displaced individuals. The operator may, however, take into account a displaced individual's occupancy for purposes of § 142(d)(3)(B) if the operator obtains sufficient evidence that the displaced individual's income does not exceed the applicable income limit.

.04 *Income Qualifications of Units in Bond/LIHTC Projects During the Temporary Housing Period*. The income status of a unit and the income qualification of the occupant of a unit for purposes of § 142(d) in a Bond/LIHTC Project occupied by a displaced individual during the Temporary Housing Period shall be treated the same as they are for purposes of § 42 under Notice 2013–64. For purposes of determining compliance with the next available unit rule, an operator of a Bond/LIHTC Project may disregard the new occupancy of units during the Temporary Housing Period by displaced individuals, and apply the rule solely based on new occupancy by persons who are not displaced individuals. The operator may, however, take into account a displaced individual's occupancy for purposes of § 142(d)(3)(B) if the operator obtains sufficient evidence that the displaced individual's income does not exceed the applicable income limit.

.05 *Income Qualifications when Temporary Housing Period Ends*. After the end of the Temporary Housing Period, the status as a displaced individual of an occupant remaining in a unit in a Project will be disregarded and the status of the unit occupied by such individual and the income of such individual will be reevaluated as though the formerly displaced individual commenced occupancy of the unit on the day immediately following the end of the Temporary Housing Period. Thus, if the displaced individual remains in the unit, the unit will be treated as occupied for all purposes of § 142(d) and the income of the displaced individual will be used for determining compliance with the requirements of § 142(d). If noncompliance relates to continued occupancy of the unit after the Temporary Housing Period by an occupant who was a displaced individual during the Temporary Housing Period, a 60-day period is allowed for correction.

SECTION 4. CERTIFICATIONS AND RECORDKEEPING

In addition to any information and certifications required by § 142(d)(7), Project operators must maintain and certify certain information concerning each displaced individual temporarily housed in the Project. The records must contain the following information: the name of the displaced individual, the address of the damaged residence of the displaced individual, the displaced individual's social security number, and a statement signed under penalties of perjury by the displaced individual that, because of damage to the individual's residence in a jurisdiction designated for Individual Assistance by FEMA as a result of the devastation caused by the Disaster, the individual requires temporary housing. In addition, the Project operator must keep accurate records of the Issuer's approval of the Project's use for displaced individuals and the approved Temporary Housing Period and the dates during which displaced individuals occupied units in the Project.

The recordkeeping described under this paragraph must be included as part of the books and records of the Project operator and also must be maintained in a manner that is consistent with any compliance monitoring process imposed by § 142(d).

SECTION 5. EFFECTIVE DATE

This Notice is effective September 14, 2013.

SECTION 6. PAPERWORK REDUCTION ACT

The collection of information contained in this Notice has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–2244.

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

The collection of information in this Notice is in the section entitled "Section 4: CERTIFICATIONS AND RECORDKEEPING." This information is required to enable the Service to verify whether individuals are displaced as a result of the devastation caused by the Disaster and thus warrant temporary housing in vacant units in certain Projects. The collection of information is required to obtain a benefit. The likely respondents are individuals and businesses.

The estimated total annual recordkeeping burden is 250 hours.

The estimated annual burden per recordkeeper is approximately 30 minutes. The estimated number of recordkeepers is 500.

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

SECTION 7. DRAFTING INFORMATION

The principal authors of this notice are Timothy L. Jones and Spence Hanemann of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this notice, contact Mr. Hanemann at (202) 622-3980 (not a toll-free call).

Low-Income Housing Credit Disaster Relief for Severe Storms, Flooding, Landslides, and Mudslides in Colorado

Notice 2013–64

The Internal Revenue Service is suspending certain requirements under § 42 of the Internal Revenue Code for low-income housing credit projects to provide emergency housing relief needed as a result of the devastation caused by recent weather-related disasters in the State of Colorado (the Disaster). The Disaster includes severe storms, flooding, landslides, and mudslides and is more fully described in the Federal Emergency Management Agency's (FEMA) Notice of a Major Disaster Declaration for the State of Colorado (Internal Agency Docket No. FEMA-4145-DR) and all amendments thereto. This relief is being granted pursuant to the Service's authority under § 42(n) and § 1.42–13(a) of the Income Tax Regulations. This Notice should be read in conjunction with Notice 2013–63, I.R.B. 2013–44 (October 28, 2013), which suspends certain requirements under § 142(d) for qualified residential rental projects financed with exempt facility bonds under § 142 to provide emergency housing relief as a result of the Disaster.

BACKGROUND

On September 14, 2013, the President issued a major disaster declaration for the State of Colorado because of the devastation caused by the Disaster. The President issued the declaration under the Robert T. Stafford Disaster Relief and Emergency Assistance Act, 42 U.S.C. 5121 *et seq.* Subsequently, FEMA designated some jurisdictions in Colorado for Individual Assistance. Because of the damage to housing caused by the Disaster, the Service has determined that State housing agencies (Agencies) may provide approval to project owners in their respective States to provide temporary emergency housing for displaced individuals in accordance with this Notice. For purposes of this Notice, the term "displaced individual" means an individual who resided in a jurisdiction designated for Individual Assistance and who has been displaced because his or her residence was destroyed or damaged as a result of the Disaster. The Service has also determined that the projects to which this approval may be given may be located in any State, regardless of whether a major disaster declaration with Individual Assistance has been issued for that State.

I. SUSPENSION OF INCOME LIMITATIONS

The Service has determined that it is appropriate to temporarily suspend certain income limitation requirements under § 42 for certain qualified low-income housing projects. The suspension will apply to low-income housing projects which are approved by the Agency with jurisdiction over the project (the applicable Agency) and in which vacant units are rented to displaced individuals. The applicable Agency will determine the appropriate period of temporary housing for each project, not to extend beyond September 30, 2014 (temporary housing period).

II. STATUS OF UNITS

A. Units in the first year of the credit period

A displaced individual temporarily occupying a unit during the first year of the credit period under § 42(f)(1) will be deemed a qualified low-income tenant for purposes of determining the project's qualified basis under § 42(c)(1), and for meeting the project's 20–50 test or 40–60 test as elected by the project owner under § 42(g)(1). After the end of the temporary housing period established by the applicable Agency, a displaced individual will no longer be deemed a qualified low-income tenant.

B. Vacant units after the first year of the credit period

During the temporary housing period established by the applicable Agency, the status of a vacant unit (that is, market-rate or low-income for purposes of § 42 or never previously occupied) after the first year of the credit period that becomes temporarily occupied by a displaced individual remains the same as the unit's status before the displaced individual moves in. Displaced individuals temporarily occupying vacant units will not be treated as low-income tenants under § 42(i)(3)(A)(ii). However, even if it houses a displaced individual, a low-income or market rate unit that was vacant before the effective date of this Notice will continue to be treated as a vacant low-income or market rate unit. Similarly, a unit that was never previously occupied before the effective date of this Notice will continue to be treated as a unit that has never been previously occupied even if it houses a displaced individual. Thus, the fact that a vacant unit becomes occupied by a displaced individual will not affect the building's applicable fraction under § 42(c)(1)(B) for purposes of determining the building's qualified basis, nor will it affect the 20–50 test or 40–60 test of § 42(g)(1). If the income of occupants in low-income units exceeds 140 percent of the applicable income limitation, the temporary occupancy of a unit by a displaced individual will not cause application of the available unit rule under § 42(g)(2)(D)(ii). In addition, the project owner is not required during the temporary housing period to make attempts to rent to low-income individuals the low-income units that house displaced individuals.

III. SUSPENSION OF NON-TRANSIENT REQUIREMENTS

The non-transient use requirement of § 42(i)(3)(B)(i) shall not apply to any unit providing temporary housing to a displaced individual during the temporary housing period determined by the applicable Agency.

IV. OTHER REQUIREMENTS

All other rules and requirements of § 42 will continue to apply during the temporary housing period established by the applicable Agency. After the end of the temporary housing period, the applicable income limitations contained in § 42(g)(1), the available unit rule under § 42(g)(2)(D)(ii), the nontransient requirement of § 42(i)(3)(B)(i), and the requirement to make reasonable attempts to rent vacant units to low-income individuals shall resume. If a project owner offers to rent a unit to a displaced individual after the end of the temporary housing period, the displaced individual must be certified under the requirements of § 42(i)(3)(A)(ii) and § 1.42–5(b) and (c) to be a qualified low-income tenant. To qualify for the relief in this Notice, the project owner must additionally meet all of the following requirements:

(1) Major Disaster Area

In the case of an individual displaced by the Disaster, the displaced individual must have resided in a jurisdiction designated for Individual Assistance by FEMA as a result of the devastation caused by the Disaster.

(2) Agency Approval

The project owner must obtain approval from the applicable Agency for the relief described in this Notice. The applicable Agency will determine the appropriate period of temporary housing for each project, not to extend beyond September 30, 2014.

(3) Certifications and Recordkeeping

To comply with the requirements of § 1.42–5, project owners are required to maintain and certify certain information concerning each displaced individual temporarily housed in the project, specifically the following: name, address of damaged residence, social security number, and a statement signed under penalties of perjury by the displaced individual that, because of damage to the individual's residence in a jurisdiction designated for Individual Assistance by FEMA as a result of the Disaster, the individual requires temporary housing. The owner must notify the applicable Agency that vacant units are available for rent to displaced individuals.

The owner must also certify the date the displaced individual began temporary occupancy and the date the project will discontinue providing temporary housing as established by the applicable Agency. The certifications and recordkeeping for displaced individuals must be maintained as part of the annual compliance monitoring process with the Agency.

(4) Rent Restrictions

Rents for the low-income units that house displaced individuals must not exceed the existing rent-restricted rates for the low-income units established under § 42(g)(2).

(5) Protection of Existing Tenants

Existing tenants in occupied low-income units cannot be evicted or have their tenancy terminated as a result of efforts to provide temporary housing for displaced individuals.

EFFECTIVE DATE

This Notice is effective September 14, 2013.

PAPERWORK REDUCTION ACT

The collection of information contained in this Notice has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–2244.

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

The collection of information in this Notice is in the section titled "OTHER REQUIREMENTS" under "(3) Certifications and Recordkeeping." This information is required to enable the Service to verify whether individuals are displaced as a result of the Disaster and thus warrant temporary housing in vacant low-income housing units. The collection of information is required to obtain a benefit. The likely respondents are individuals and businesses.

The estimated total annual recordkeeping burden is 300 hours.

The estimated annual burden per recordkeeper is approximately 15 minutes. The estimated number of recordkeepers is 1200.

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

DRAFTING INFORMATION

The principal author of this Notice is David Selig of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this Notice, contact Mr. Selig at (202) 622-3040 (not a toll-free call).

2013–2014 Special Per Diem Rates

Notice 2013–65

SECTION 1. PURPOSE

This annual notice provides the 2013–2014 special *per diem* rates for taxpayers to use in substantiating the amount of ordinary and necessary business expenses incurred while traveling away from home, specifically (1) the special transportation industry meal and incidental expenses (M&IE) rates, (2) the rate for the incidental expenses only deduction, and (3) the rates and list of high-cost localities for purposes of the high-low substantiation method.

SECTION 2. BACKGROUND

Rev. Proc. 2011–47, 2011–42 I.R.B. 520, provides rules for using a *per diem* rate to substantiate, under § 274(d) of the Internal Revenue Code and § 1.274–5 of the Income Tax Regulations, the amount of ordinary and necessary business expenses paid or incurred while traveling away from home. Taxpayers using the rates and list of high-cost localities provided in this notice must comply with Rev. Proc. 2011–47. Notice 2012–63, 2012–42 I.R.B. 496, provides the rates and list of high-cost localities for the period October 1, 2012, to September 30, 2013.

Section 3.02(3) of Rev. Proc. 2011-47 provides that the term "incidental expenses" has the same meaning as in the Federal Travel Regulations, 41 C.F.R. 300–3.1, and that future changes to the definition of incidental expenses in the Federal Travel Regulations would be announced in the annual *per diem* notice. On October 22, 2012, the General Services Administration published final regulations revising the definition of incidental expenses under the Federal Travel Regulations to include only fees and tips given to porters, baggage carriers, hotel staff, and staff on ships. Transportation between places of lodging or business and places where meals are taken, and the mailing cost of filing travel vouchers and paying employer-sponsored charge card billings, are no longer included in incidental expenses. Accordingly, taxpayers using *per diem* rates may separately deduct or be reimbursed for transportation and mailing expenses.

SECTION 3. SPECIAL M&IE RATES FOR TRANSPORTATION INDUSTRY

The special M&IE rates for taxpayers in the transportation industry are $59 for any locality of travel in the continental United States (CONUS) and $65 for any locality of travel outside the continental United States (OCONUS). *See* section 4.04 of Rev. Proc. 2011–47.

SECTION 4. RATE FOR INCIDENTAL EXPENSES ONLY DEDUCTION

The rate for any CONUS or OCONUS locality of travel for the incidental expenses only deduction is $5 per day. *See* section 4.05 of Rev. Proc. 2011–47.

SECTION 5. HIGH-LOW SUBSTANTIATION METHOD

1. *Annual high-low rates*. For purposes of the high-low substantiation method, the *per diem* rates in lieu of the rates described in Notice 2012–63 (the

per diem substantiation method) are $251 for travel to any high-cost locality and $170 for travel to any other locality within CONUS. The amount of the $251 high rate and $170 low rate that is treated as paid for meals for purposes of § 274(n) is $65 for travel to any high-cost locality and $52 for travel to any other locality within CONUS. See section 5.02 of Rev. Proc. 2011–47. The *per diem* rates in lieu of the rates described in Notice 2012–63 (the meal and incidental expenses only substantiation method) are $65 for travel to any high-cost locality and $52 for travel to any other locality within CONUS.

2. *High-cost localities*. The following localities have a federal *per diem* rate of $210 or more, and are high-cost localities for all of the calendar year or the portion of the calendar year specified in parentheses under the key city name.

Key city	*County or other defined location*
Arizona	
Sedona (March 1–April 30)	City limits of Sedona
California	
Monterey (July 1–August 31)	Monterey
Napa (October 1–November 30 and April 1–September 30)	Napa
San Diego	San Diego
San Francisco	San Francisco
Santa Barbara	Santa Barbara
Santa Cruz (June 1–August 31)	Santa Cruz
Santa Monica	City limits of Santa Monica
Yosemite National Park (June 1–August 31)	Mariposa
Colorado	
Aspen (December 1–March 31 and June 1–August 31)	Pitkin
Denver/Aurora	Denver, Adams, Arapahoe, and Jefferson
Steamboat Springs (December 1–March 31)	Routt
Telluride (December 1–March 31 and June 1–September 30)	San Miguel
Vail (December 1–August 31)	Eagle
District of Columbia	
Washington D.C. (also the cities of Alexandria, Falls Church, and Fairfax, and the counties of Arlington and Fairfax, in Virginia; and the counties of Montgomery and Prince George's in Maryland) (See also Maryland and Virginia)	
Florida	
Boca Raton/Delray Beach/Jupiter (January 1–April 30)	Palm Beach/Hendry
Fort Lauderdale (January 1–May 31)	Broward
Fort Walton Beach/De Funiak Springs (June 1–July 31)	Okaloosa and Walton
Key West	Monroe
Miami (January 1–March 31)	Miami-Dade
Naples (January 1–April 30)	Collier
Illinois	
Chicago (October 1–November 30 and March 1–September 30)	Cook and Lake
Louisiana	
New Orleans (October 1–June 30)	Orleans, St. Bernard, Jefferson and Plaquemine Parishes

Key city	*County or other defined location*
Maine	
Bar Harbor (July 1–August 31)	Hancock
Maryland	
Baltimore City (October 1–November 30 and March 1–September 30)	Baltimore City
Cambridge/St. Michaels (June 1–August 31)	Dorchester and Talbot
Ocean City (June 1–August 31)	Worcester
Washington, DC Metro Area	Montgomery and Prince George's
Massachusetts	
Boston/Cambridge	Suffolk, City of Cambridge
Falmouth (July 1–August 31)	City limits of Falmouth
Martha's Vineyard (July 1–August 31)	Dukes
Nantucket (June 1–September 30)	Nantucket
New Hampshire	
Conway (July 1–August 31)	Carroll
New York	
Floral Park/Garden City/Great Neck	Nassau
Glens Falls (July 1–August 31)	Warren
Lake Placid (July 1–August 31)	Essex
Manhattan (includes the boroughs of Manhattan, Brooklyn, the Bronx, Queens and Staten Island)	Bronx, Kings, New York, Queens, Richmond
Saratoga Springs/Schenectady (July 1–August 31)	Saratoga and Schenectady
Tarrytown/White Plains/New Rochelle	Westchester
North Carolina	
Kill Devil (June 1–August 31)	Dare
Pennsylvania	
Philadelphia	Philadelphia
Rhode Island	
Jamestown/Middletown/Newport (October 1–October 31 and May 1–September 30)	Newport
South Carolina	
Charleston (March 1–May 31)	Charleston, Berkeley and Dorchester
Texas	
Midland	Midland
Utah	
Park City (December 1–March 31)	Summit
Virginia	
Washington, DC Metro Area	Cities of Alexandria, Fairfax, and Falls Church; counties of Arlington and Fairfax
Virginia Beach (June 1–August 31)	City of Virginia Beach
Washington	
Seattle	King
Wyoming	
Jackson/Pinedale (July 1–August 31)	Teton and Sublette

3. *Changes in high-cost localities*. The list of high-cost localities in this notice differs from the list of high-cost localities in section 5 of Notice 2012–63.

a. The following localities have been added to the list of high-cost localities: Santa Cruz, California; Boca Raton/Delray Beach/Jupiter, Florida; Charleston, South Carolina; and Midland, Texas.

b. The following localities have changed the portion of the year in which they are high-cost localities: Monterey, California; Telluride, Colorado; Miami, Florida; Chicago, Illinois; and Park City, Utah.

c. No localities have been removed from the list of high-cost localities.

SECTION 6. EFFECTIVE DATE

This notice is effective for *per diem* allowances for lodging, meal and incidental expenses, or for meal and incidental expenses only, that are paid to any employee on or after October 1, 2013, for travel away from home on or after October 1, 2013. For purposes of computing the amount allowable as a deduction for travel away from home, this notice is effective for meal and incidental expenses or for incidental expenses only paid or incurred on or after October 1, 2013. See sections 4.06 and 5.04 of Rev. Proc. 2011–47 for transition rules for the last 3 months of calendar year 2013.

SECTION 7. EFFECT ON OTHER DOCUMENTS

Notice 2012–63 is superseded.

DRAFTING INFORMATION

The principal author of this notice is Neville R. Jiang of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this notice contact Mr. Jiang at (202) 622-4970, or if after November 15, 2013, at (202) 317-7007.

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Research Expenditures

REG–124148–05

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document proposes regulations to amend the definition of research and experimental expenditures under section 174 of the Internal Revenue Code (Code). In particular, these proposed regulations provide guidance on the treatment of amounts paid or incurred in connection with the development of tangible property, including pilot models. The regulations will affect taxpayers engaged in research activities. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by December 5, 2013. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for January 8, 2014, at 10 a.m., must be received by December 5, 2013.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–124148–05), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–124148–05), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC, or sent electronically, via the Federal eRulemaking Portal at *www.regulations.gov* (indicate IRS and REG–124148–05). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning these proposed regulations, David McDonnell, (202) 622-3040; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Oluwafunmilayo (Funmi) Taylor, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Overview of Provisions

Section 174—Background

Section 174 was enacted as a part of the Internal Revenue Code of 1954 to eliminate uncertainty in the tax accounting treatment of research and experimental expenditures and to encourage taxpayers to carry on research and experimentation. *See* H.R. Rep. No.1337, 83d Cong., 2d Sess. 28 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 33 (1954). Before the enactment of section 174, courts consistently held that the law required capitalization of product research and development costs, including production costs of tangible property used in the research process. Under prior law, expenditures related to a taxpayer's research and experimentation generally were capitalized and held in suspense until the taxpayer could determine (1) whether or not the research had failed; and (2) if the research was successful, whether or not the research resulted in property that had a useful life determinable with reasonable accuracy. Research and experimental expenditures resulting in property with a useful life determinable with reasonable accuracy were amortized over the useful life of the property or, if intangible, may have been allocated to tangible assets. For example, if a design developed through research and experimentation ("appropriate design") was used to produce a tangible asset that was used in the taxpayer's trade or business or if the appropriate design was used to produce inventory or other property held for sale to customers, then the research costs were recovered by an adjustment to basis at the time the tangible property was used, sold, placed in service, or otherwise disposed of by the taxpayer. Where, however, projects were not abandoned and a useful life could not be definitely determined, taxpayers had no means of amortizing research expenditures. *See* H.R. Rep. No.1337, 83d Cong., 2d Sess. 28 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 33 (1954). Congress addressed this issue by enacting section 174, which allows taxpayers to either currently deduct research or experimental expenditures as they are paid or incurred or treat them as deferred expenses amortizable over a period not less than 60 months. *See* sections 174(a) and (b). Section 174 does not define the phrase "research or experimental expenditures."

In 1957, the IRS published T.D. 6255 (the 1957 Regulations) and adopted §1.174–2(a)(1), which defines the phrase "research or experimental expenditures" as expenditures "which represent research and development costs in the experimental or laboratory sense." In 1994, the IRS published T.D. 8562, which adopted amendments to § 1.174–2(a)(1). The amendments clarified the 1957 Regulations by providing that the determination of whether costs qualify as research or experimental expenditures under section 174 depends upon whether the costs are incident to activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Applying this general rule, costs relating to the production of a product after the uncertainty relating to the development or improvement of the product is eliminated do not qualify under section 174.

Section 174(c)—Depreciable Property

Since its enactment in 1954, section 174(c) has provided, in relevant part, that section 174 shall not apply to any expenditure for the acquisition or improvement of land, or for the acquisition or improvement of property to be used in connection with the research or experimentation and of a character that is subject to the allowance under section 167, relating to depreciation, or section 611, relating to depletion, except that allowances under sections 167 and 611 will be considered as expenditures.

Consistent with the statute, the 1957 Regulations provided that expenditures for the acquisition or improvement of property that is subject to an allowance for depreciation or depletion were not deductible under section 174 in the year of the acquisition or improvement. Section 1.174–2(b)(1). However, in accordance with section 174(c), the 1957 Regulations treated depreciation deductions as section 174 expenditures to the extent that the property to which the allowances related was used in connection with research and experimentation. Section 1.174–2(b)(1).

The 1957 Regulations further provided that expenditures could qualify as research or experimental expenditures even if those expenditures resulted, as an end product of the research and experimentation, in depreciable property to be used in the taxpayer's trade or business. Section 1.174–2(b)(4). However, the 1957 Regulations attempted to make clear that costs resulting in depreciable property were nonetheless required to meet the general requirement for section 174 treatment, namely, that amounts so expended must be for research and experimentation (within the meaning of §1.174–2(a)(1) of the 1957 Regulations).

To that end, the 1957 Regulations provided, in relevant part, that amounts expended for research or experimentation do not include the costs of the component materials of depreciable property, the costs of labor or other elements involved in its construction and installation, or costs attributable to the acquisition or improvement of the property. Section 1.174–2(b)(4). The 1957 Regulations provide an example where a taxpayer undertakes to develop a new machine for use in the taxpayer's business. The taxpayer expends $30,000 on the project of which $10,000 represents the actual costs of material, labor, etc., to construct the machine, and $20,000 represents research costs that are not attributable to the machine itself. The example concludes that under section 174(a) the taxpayer would be permitted to deduct the $20,000 as expenses not chargeable to capital account, but the $10,000 must be charged to the asset account (the machine). Section 1.174–2(b)(4). This preamble refers to the rules in §1.174–2(b)(1) and §1.174–2(b)(4) as the "Depreciable Property Rule." The Depreciable Property Rule has remained unchanged from the rule's adoption in the 1957 Regulations.

Explanation of Provisions and Summary of Provisions

This document contains proposed amendments to 26 CFR part 1 under section 174. First, these proposed regulations provide that if expenditures qualify as research or experimental expenditures, it is irrelevant whether a resulting product is ultimately sold or used in the taxpayer's trade or business. Second, these proposed regulations provide that the Depreciable Property Rule contained in §1.174–2(b)(4) is an application of the general definition of research and experimental expenditures contained in §1.174–2(a)(1) to depreciable property. Third, these proposed regulations define the term "pilot model." Fourth, these proposed regulations clarify the general rule that the costs of producing a product after uncertainty concerning the development or improvement of a product is eliminated are not eligible expenses under section 174 because these costs are not for research or experimentation. Finally, these proposed regulations provide a "shrinking-back" provision, similar to the rule provided for in §1.41–4(b)(2), to address situations in which the requirements of §1.174–2(a)(1) are met with respect to only a component part of a larger product and are not met with respect to the overall product itself.

In general

Questions have been raised concerning whether the sale of a product resulting from otherwise qualifying research or experimental expenditures subsequently disqualifies those expenditures from section 174 treatment. Specifically, it has been argued that section 174(c) precludes section 174 treatment in the case of a subsequent sale of a resulting product to a customer, because the sale gives rise to depreciable property in the hands of the customer. *See T.G. Missouri Company v. Commissioner*, 133 T.C. 278 (2009) (rejecting the Commissioner's argument that research or experimental expenditures were disqualified under section 174 because the product resulting from research was sold to customers and was subject to depreciation in the customers' hands).

The IRS and the Treasury Department believe that an interpretation of the Depreciable Property Rule that creates an override to section 174 eligibility upon the occurrence of a subsequent event (such as a sale of a resulting product or its use in the taxpayer's trade or business) does not further the Congressional purpose of resolving accounting uncertainties and encouraging business investment in research because taxpayers may not be able to know whether an expenditure was section 174 eligible at the time the expense is paid or incurred.

Instead, the IRS and the Treasury Department believe that the Depreciable Property Rule accomplishes two things. First, to the extent that land or depreciable property is used in connection with research or experimentation, the rule limits the amount that a taxpayer can treat as an eligible section 174 expense to depletion or depreciation deductions. Second, the Depreciable Property Rule in §1.174–2(b)(4) reiterates that the only expenditures related to the production of depreciable property that are deductible section 174 expenditures are amounts expended for research or experimentation. Thus, for example, where a $30,000 total cost expended on a machine includes $20,000 of research-related labor and materials and, after all uncertainties related to the machine are resolved, $10,000 of construction-related labor and materials, the $10,000 of construction-related labor and materials is not a section 174 expenditure because that cost was not a research or experimental cost within the meaning of §1.174–2(a).

Consistent with this interpretation, the IRS and the Treasury Department propose the following revisions to the current regulations and provide additional examples to further administration of the statute.

First, to counter an interpretation that section 174 eligibility can be reversed by a subsequent event, the proposed regulations provide that the ultimate success, failure, sale, or other use of the research or property resulting from research or experimentation is not relevant to a determination of eligibility under section 174.

Second, the proposed regulations amend §1.174–2(b)(4) to provide that the Depreciable Property Rule is an application of the general definition of research or experimental expenditures provided for in §1.174–2(a)(1) and should not be applied to exclude otherwise eligible expenditures.

Third, the proposed regulations define the term “pilot model” as any representation or model of a product that is produced to evaluate and resolve uncertainty concerning the product during the development or improvement of the product. The term includes a fully-functional representation or model of the product or a component of a product (to the extent the “shrinking-back” provision, described in this preamble, applies).

Fourth, the proposed regulations clarify the general rule that the costs of producing a product after uncertainty concerning the development or improvement of a product is eliminated are not eligible under section 174 because these costs are not for research or experimentation.

Finally, the proposed regulations provide a “shrinking-back” provision, similar to the rule provided in §1.41–4(b)(2), to address situations in which the requirements of §1.174–2(a)(1) are met with respect to only a component part of a larger product and are not met with respect to the overall product itself.

The proposed regulations provide new examples applying the foregoing provisions.

Shrinking-back rule

As with business components under section 41, research or experimental expenditures may relate only to one or more components of a larger product. Taxpayers may refine the design of the product, or even redesign components of the product, after production of the product has begun, particularly in the case of a large tangible asset made up of numerous individual components. In these situations, although a basic design specification of the product may be established, amounts paid to eliminate uncertainty regarding the appropriate design of certain components of the product continue to qualify under section 174. For example, the design of an automobile may be certain except for the appropriateness of design of its braking system. The IRS and the Treasury Department believe that it is inappropriate to deny section 174 eligibility with respect to the development and design of the braking system simply because there is not uncertainty with respect to the automobile’s general design. Accordingly, these proposed regulations provide a shrinking-back rule to ensure that section 174 eligibility is preserved in these instances. The IRS and the Treasury Department intend for this rule to be applied and administered in a manner that is consistent with the principles underlying the shrinking-back rule in §1.41–4(b)(2). Thus, for example, the shrinking-back rule applies only if the requirements of section 174 are not met with respect to an overall product (as defined in §1.174–2(a)(1)), and the shrinking-back rule is not itself applied to exclude research or experimental expenditures from section 174 eligibility.

Recordkeeping for section 174

The IRS and the Treasury Department note that the rules generally applicable under section 6001 provide sufficient detail about required documentary substantiation for purposes of section 174. Section 1.6001–1(a) requires the keeping of records sufficient to establish the amount of deductions. The IRS may deny a deduction for failure to provide sufficient records substantiating the claimed deduction.

Proposed effective date

These regulations are proposed to apply to any taxable year ending on or after the date of publication of a Treasury decision adopting these rules as final regulations in the *Federal Register*. Notwithstanding the prospective effective date, the IRS will not challenge return positions consistent with these proposed regulations. Therefore, taxpayers may rely on these proposed regulations until the date that the final regulations are published 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, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been 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 Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments will be available for public inspection and copying.

A public hearing has been scheduled for January 8, 2014, beginning at 10 a.m. in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, N.W., 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 written or electronic comments by December 5, 2013 and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by December 5, 2013. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is David McDonnell of the

Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

* * * * *

Proposed Amendments to the Regulations

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

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

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

Par. 2. Section 1.174–2 is amended as follows:

1. Amending paragraph (a)(1) by adding a heading and adding two sentences at the end.

2. Redesignating paragraph (a)(2) as paragraph (a)(3) and adding a heading to newly designated paragraph (a)(3).

3. Adding paragraph (a)(2).

4. Removing paragraph (a)(7).

5. Redesignating paragraphs (a)(8) and (a)(9) as paragraphs (a)(10) and (a)(11), respectively, and adding headings to newly designated paragraphs (a)(10) and (a)(11).

6. Redesignating paragraphs (a)(3) through (a)(6) as paragraphs (a)(6) through (a)(9), respectively, and adding headings to newly designated paragraphs (a)(6) through (a)(9).

7. Adding paragraphs (a)(4) and (a)(5).

8. Amending newly designated paragraph (a)(7) by removing the language "(a)(3)(i)" and adding "(a)(6)(i)" in its place.

9. Amending newly designated paragraph (a)(9) by removing the language "(a)(6)" and adding "(a)(9)" in its place.

10. Amending newly designated paragraph (a)(11) by removing the language "subparagraph (2) of this paragraph" and adding "this paragraph (a)" in its place.

11. Amending Example 2 in newly designated paragraph (a)(11) by removing the language "X" and adding "S" in its place everywhere "X" appears and by removing the language "Y" and adding "T" in its place everywhere "Y" appears.

12. Amending newly designated paragraph (a)(11) by adding *Example 3* through *Example 9*.

13. Adding headings to paragraphs (b)(1) through (b)(3).

14. Revising paragraph (b)(4).

15. Adding paragraph (b)(5).

16. Adding paragraph (d).

The revisions and additions read as follows:

§1.174–2 Definition of research and experimental expenditures.

(a) *In general*. (1) *Research or experimental expenditures defined*. * * * The ultimate success, failure, sale, or use of the product is not relevant to a determination of eligibility under section 174. Costs may be eligible under section 174 if paid or incurred after production begins but before uncertainty concerning the development or improvement of the product is eliminated.

(2) *Production costs*. Except as provided in paragraph (a)(5) of this section (shrinking-back rule), costs paid or incurred in the production of a product after the elimination of uncertainty concerning the development or improvement of the product are not eligible under section 174.

(3) *Product defined*. * * *

(4) *Pilot model defined*. For purposes of this section, the term *pilot model* means any representation or model of a product that is produced to evaluate and resolve uncertainty concerning the product during the development or improvement of the product. The term includes a fully-functional representation or model of the product or, to the extent paragraph (a)(5) of this section applies, a component of the product.

(5) *Shrinking-back rule*. If the requirements of paragraph (a)(1) of this section are not met at the level of a product (as defined in paragraph (a)(3) of this section), then whether expenditures represent research and development costs is determined at the level of the component or subcomponent of the product. The presence of uncertainty concerning the development or improvement of certain components of a product does not necessarily indicate the presence of uncertainty concerning the development or improvement of other components of the product or the product as a whole. The rule in this paragraph (a)(5) is not itself applied as a reason to exclude research or experimental expenditures from section 174 eligibility. The rule in this paragraph (a)(5) is to be applied and administered in a manner that is consistent with the principles underlying the shrinking-back rule in §1.41–4(b)(2).

(6) *Research or experimental expenditures—exclusions*. * * *

(7) *Quality control testing*. * * *

(8) *Expenditures for literary, historical, or similar research—cross reference*. * * *

(9) *Research or experimental expenditures limited to reasonable amounts*. * * *

(10) *Amounts paid to others for research or experimentation*. * * *

(11) *Examples*. * * *

Example 3. U is engaged in the manufacture and sale of custom machines. U contracts to design and produce a machine to meet a customer's specifications. Because U has never designed a machine with these specifications, U is uncertain regarding the appropriate design of the machine, and particularly whether features desired by the customer can be designed and integrated into a functional machine. U incurs a total of $31,000 on the project. Of the $31,000, U incurs $10,000 of costs on materials and labor to produce a model that is used to evaluate and resolve the uncertainty concerning the appropriate design. U also incurs $1,000 of costs using the model to test whether certain features can be integrated into the design of the machine. This $11,000 of costs represents research and development costs in the experimental or laboratory sense. After uncertainty is eliminated, U incurs $20,000 to produce the machine for sale to the customer based on the appropriate design. The model produced and used to evaluate and resolve uncertainty is a pilot model within the meaning of paragraph (a)(4) of this section. Therefore, the $10,000 incurred to produce the model and the $1,000 incurred on design testing activities qualifies as research or experimental expenditures under section 174. However, section 174 does not apply to the $20,000 that U incurred to produce the machine for sale to the customer based on the appropriate design. See paragraph (a)(2) of this section (relating to production costs).

Example 4. Assume the same facts as *Example 3*, except that during a quality control test of the machine, a component of the machine fails to function due to the component's inappropriate design. U incurs an additional $8,000 (including design retesting) to reconfigure the component's design. The $8,000 of costs represents research and development costs in the experimental or laboratory sense. After the elimination of uncertainty regarding the appropriate design of the component, U incurs an additional $2,000 on its production. The reconfigured component produced and used to evaluate and resolve uncertainty with respect to the component is a pilot model within the meaning of paragraph (a)(4) of this section. Therefore, in addition to the $11,000 of research and experimental expenditures previously incurred, the $8,000 incurred on design activities to establish the appropriate design of the component qualifies as research or experimental expenditures under section 174. However, section 174 does not apply to the additional $2,000 that U incurred for the production after the elimination of uncertainty of the re-designed component based on the appropriate design or to the $20,000 previously incurred to produce the machine. See paragraph (a)(2) of this section (relating to production costs).

Example 5. V is a manufacturer that designs a new product. V incurs $5,000 to produce several models of the product that are to be used in testing the appropriate design before the product is mass-produced for sale. The $5,000 of costs represents research and development costs in the experimental or laboratory sense. Multiple models are necessary to test the design in a variety of different environments (exposure to extreme heat, exposure to extreme cold, submersion, and vibration). Upon completion of several years of testing, V enters into a contract to sell one of the models to a customer, and uses another model in its trade or business. The remaining models were rendered inoperable as a result of the testing process. Because V produced the models to resolve uncertainty regarding the appropriate design of the product, the models are pilot models under paragraph (a)(4) of this section. Therefore, the $5,000 that V incurred in producing the models qualifies as research or experimental expenditures under section 174. See also paragraph (a)(1) of this section (ultimate use is not relevant).

Example 6. W wants to improve a machine for use in its trade or business and incurs $20,000 to develop a new component for the machine. The $20,000 is incurred for engineering labor and materials to produce a model of the new component that is used to eliminate uncertainty regarding the development of the new component for the machine. The $20,000 of costs represents research and experimental costs in the experimental or laboratory sense. After W completes its research and experimentation on the new component, W incurs $10,000 for materials and labor to produce the component and incorporate it into the machine. The model produced and used to evaluate and resolve uncertainty with respect to the new component is a pilot model within the meaning of paragraph (a)(4) of this section. Therefore, the $20,000 incurred to produce the model and eliminate uncertainty regarding the development of the new component qualifies as research or experimental expenditures under section 174. However, section 174 does not apply to the $10,000 of production costs of the component because those costs were not incurred for research or experimentation. See paragraph (a)(2) of this section (relating to production costs).

Example 7. X is a manufacturer of aircraft. X is researching and developing a new, experimental aircraft that can take off and land vertically. To evaluate and resolve uncertainty during the development or improvement of the product and test the appropriate design of the experimental aircraft, X produces a working aircraft at a cost of $5,000,000. The $5,000,000 of costs represents research and development costs in the experimental or laboratory sense. In a later year, X sells the aircraft. Because X produced the aircraft to resolve uncertainty regarding the appropriate design of the product during the development of the experimental aircraft, the aircraft is a pilot model under paragraph (a)(4) of this section. Therefore, the $5,000,000 of costs that X incurred in producing the aircraft qualifies as research or experimental expenditures under section 174. Further, it would not matter if X sold the pilot model or incorporated it in its own business as a demonstration model. See paragraph (a)(1) of this section (ultimate use is not relevant).

Example 8. Y is a manufacturer of aircraft engines. Y is researching and developing a new type of compressor blade, a component of an aircraft engine, to improve its existing aircraft engine design's performance. To test the appropriate design of the new compressor blade and evaluate the impact of fatigue on the design, Y produces and installs the compressor blade on an aircraft engine produced by Y. The costs of producing and installing the compressor blade component that Y incurred represent research and development costs in the experimental or laboratory sense. Because Y produced the compressor blade component to resolve uncertainty regarding the appropriate design of the component, the component is a pilot model under paragraph (a)(4) of this section. Therefore, the costs that Y incurred to produce and install the component qualify as research or experimental expenditures under section 174. See paragraph (a)(5) of this section (shrinking-back rule). However, section 174 does not apply to Y's costs of producing the aircraft engine on which the component was installed. See paragraph (a)(2) of this section (relating to production costs).

Example 9. Z is a wine producer. Z is researching and developing a new wine production process that involves the use of a different method of crushing the wine grapes. In order to test the effectiveness of the new method of crushing wine grapes, Z incurs $2,000 in labor and materials to conduct the test on this part of the new manufacturing process. The $2,000 of costs represents research and development costs in the experimental or laboratory sense. Therefore, the $2,000 incurred qualifies as research or experimental expenditures under section 174 because it is a cost incident to the development or improvement of a component of a process.

(b) * * * (1) *Land and other property*. * * *

(2) *Expenditure resulting in depreciable property*. * * *

(3) *Amounts paid to others for research or experimentation resulting in depreciable property*. * * *

(4) *Deductions limited to amounts expended for research or experimentation*. The deductions referred to in paragraphs (b)(2) and (3) of this section for expenditures in connection with the acquisition or production of depreciable property to be used in the taxpayer's trade or business are limited to amounts expended for research or experimentation within the meaning of section 174 and paragraph (a) of this section.

(5) *Examples*. The application of paragraph (b) of this section may be illustrated by the following examples:

Example 1. X is a tool manufacturer. X has developed a new tool design, and orders a specially-built machine from Y to produce X's new tool. The machine is built upon X's order and at X's risk, and Y does not provide a guarantee of economic utility. There is uncertainty regarding the appropriate design of the machine. Under X's contract with Y, X pays $15,000 for Y's engineering and design labor, $5,000 for materials and supplies used to develop the appropriate design of the machine, and $10,000 for Y's machine production materials and labor. The $15,000 of engineering and design labor costs and the $5,000 of materials and supplies costs represent research and development costs in the experimental or laboratory sense. Therefore, the $15,000 X pays Y for Y's engineering and design labor and the $5,000 for materials and supplies used to develop the appropriate design of the machine are for research or experimentation under section 174. However, section 174 does not apply to the $10,000 of production costs of the machine because those costs were not incurred for research or experimentation. See paragraph (a)(2) of this section (relating to production costs) and paragraph (b)(4) of this section (limiting deduction to amounts expended for research or experimentation).

Example 2. Z is an aircraft manufacturer. Z incurs $5,000,000 to construct a new test bed that will be used in the development and improvement of Z's aircraft. No portion of Z's $5,000,000 of costs to construct the new test bed represent research and development costs in the experimental or laboratory sense to develop or improve the test bed. Because no portion of the costs to construct the new test bed were incurred for research or experimentation, the $5,000,000 will be considered an amount paid or incurred in the production of depreciable property to be used in the taxpayer's trade or business that are not allowable under section 174. However, the allowances for depreciation of the test bed are considered research and experimental expenditures of other products, for purposes of section 174, to the extent the test bed is used in connection with research or experimentation of other products. See paragraph (b)(1) of this section (depreciation allowances may be considered research or experimental expenditures).

Example 3. Assume the same facts as *Example 2*, except that $50,000 of the costs of the test bed relates to costs to resolve uncertainties regarding the new test bed design. The $50,000 of costs represents research and development costs in the experimental or laboratory sense. Because $50,000 of Z's costs to construct the new test bed was incurred for research and experimentation, the costs qualify as research or experimental expenditures under section 174. Paragraph (b)(2) of this section applies to $50,000 of Z's costs for the test bed because they are expenditures for research or experimentation that result in depreciable property to be used in the taxpayer's trade or business. Z's remaining $4,950,000 of costs is not allowable under section 174 because these costs were not incurred for research or experimentation.

* * * * *

(d) *Effective date*. These amendments to paragraphs (a) and (b) of this section apply to taxable years ending on or after the date the final regulations are published in the *Federal Register*. Notwithstanding the prospective effective date, the IRS will not challenge return positions consistent with these proposed regulations. Therefore, taxpayers may rely on these proposed regulations until the date that the final regulations are published in the *Federal Register*.

Beth Tucker,
Deputy Commissioner for Operations Support.

(Filed by the Office of the Federal Register on September 5, 2013, 8:45 a.m., and published in the issue of the Federal Register for September 6, 2013, 78 F.R. 54796)

Notice of Proposed Rulemaking

Limitations on the Importation of Net Built-In Losses

REG–161948–05

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under sections 334(b)(1)(B) and 362(e)(1) of the Internal Revenue Code of 1986 (Code). The proposed regulations apply to certain nonrecognition transfers of loss property to corporations that are subject to Federal income tax. The proposed regulations affect the corporations receiving the loss property. This document also invites comments from the public regarding these proposed regulations.

DATES: Written or electronic comments and a request for a public hearing must be received by December 9, 2013.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG 161948–05), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–161948–05), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the Federal eRulemaking Portal at *www.regulations.gov* (IRSREG–161948–05).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, John P. Stemwedel (202) 622-7550 or Theresa A. Abell (202) 622-7000, and, concerning submissions of comments and requests for a public hearing, Oluwafunmilayo (Funmi) Taylor at (202) 622-7180 (not toll free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking revises a collection of information approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-2019. Comments on the revised 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, D.C. 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, D.C. 20224. Comments on the collection of information should be received by October 15, 2013. Comments are specifically requested concerning:

Whether the proposed revised collection of information is necessary for the proper performance of the functions of the **Internal Revenue Service**, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information;

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 service to provide information.

The revised collection of information in these proposed regulations is in §§1.332–6, 1.351–3, and 1.368–3. By requiring that taxpayers separately report the fair market value and basis of property (including stock) described in section 362(e)(1)(B) and in 362(e)(2)(A) that is transferred in a tax-free transaction, this revised collection of information aids in identifying transactions within the scope of sections 334(b)(1)(B), 362(e)(1), and 362(e)(2) and thereby facilitates the IRS' verification that taxpayers are complying with sections 334(b)(1)(B), 362(e)(1), and 362(e)(2). The respondents will be corporations and their shareholders.

Revised estimated total annual reporting burden: 375,000 hours.

Revised estimated average annual burden hours per respondent: 1.25 hours.

Estimated number of respondents: 225,000 (of the originally estimated 350,000; original 0.75 hour estimate unchanged for the remaining 125,000 respondents).

Estimated frequency of responses: once.

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

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 section 6103.

Background

Sections 334(b)(1)(B) and 362(e)(1) (the anti-loss importation provisions) were enacted in the American Jobs Creation Act of 2004 (Public Law 108–357, 188 Stat. 1418 (2004)) to prevent erosion of the corporate tax base through the importation of loss in nonrecognition transfers. This notice of proposed rulemaking proposes regulations under both of these anti-loss importation provisions.

Explanation of provisions

1. *The Anti-loss Importation Provisions: Sections 334(b)(1)(B) and 362(e)(1)*

Section 334(b)(1)(B) applies to corporate acquisitions of loss property in liquidations described in section 332 (complete liquidation of subsidiary). Section 362(e)(1) applies to corporate acquisitions of loss property in transactions described in section 362(a) (transactions to which section 351 applies and acquisitions of property as paid-in surplus or contributions to capital, each a section 362(a) transaction) and in transactions described in section 362(b) (reorganizations). The application and effect of the anti-loss importation provisions are materially identical, and so the proposed regulations use the same nomenclature and operating rules for both anti-loss importation provisions.

The anti-loss importation provisions apply when a corporation acquires property that is described in section 362(e)(1)(B) in a transaction described in section 332, 362(a), or 362(b), and, under the generally applicable basis rules (other than the anti-loss duplication rule in section 362(e)(2)), the acquiring corporation (Acquiring) would take the property with an aggregate basis in excess of "value" (generally equal to fair market value under the proposed regulations; see paragraph 1.b.ii. of this preamble). When an anti-loss importation rule applies, Acquiring's basis in each such property is equal to the property's value. To the extent Acquiring receives property in the transaction that is not subject to the anti-loss importation rules, Acquiring's basis in the property is determined under generally applicable basis rules, including section 362(e)(2).

Property is described in section 362(e)(1)(B) (designated "importation property" in the proposed regulations) if two conditions are satisfied. First, any gain or loss recognized on a disposition of the property would not be subject to Federal income tax in the hands of the transferor immediately before the transfer. Section 362(e)(1)(B)(i). Second, any gain or loss recognized on a disposition of the property would be subject to Federal income tax in the hands of the transferee immediately after the transfer. Section 362(e)(1)(B)(ii).

Since the enactment of the anti-loss importation provisions, a number of questions have arisen concerning their application. The principal concern has been the determination of whether property is importation property, but various other questions (discussed subsequently in this preamble) have also been raised regarding the application of the anti-loss importation provisions and their interaction with other rules of law. To address these issues, the proposed regulations provide a framework for identifying importation property and determining whether the transfer of the property is a transaction subject to the anti-loss importation provisions (designated a "loss importation transaction" under the proposed regulations).

a. *Importation property*

The proposed regulations use a hypothetical sale analysis to identify importation property. Under this approach, the actual tax treatment of any gain or loss that would be recognized on a sale of the property, first by the transferor immediately before and then by Acquiring immediately after the transfer, determines whether an individual property is importation property. If any gain or loss that would be recognized on a hypothetical sale of the property by the transferor immediately before the transfer would not be subject to Federal income tax in the hands of the transferor, the first condition for classification as importation property is satisfied. If any gain or loss that would be recognized on a hypothetical sale of the property by Acquiring immediately after the transfer would be subject to Federal income tax in the hands of Acquiring, the second condition for classification as importation property is satisfied. Property is importation property only if both conditions are satisfied.

In general, the determination is made by reference to the tax treatment of the hypothetical seller of the transferred or acquired property, that is, whether the hypothetical seller would take the gain or loss into account in determining its Federal income tax liability. This determination must take into account all relevant facts and circumstances. The proposed regulations include a number of examples illustrating this approach. Thus, in one example, a tax-exempt entity transfers property to a taxable domestic corporation, and the determination takes into account whether the transferor, though generally tax-exempt, would nevertheless be required to include the amount of the gain or loss in unrelated business taxable income under sections 511 through 514 of the Code. In other examples, a foreign corporation transfers property to a taxable domestic corporation and the determination takes into account whether the foreign corporation would be required to include the amount of gain or loss under section 864 or 897 as income effectively connected with, or treated as effectively connected with, the conduct of a U.S. trade or business. Although the examples assume there is no applicable income tax treaty, in the case of an applicable income tax treaty, the determination of whether property is importation property would take into account whether the transferor would be taxable under the business profits article or gains article of the income tax treaty.

i. *Partnerships, S corporations, grantor trusts as hypothetical seller*

Although the general rule in the proposed regulations looks solely to the tax treatment of the hypothetical seller, a modified rule applies if a hypothetical seller is a partnership, a small business corporation that has elected under section 1362(a) to be an S corporation, or a grantor trust. In these cases, the determination is made by reference to the tax treatment of the gain or loss as taken into account by the partners, shareholders, or owners of the entities. The modified rule recognizes that, in these cases, the Code provides that the gain or loss on the hypothetical sale would be included by the partner, shareholder, or owner, and would not be taxable to the hypothetical seller, irrespective of whether any amount is actually distributed to such other person. See section 701 (partnership not subject to tax), flush language in section 362(e)(1)(B) (partners treated as owning partnership property); sections 1363 and 1366 (S corporation's income generally taxable to shareholders, not S corporation); section 671 (grantor or other person treated as owning trust property).

If an organizing instrument assigns gain and loss to partners or beneficiaries in different amounts, including by reason of a special allocation under a partnership agreement, the proposed regulations make clear that the hypothetical sale model makes the determination of whether gain or loss is subject to Federal income tax by reference to the person to whom, under the terms of the instrument, the hypothetical gain or loss would actually be allocated, taking into account the entity's net gain or loss actually recognized in the tax period in which the transaction occurs.

ii. *Other pass-through entities: anti-avoidance rule*

In certain circumstances, the Code permits distributions to effect a similar shifting of tax consequences. For example, under sections 651 and 652, and sections 661 and 662, distributions made by a trust are deducted from the trust's income and included in the beneficiary's (or beneficiaries') income. Certain domestic corporations are also able to shift tax consequences by distributing income or gain from a property sale. These corporations include regulated investment companies (RICs, as defined in section 851(a)), real estate investment trusts (REITs, as defined in section 856(a)), and domestic corporations taxable as cooperatives (see section 1381).

The IRS and the Treasury Department are concerned that disregarding the effects of this shifting of tax liability would in certain circumstances undermine the anti-importation provisions. However, the IRS and the Treasury Department are also concerned that applying a look-through rule in all such cases would present a significant administrative burden.

Accordingly, the proposed regulations contain an anti-avoidance rule that applies to domestic trusts, estates, RICs, REITs, and cooperatives that directly or indirectly transfer property (including through other such entities) in a section 362 transaction, if the property had been directly or indirectly transferred to or acquired by the entity as part of a plan to avoid the application of the anti-importation provisions. For purposes of this rule, it is immaterial who had the plan to avoid the anti-importation provisions. When the anti-avoidance rule applies, the domestic entity, which, absent application of the anti-avoidance rule, would be treated under these regulations as subject to Federal income tax, is treated as subject to a look-through rule. Under the look-through rule, the entity is presumed to distribute the proceeds of the hypothetical sale (which, for this purpose, are presumed to be an amount greater than zero), and, to the fullest extent permitted by the terms of its organizing instrument, it is presumed to make the distributions to persons that would not take distributions from the entity into account in determining a Federal income tax liability. If an interest in such an entity is held indirectly through one or more other such entities, the principles of this rule apply to look to the ultimate owners of the interest. The determination of whether the property is importation property is then made by reference to the deemed distributees or, in the case of tiered entities, to the ultimate deemed distributees.

To illustrate, assume 90 percent of a REIT's shares are owned by persons that would not take into account any gain or loss in determining a Federal income tax liability and that each share has an equal right to any distribution by the REIT. The REIT holds property that was transferred to the REIT as part of a plan to avoid the application of the anti-importation rule to a section 362 transaction. At a time when the acquired property has a built-in loss, the REIT transfers the property to a domestic corporation in a section 362 transaction. In this case, the anti-avoidance rule would apply. Thus, the REIT is presumed to distribute all the proceeds of the hypothetical sale of the property transferred in the section 362 transaction, and the determination of whether any gain or loss on that hypothetical sale would be taken into account in determining a Federal income tax liability is made by reference to the distributee REIT shareholders. Thus, 90 percent of the property transferred in the section 362 transaction would be importation property. Alternatively, assume that the property was originally acquired (as part of a plan to avoid the application of the anti-importation rule to a section 362 transaction) by a trust whose trustee has discretion to distribute all or a portion of the trust's gain or loss to a person that would not take any amount of such distribution into account in determining a Federal income tax liability and, when the property has a built-in loss, the trust transfers the property to a domestic corporation in a section 362 transaction. In this case, all of the property transferred in the section 362 transaction would be importation property because the trustee could distribute all of the proceeds from the hypothetical sale to a person that would not take the distribution into account in determining a Federal income tax liability.

The IRS and the Treasury Department continue to study whether a look-through approach should be generally applied to trusts and request comments on the need for, and potential scope of, such a rule.

iii. *Gain or loss affecting certain income inclusions*

Practitioners have raised numerous questions regarding the treatment of property held by or transferred to controlled foreign corporations (CFC), as defined in section 957 (taking into account section 953(c)). Because the general rule looks to the tax treatment of the hypothetical seller, and no exception applies for CFCs, the general operation of the proposed regulations would not treat such amounts as subject to Federal income tax. Nevertheless, because the characterization of gain or loss that would be taken into account in determining a potential income inclusion under section 951(a) has generated some concern among practitioners, the proposed regulations include an express provision stating that gain or loss recognized by a CFC is not considered subject to Federal income tax solely by reason of an income inclusion under section 951(a). The proposed regulations include a similar provision to clarify that gain or loss recognized by a passive foreign investment company, as defined in section 1297(a), is also considered not subject to Federal income tax notwithstanding that it could affect an inclusion under section 1293(a). Comments are specifically requested on this approach.

iv. *Gain or loss taxed to more than one person*

If any gain or loss realized on a hypothetical sale would be includible in income by more than one person, the proposed regulations treat such property as tentatively divided into separate portions in proportion to the allocation of gain or loss to each person. Tentatively divided portions are treated and analyzed in the same manner as any other property for purposes of applying the anti-importation provisions. (See paragraph c. of this preamble for an illustration of the application of this rule.) Thus, the generally applicable rules determine whether a portion of tentatively divided property is importation property, and, if the tentatively divided portion is importation property, it is taken into account (as described subsequently in this preamble) with all other importation property to determine whether the transaction is a loss importation transaction.

b. *Loss importation transaction*

Once the importation property has been identified, Acquiring determines the aggregate basis that it would have in all importation property acquired in the transaction (including the tentatively divided portions of transferred property), without regard to the anti-loss importation provisions or section 362(e)(2). If the aggregate basis of the importation property exceeds such property's aggregate value, the transaction is a loss importation transaction and subject to the anti-loss importation provisions. If the aggregate basis of importation property does not exceed such property's value, the anti-loss importation provisions have no further application.

i. *Aggregate, not transferor-by-transferor, approach*

Under section 362(e)(1) and the proposed regulations, the determination of whether a section 362 transaction is a loss importation transaction is made by reference to the net amount of built-in gain and built-in loss in all importation property acquired from all transferors in the transaction. This approach differs from the transferor-by-transferor approach of section 362(e)(2), which expressly focusses on the net built-in loss transferred by a particular transferor in a section 362(a) transaction.

ii. *Valuing partnership interests*

In general, the anti-loss importation rules do not take liabilities into account in determining the value of transferred property and, thus, whether the transfer of such property is a transfer of loss property.

However, in both informal inquiries and written comments, practitioners have raised concerns about the effect of this rule when the property transferred is an interest in a partnership with liabilities. In particular, practitioners are concerned that the inclusion of a partner's share of partnership liabilities in outside basis may create the appearance of a built-in loss because partnership liabilities do not correspondingly increase the value of the interest. The amount of cash at which the partnership interest would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts, should reflect the appropriate measure of fair market value. When a partnership interest is sold, the amount realized may include a share of partnership liabilities from which the transferor is discharged, which is generally equal to the amount of liabilities included in the transferor's outside basis. As such, the sale of a partnership interest properly accounts for the transferee partner's share of partnership liabilities and therefore, reflects the value of that partnership interest.

To address this issue, the proposed regulations generally adopt the approach proposed by commentators and modify the definition of "value" (generally, fair market value) to take liabilities into account when determining whether a partnership interest is a loss asset. However, because there can be differences between Transferor's share of partnership liabilities and Acquiring's share of partnership liabilities, the proposed regulations provide that the value of a partnership interest is the sum of cash that Acquiring would receive for such interest, increased by any §1.752–1 liabilities (as defined in §1.752–1(a)(4)) of the partnership that are allocated to Acquiring with regard to such transferred interest under section 752. The proposed regulations include an example that illustrates the application and effect of this rule. The proposed regulations also clarify that any section 743(b) adjustment to be made as a result of the transaction is made after any section 362(e) basis adjustment.

c. *Acquiring's basis in acquired property*

If a transaction is a loss importation transaction, Acquiring's basis in each importation property received (including the tentatively divided portions of property determined to be importation property) is an amount equal to value, notwithstanding the general rules in sections 334(b)(1)(B), 362(a), and 362(b). This rule applies to all importation property, regardless of whether the property's value is greater or less than its basis prior to the loss importation transaction.

Immediately following the application of the anti-loss importation provisions (and prior to any application of section 362(e)(2)), any property that was treated as tentatively divided for purposes of applying these provisions ceases to be treated as divided and is treated as one undivided property (re-constituted property) with a basis equal to the sum of the bases of the portions determined under the anti-importation provision and the bases of all other portions determined under generally applicable provisions (other than section 362(e)(2)). For example, assume that property is transferred in a section 362(a) transaction and the property is treated as tentatively divided for purposes of applying section 362(e)(1) (see paragraph a.iv. of this preamble). Further assume that one tentatively divided portion (basis $125, value $100) is determined to be importation property and the other (basis $125, value $100) is not. Finally, assume that, the aggregate basis of all importation property transferred in the transaction (including the $125 basis of the tentatively divided portion) is $900 and the aggregate value of all importation property (including the $100 value of the tentatively divided portion) is only $800. Thus, the importation property has a net loss, the transaction is a loss importation transaction, and the basis of each importation property is equal to its value. Accordingly, immediately after the application of section 362(e)(1), the tentatively divided property is treated as one single property with a basis of $225 ($100 basis in the importation portion plus $125 basis in the non-importation portion).

If the transaction is described in section 362(a), the transferred property (including the re-constituted property that was tentatively divided for purposes of applying section 362(e)(1)) is then aggregated on a transferor-by-transferor basis to determine whether further adjustment will be required to the bases of loss property under section 362(e)(2). Therefore in the example in the preceding paragraph, after the application of section 362(e)(1), the provisions of section 362(e)(2) may apply to adjust the basis of the property further because the transfer is a section 362(a) transaction. The proposed regulations include a cross-reference to section 362(e)(2) as well as examples illustrating the application of both sections 362(e)(1) and section 362(e)(2) to situations involving multiple transferors and multiple properties that are not all importation properties. Because section 362(e)(2) only applies to transactions described in section 362(a), section 362(e)(2) has no application to liquidations or to reorganizations that do not include a transaction described in section 362(a). The proposed regulations include examples illustrating the interaction of these provisions.

2. *Filing Requirements*

To facilitate the administration of both the anti-loss importation provisions and the anti-duplication provisions in section 362(e)(2), the proposed regulations modify the reporting requirements applicable in all affected transactions (section 332 liquidations and transactions described in section 362(a) or section 362(b)) to require taxpayers to identify the basis and value of property subject to those sections.

3. *Modifications to Liquidation Regulations*

The proposed regulations also include several modifications to the regulations applicable to corporate liquidations. These modifications are not changes to current substantive law; they are intended solely to update the regulations to reflect certain statutory changes. The statutory changes reflected in these modifications include the repeal of the *General Utilities* doctrine (reflected in the modification of sections 334(a) and 337(a), and the repeal of sections 333 and 334(c)), the removal of former section 334(b)(2) (replaced by section 338), and the relocation of former section 332(c) (subsidiary indebtedness) to current section 337(b). In response to certain regulatory changes, the proposed regulations also add several cross-references to regulations under section 367 and 897 to highlight the treatment of certain transfers between foreign corporations.

The proposed regulations do not address the regulations under section 346 and no inference should be drawn from the omission of a proposal under that section.

Effective/applicability date

These regulations are generally proposed to apply to transactions occurring on or after the date the regulations are published as final regulations in the **Federal Register**, unless completed pursuant to a binding agreement that was in effect immediately before the date such final regulations are published and all times afterwards. It is also proposed that taxpayers would be permitted to apply the final regulations (when published) to transactions occurring after October 22, 2004.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. 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. Further, it is hereby certified that these proposed regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the collection of information requirement in these regulations modifies an existing collection of information by requiring that certain information be reported separately instead of in the aggregate. Although there may be an increase in reporting burden, the increased burden is expected to be minimal because taxpayers should have ready access to the requested information as the proposed regulations would not require taxpayers to report or maintain records on information that is not, in the aggregate, already required to be reported and maintained under the current regulations. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are timely submitted to the IRS. Alternatively, taxpayers may submit comments electronically via the Federal e-Rulemaking Portal at *www.regulations.gov* (IRS REG–161948–05). The IRS and the Treasury Department request comments on all aspects of the proposed regulations. Comments are specifically requested on the appropriate treatment of transactions subject to both section 367(b) and either section 334(b)(1)(B) or 362(e)(1). Comments are also specifically requested on what effect a basis reduction required under section 334(b)(1)(B) or section 362(e)(1) may have on earnings and profits and any inclusion required under §1.367(b)–3. All comments that are submitted by the public will be available for public inspection and copying at *www.regulations.gov* or upon request. A public hearing may be scheduled if requested in writing by any person who timely submits comments. If a public hearing is scheduled, notice of the date, time, and place of the hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is John P. Stemwedel of the Office of Associate Chief Counsel (Corporate), IRS. However, other personnel from the IRS and the 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 is amended by adding entries to read in part as follows:

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

Par. 2. Section 1.332–6 is amended by revising paragraph (a)(3) and adding a new sentence at the end of paragraph (e) to read as follows:

§1.332–6 Records to be kept and information to be filed with return.

(a) * * *

(3) The fair market value and basis of assets of the liquidating corporation that have been or will be transferred to any recipient corporation, aggregated as follows:

(i) Importation property distributed in a loss importation transaction, as defined in §1.362–3(c)(2) and (c)(3) (except that "section 332 liquidation" is substituted for "section 362 transaction"), respectively;

(ii) Property with respect to which gain or loss was recognized on the distribution;

(iii) Property not described in paragraph (a)(3)(i) or paragraph (a)(3)(ii) of this section;

* * * * *

(e) *Effective/applicability date*. * * * Paragraph (a)(3) of this section applies to any taxable year beginning on or after these regulations are published as final regulations in the **Federal Register**, unless effected pursuant to a binding agreement that was in effect prior to that date and at all times thereafter.

Par. 3. Section 1.332–7 is amended by adding a new sentence after the first sentence of the paragraph to read as follows:

§1.332–7 Indebtedness of subsidiary to parent.

* * * See section 337(b)(1) (for any taxable year beginning on or after these regulations are published as final regulations in the **Federal Register**). * * *

Par. 4. Section 1.334–1 is revised to read as follows:

§1.334–1 Basis of property received in liquidations.

(a) *In general*. Section 334 sets forth rules for determining a distributee's basis in property received in a distribution in complete liquidation of a corporation. The general rule is set forth in section 334(a) and provides that, if property is received in a distribution in complete liquidation of a corporation and if gain or loss is recognized on the receipt of the property, then the distributee's basis in the property is the fair market value of the property at the time of the distribution. However, if property is received in a complete liquidation to which section 332 applies, including property received in satisfaction of an indebtedness described in section 337(b)(1), see section 334(b)(1) and paragraph (b) of this section.

(b) *Liquidations under section 332*—(1) *General rule*. Except as otherwise provided in paragraph (b)(2) or (b)(3) of this section, if a corporation (P) meeting the ownership requirements of section 332(b)(1) receives property from a subsidiary (S) in a complete liquidation to which section 332 applies (section 332 liquidation), including property received in a transfer in satisfaction of indebtedness that satisfies the requirements of section 337(b)(1), P's basis in the property received is the same as S's basis in the property immediately before the property was distributed. However, see §1.460–4(k)(3)(iv)(B)(*2*) for rules relating to adjustments to the basis of certain contracts accounted for using a long-term contract method of accounting that are acquired in a section 332 liquidation.

(2) *Basis in property with respect to which gain or loss was recognized*. Except as otherwise provided in the Internal Revenue Code and regulations, if S recognizes gain or loss on the distribution of property to P in a section 332 liquidation, P's basis in that property is the fair market value of the property at the time of the distribution. Section 334(b)(1)(A) (certain tax-exempt distributions under section 337(b)(2)); see also, for example, §1.367(e)–2(b)(3)(i).

(3) *Basis in importation property received in loss importation transaction*—(i) *Purpose*. The purpose of section 334(b)(1)(B) and this paragraph (b)(3) is to prevent P from importing a net built-in loss in a transaction described in section 332. See paragraph (b)(3)(iii)(A) of this section for definitions of terms used in this paragraph (b)(3).

(ii) *Determination of basis*. Notwithstanding paragraph (b)(1) of this section, if a section 332 liquidation is a loss importation transaction, P's basis in each importation property received from S in the liquidation is an amount that is equal to the value of the property. The basis of property received in a section 332 liquidation that is not importation property received in a loss importation transaction is determined under generally applicable basis rules without regard to whether the liquidation also involves the receipt of importation property in a loss importation transaction.

(iii) *Operating rules*—(A) *In general*. For purposes of section 334(b)(1)(B) and this paragraph (b)(3), the provisions of §1.362–3 (basis of importation property received in a loss importation transaction) apply, adjusted as appropriate to apply to section 332 liquidations. Thus, when used in this paragraph (b)(3), the terms "importation property," "loss importation transaction," and "value" have the same meaning as in §1.362–3(c)(2), (c)(3) and (c)(4), respectively, except that "section 332 liquidation" is substituted for "section 362 transaction." Similarly, when gain or loss on property would be owned or treated as owned by multiple persons, the provisions of §1.362–3(d)(2) apply to tentatively divide the property in applying this section, substituting "section 332 liquidation" for "section 362 transaction" and making such other adjustments as necessary.

(B) *Time for making determinations*. For purposes of section 334(b)(1)(B) and this paragraph (b)(3)—

(*1*) *P's basis in distributed property*. P's basis in each property S distributes to P in the section 332 liquidation is determined immediately after S distributes each such property;

(*2*) *Value of distributed property*. The value of each property S distributes to P in the section 332 liquidation is determined immediately after S distributes the property;

(*3*) *Importation property*. The determination of whether each property distributed by S is importation property is made as of the time S distributes each such property;

(*4*) *Loss importation transaction*. The determination of whether a section 332 liquidation is a loss importation transaction is made immediately after S makes the final liquidating distribution to P.

(iv) *Examples*. The examples in this paragraph (b)(3)(iv) illustrate the application of section 334(b)(1)(B) and the provisions of this paragraph (b)(3). Unless the facts indicate otherwise, the examples use the following nomenclature and assumptions: USP is a domestic corporation that has not elected to be an S corporation within the meaning of section 1361(a)(1); FC, CFC1, and CFC2 are controlled foreign corporations within the meaning of section 957(a), which are not engaged in a U.S. trade or business, have no U.S. real property interests, and have no other relationships, activities, or interests that would cause their property to be subject to Federal income taxation; there is no applicable income tax treaty; and all persons and transactions are unrelated. All other relevant facts are set forth in the examples:

Example 1. *Basic application of this paragraph (b)(3)*. (i) *Distribution of importation property in a loss importation transaction*. (A) *Facts*. USP owns the sole outstanding share of FC stock. FC owns three assets, A1 (basis $40, value $50), A2 (basis $120, value $30), and A3 (basis $140, value $20). On Date 1, FC distributes A1, A2, and A3 to USP in a complete liquidation that qualifies under section 332.

(B) *Importation property*. Under §1.362–3(d)(2), the fact that any gain or loss recognized by a CFC may affect an income inclusion under section 951(a) does not alone cause gain or loss recognized by the CFC to be treated as taken into account in determining a Federal income tax liability for purposes of this section. Thus, if FC had sold either A1, A2, or A3 immediately before the transaction, no gain or loss recognized on the sale would have been taken into account in determining a Federal income tax liability. Further, if USP had sold A1, A2, or A3 immediately after the transaction, USP would take into account any gain or loss recognized on the sale in determining its Federal income tax liability. Therefore, A1, A2, and A3 are all importation properties. See paragraph (b)(3)(iii)(A) of this section and §1.362–3(c)(2).

(C) *Loss importation transaction*. Immediately after the distribution, USP's aggregate basis in the importation properties, A1, A2, and A3, would, but for section 334(b)(1)(B) and this section, be $300 ($40 + $120 + $140) and the properties' aggregate value would be $100 ($50 + $30 + $20). Therefore, the importation properties' aggregate basis would exceed their aggregate value and the distribution is a loss importation transaction. See paragraph (b)(3)(iii)(A) of this section and §1.362–3(c)(3).

(D) *Basis of importation property distributed in loss importation transaction*. Because the importation properties, A1, A2, and A3, were transferred in a loss importation transaction, the basis in each of the importation properties received is equal to its value immediately after FC distributes the property. Accordingly, USP's basis in A1 is $50; USP's basis in A2 is $30; and USP's basis in A3 is $20.

(ii) *Distribution of both importation and non-importation property in a loss importation transaction*. (A) *Facts*. The facts are the same as in paragraph (i)(A) of this *Example 1* except that FC is engaged in a U.S. trade or business and A3 is used in that U.S. trade or business.

(B) *Importation property*. A1 and A2 are importation properties for the reasons set forth in paragraph (i)(B) of this *Example 1*. However, if FC had sold A3 immediately before the transaction, FC would take into account any gain or loss recognized on the sale in determining its Federal income tax liability. Therefore, A3 is not importation property. See paragraph (b)(3)(iii)(A) of this section and §1.362–3(c)(2).

(C) *Loss importation transaction*. Immediately after the distribution, USP's aggregate basis in the importation properties, A1 and A2, would, but for section 334(b)(1)(B) and this section, be $160 ($40 + $120). Further, the properties' aggregate value would be $80 ($50 + $30). Therefore, the importation properties' aggregate basis would exceed their aggregate value and the distribution is a loss importation transaction. See paragraph (b)(3)(iii)(A) of this section and §1.362–3(c)(3).

(D) *Basis of importation property distributed in loss importation transaction*. Because the importation properties, A1 and A2, were transferred in a loss importation transaction, the basis in each of the importation properties received is equal to its value immediately after FC distributes the property. Accordingly, USP's basis in A1 is $50 and USP's basis in A2 is $30.

(E) *Basis of other property*. Because A3 is not importation property distributed in a loss importation transaction, USP's basis in A3 is determined under generally applicable basis rules. Accordingly, USP's basis in A3 is $140, the adjusted basis that FC had in the property immediately before the distribution. See section 334(b)(1).

(iii) *FC not wholly owned*. The facts are the same as in paragraph (i)(A) of this *Example 1* except that USP owns only 80% of the sole outstanding class of FC stock and the remaining 20% is owned by individual X. Further, on Date 1 and pursuant to the plan of liquidation, FC distributes A1 and A2 to USP and A3 to X. A1 and A2 are importation properties, the distribution to USP is a loss importation transaction, and USP's bases in A1 and A2 are equal to their value ($50 and $30, respectively) for the reasons set forth in paragraphs (ii)(C) and (ii)(D) of this *Example 1*. Under section 334(a), X's basis in A3 is $20.

(iv) *Importation property, no net built in loss*. (A) *Facts*. The facts are the same as in paragraph (i)(A) of this *Example 1* except that the value of A2 is $230.

(B) *Importation property*. A1, A2, and A3, are importation properties for the reasons set forth in (i)(B) of this *Example 1.*

(C) *Loss importation transaction*. Immediately after the distribution, USP's aggregate basis in the importation properties, A1, A2, and A3, would, but for section 334(b)(1)(B) and this section, be $300 ($40 + $120 + $140). However, the properties' aggregate value would also be $300 ($50 + $230 + $20). Therefore, the importation properties' aggregate basis would not exceed their aggregate value and the distribution is not a loss importation transaction. See paragraph (b)(3)(iii)(A) of this section and §1.362–3(c)(3).

(D) *Basis of importation property not distributed in loss importation transaction*. Because the importation properties, A1, A2, and A3, were not distributed in a loss importation transaction, the basis of each of the importation properties is determined under the generally applicable basis rules. Accordingly, immediately after the distribution, USP's basis in A1 is $40, USP's basis in A2 is $120, and USP's basis in A3 is $140, the adjusted bases that FC had in the properties immediately before the distribution. See section 334(b)(1).

(v) *CFC stock as importation property distributed in loss importation transaction*. (A) *Facts*. USP owns the sole outstanding share of FC stock. FC owns the sole outstanding share of CFC1 stock (basis $80, value $100) and the sole outstanding share of CFC2 stock (basis $100, value $5). On Date 1, FC distributes its shares of CFC1 and CFC2 stock to USP in a complete liquidation that qualifies under section 332.

(B) *Importation property*. No special rule applies to the treatment of property that is the stock of a CFC. Thus, if FC had sold either the CFC1 share or the CFC2 share immediately before the transaction, no gain or loss recognized on the sale would have been taken into account in determining a Federal income tax liability. Further, if USP had sold either the CFC1 share or the CFC2 share immediately after the transaction, USP would take into account any gain or loss recognized on the sale in determining its Federal income tax liability. Thus, the CFC1 share and the CFC2 share are importation property. See paragraph (b)(3)(iii)(A) of this section and §1.362–3(c)(2).

(C) *Loss importation transaction*. Immediately after the distribution, USP's aggregate basis in importation property (the CFC1 share and the CFC2 share) would, but for section 334(b)(1)(B) and this section, be $180 ($80 + $100) and the shares' aggregate value is $105 ($100 + $5). Therefore, the importation property's aggregate basis would exceed their aggregate value and the distribution is a loss importation transaction. See paragraph (b)(3)(iii)(A) of this section and §1.362–3(c)(3).

(D) *Basis of importation property distributed in loss importation transaction*. Because the importation property (the CFC1 share and the CFC2 share) was transferred in a loss importation transaction, USP's basis in each of the shares received is equal to its value immediately after FC distributes the shares. Accordingly, USP's basis in the CFC1 share is $100 and USP's basis in the CFC2 share is $5.

Example 2. *Multiple step liquidation*. (i) *Facts*. USP owns the sole outstanding share of FC stock.

On January 1 of year 1, FC adopts a plan of liquidation. FC makes the following distributions to USP in a transaction that qualifies as a complete liquidation under section 332. In year 1, FC distributes A1 and, immediately before the distribution, FC's basis in A1 is $100 and A1's value is $120. In Year 2, FC distributes A2, and, immediately before the distribution, FC's basis in A2 is $100 and A2's value is $120. In year 3, in its final liquidating distribution, FC distributes A3 and, immediately before the distribution, FC's basis in A3 is $100 and A3's value is $120. As of the time of the final distribution, USP had depreciated the bases of A1 and A2 to $90 and $95, respectively; the value of A1 had appreciated to $160; and, the value of A2 has declined to $0.

(ii) *Importation property*. If FC had sold either A1, A2, or A3 immediately before it was distributed, no gain or loss recognized on the sale would have been taken into account in determining a Federal income tax liability. Further, if USP had sold either A1, A2, or A3 immediately after it was distributed, USP would take into account any gain or loss recognized on the sale in determining its Federal income tax liability. Therefore, A1, A2, and A3 are all importation properties. See paragraph (b)(3)(iii)(A) of this section and §1.362–3(c)(2).

(iii) *Loss importation transaction*. Immediately after it was distributed, USP's basis in each of the importation properties, A1, A2, and A3, would, but for section 334(b)(1)(B) and this section, have been $100. Further, immediately after each such property was distributed, its value was $120. Thus, the properties' aggregate basis, $300, would not have exceeded the properties' aggregate value, $360. Accordingly, the distribution is not a loss importation transaction irrespective of the fact that, when the liquidation was completed, the properties' aggregate basis was $285 and the properties' aggregate value was $280. See paragraph (b)(3)(iii)(B) of this section and §1.362–3(c)(3).

(iv) *Basis of importation property not distributed in loss importation transaction*. Because the importation properties, A1, A2, and A3, were not distributed in a loss importation transaction, the basis of each of the importation properties is determined under the generally applicable basis rules. Accordingly, USP takes each of the properties with a basis of $100 and, immediately after the final distribution, has an adjusted basis of $90 in A1 (USP's $100 basis less the $10 depreciation), $95 in A2 (USP's $100 basis less the $5 depreciation), and $100 in A3. See section 334(b).

(c) *Effective/applicability date.* This section applies to any taxable year beginning on or after these regulations are published as final regulations in the **Federal Register**, unless effected pursuant to a binding agreement that was in effect prior to that date and at all times thereafter. However, taxpayers may apply this section to transactions occurring after October 22, 2004.

Par. 5. Section 1.337–1 is added to read as follows:

§1.337–1 Nonrecognition for property distributed to parent in complete liquidation of subsidiary.

(a) *General rule*. If section 332(a) is applicable to the receipt of a subsidiary's property in complete liquidation, no gain or loss is recognized to the liquidating subsidiary with respect to such property (including property distributed with respect to indebtedness, see section 337(b)(1) and §1.332–7), except as provided in section 337(b)(2) (distributions to certain tax-exempt distributees), section 367(e)(2) (distributions to foreign corporations), and section 897(d) (distributions of U.S. real property interests by foreign corporations).

(b) *Effective/applicability date*. This section applies to any taxable year beginning on or after these regulations are published as final regulations in the **Federal Register**.

Par. 6. Section 1.351–3 is amended by revising paragraphs (a)(3) and (b)(3), and adding a sentence at the end of paragraph (f) to read as follows:

§1.351–3 Records to be kept and information to be filed.

(a) * * *

(3) The fair market value and basis of the property transferred by such transferor in the exchange, determined immediately before the transfer and aggregated as follows:

(i) Importation property transferred in a loss importation transaction, as defined in §1.362–3(c)(2) and §1.362–3(c)(3), respectively;

(ii) Loss duplication property as defined in §1.362–4(c)(1);

(iii) Property with respect to which any gain or loss was recognized on the transfer (without regard to whether such property is also identified in paragraph (a)(3)(i) or (ii) of this section); and

(iv) Property not described in paragraphs (a)(3)(i), (a)(3)(ii), or (a)(3)(iii) of this section.

* * * * *

(b) * * *

(3) The fair market value and basis of property received in the exchange, determined immediately before the transfer and aggregated as follows:

(i) Importation property transferred in a loss importation transaction, as defined in §1.362–3(c)(2) and §1.362–3(c)(3), respectively;

(ii) Loss duplication property as defined in §1.362–4(c)(1);

(iii) Property with respect to which any gain or loss was recognized on the transfer (without regard to whether such property is also identified in paragraph (b)(3)(ii) of this section);

(iv) Property not described in paragraphs (b)(3)(i), (b)(3)(ii), or (b)(3)(iii) of this section; and

* * * * *

(f) *Effective/applicability date*. * * * Paragraphs (a)(3) and (b)(3) of this section apply to any taxable year beginning on or after these regulations are published as final regulations in the **Federal Register**, unless effected pursuant to a binding agreement that was in effect prior to that date and at all times thereafter.

Par. 7. Section 1.358–6 is amended by revising paragraphs (c)(1)(i)(A), (c)(2)(ii)(B), (c)(3)(i), (c)(3)(ii), (c)(4), (e), (f)(1), and the first sentence of paragraph (f)(3), and adding new paragraph (f)(4) to read as follows:

§1.358–6 Stock basis in certain triangular reorganizations.

* * * * *

(c) * * *

(1) * * *

(i) * * *

(A) P acquired the T assets acquired by S in the reorganization (and P assumed any liabilities which S assumed or to which the T assets acquired by S were subject) directly from T in a transaction in which P's basis in the T assets was determined under section 362(b) (taking into account the provisions of section 362(e)(1)); and

* * * * *

(2) * * *

(ii) * * *

(B) Determine the basis in the T stock acquired as if P acquired such stock from the former T shareholders in a transaction in which P's basis in the T stock was determined under section 362(b) (taking into account the provisions of section 362(e)(1) and, to the extent the transfer is a transaction described in section 362(a), the provisions of section 362(e)(2)).

(3) * * *

(i) P acquired the T stock acquired by S in the reorganization directly from the T shareholders in a transaction in which P's basis in the T stock was determined under section 362(b) (taking into account the provisions of section 362(e)(1)); and

(ii) P transferred the T stock to S in a transaction in which P's basis in its S stock was determined under section 358 (taking into account the provisions of section 362(e)(2) to the extent the transfer is a transaction described in section 362(a)).

(4) *Examples*. The rules of this paragraph (c) are illustrated by the following examples. For purposes of these examples, P, S, and T are domestic corporations, the property transferred is not importation property within the meaning of §1.362–3(c)(2) or loss duplication property within the meaning of §1.362–4(c)(2), P and S do not file consolidated returns, P owns all of the shares of the only class of S stock, the P stock exchanged in the transaction satisfies the requirements of the applicable triangular reorganization provisions, and the facts set forth the only corporate activity.

* * * * *

(e) *Cross-references*—(1) *Triangular reorganizations involving members of a consolidated group*. For rules relating to stock basis adjustments made as a result of a triangular reorganization in which P and S, or P and T, as applicable, are, or become, members of a consolidated group, see §1.1502–30. However, if a transaction is a group structure change, stock basis adjustments are determined under §1.1502–31 and not under §1.1502–30, even if the transaction also qualifies as a reorganization otherwise subject to §1.1502–30.

(2) *Transfers of importation property in loss importation transaction and transfers of loss duplication property*. For rules relating to stock basis adjustments made as a result of a triangular reorganization in which the property treated as acquired by P would be importation property received in a loss importation transaction, see §1.362–3. For rules relating to adjustments made as a result of a triangular reorganization that also qualifies under section 362(a), see §1.362–4.

(3) *Triangular reorganizations involving certain foreign corporations*. For rules relating to stock basis adjustments made as a result of triangular reorganizations involving certain foreign corporations, see §§1.367(b)–4(b), 1.367(b)–10, and 1.367(b)–13.

(f) * * * (1) *General rule*. In general, this section applies to triangular reorganizations occurring on or after December 23, 1994. However, paragraphs (c)(1)(i)(A), (c)(2)(ii)(B), (c)(3)(i), and (c)(3)(ii) of this section apply to triangular reorganizations occurring on or after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

(3) * * * Paragraphs (b)(2)(v) and (e)(1) of this section shall apply to triangular reorganizations occurring on or after September 17, 2008. * * *

(4) *Triangular reorganizations involving importation property acquired in loss importation transaction or loss duplication transaction; triangular reorganizations involving certain foreign corporations*. Paragraphs (e)(2) and (e)(3) of this section shall apply to triangular reorganizations occurring on or after the date these regulations are published as final regulations in the **Federal Register**.

Par. 8. Section 1.362–3 is added to read as follows:

§1.362–3 Basis of importation property acquired in loss importation transaction.

(a) *Purpose*. The purpose of section 362(e)(1) and this section is to prevent a corporation (Acquiring) from importing a net built-in loss in a transaction described in either section 362(a) (section 351 transfers, contributions to capital, or paid-in surplus) or section 362(b) (reorganizations). See paragraph (c) of this section for definitions of terms used in this section.

(b) *Basis determinations under this section*—(1) *Basis of importation property received in loss importation transaction*. Notwithstanding any other provision of law, Acquiring's basis in importation property (as defined in paragraph (c)(2) of this section) acquired in a loss importation transaction (as defined in paragraph (c)(3) of this section) is equal to the value of the property immediately after the transaction.

(2) *Adjustment to basis of subsidiary stock in triangular reorganizations*. If a corporation (P) computes its basis in stock of a subsidiary (whether S or T) under §1.358–6 (stock basis in certain triangular reorganizations), P's basis in property treated as acquired by P in §1.358–6(c) is determined under section 362(e)(1) and this section to the extent such property, if actually acquired by P, would be importation property acquired in a loss importation transaction. See §1.358–6(c)(1)(i)(A), paragraphs (c)(2)(ii)(B), and (c)(3)(i). The subsidiary's basis in the property actually acquired in the transaction is determined under applicable law (including this section), without regard to the amount of any adjustment to P's basis in the subsidiary's stock. Thus, the basis of the property in S's or T's hands may differ from the amount of the adjustment to P's basis in its stock of S or T.

(3) *Acquiring's basis in other property transferred*. In general, Acquiring's basis in property received in a section 362 transaction (as defined in paragraph (c)(1) of this section) that is not determined under section 362(e)(1) and this section is determined under section 362(a) or section 362(b). However, if the transaction is described in section 362(a) (without regard to whether it is also described in any other section), further adjustment may be required under section 362(e)(2). See §1.362–4.

(c) *Definitions*. For purposes of this section, the following definitions apply:

(1) *Section 362 transaction*. The term *section 362 transaction* means any transaction described in section 362(a) or in section 362(b).

(2) *Importation property*.—(i) *General rule*. The term *importation property* means any property (including separate portions of property tentatively divided under paragraph (e)(2) of this section) with respect to which—

(A) Any gain or loss that would be recognized on its sale by the transferor immediately before the transaction (the transferor's hypothetical sale) would not be subject to tax imposed under any provision of subtitle A of the Internal Revenue Code (Federal income tax) (taking into account the provisions of paragraph (d) of this section); and

(B) Any gain or loss that would be recognized on its sale by Acquiring immediately after the transaction (Acquiring's hypothetical sale) would be subject to Federal income tax (taking into account the provisions of paragraph (d) of this section)

(ii) *Special rules for applying this paragraph (c)(2)*. See paragraph (d) of this section for rules for determining whether gain or loss on a hypothetical sale would be taken into account in determining a Federal income tax liability and paragraph (e) of this section for rules applicable when more than one person would take such gain or loss into account.

(3) *Loss importation transaction*. The term *loss importation transaction* means any section 362 transaction in which Acquiring's aggregate basis in all importation property received from all transferors in the transaction would exceed the aggregate value of such property immediately after the transaction. For this purpose, Acquiring's basis in property received is determined without regard to this section or section 362(e)(2).

(4) *Value*—(i) *General rule*. The term *value* means fair market value.

(ii) *Special rule for transfers of partnership interests*. Notwithstanding the general rule in paragraph (c)(4)(i) of this section, when referring to a partnership interest, for purposes of this section, the term *value* means the sum of the cash that Acquiring would receive for the interest, assuming an exchange 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), increased by any §1.752–1 liabilities (as defined in §1.752–1(a)(4)) of the partnership allocated to Acquiring with regard to such transferred interest under section 752 immediately after the transfer to Acquiring. See §1.743–1 regarding the application of section 743(b) following a section 362(e) basis reduction.

(d) *Rules for determining whether gain or loss would be taken into account in determining a Federal income tax liability*—(1) *General rule*. In general, any gain or loss that would be recognized on a hypothetical sale described in either paragraph (c)(2)(i) or paragraph (c)(2)(ii) of this section is considered to be subject to Federal income tax if, taking into account all relevant facts and circumstances, such gain or loss would affect or be taken into account in determining the Federal income tax liability of the transferor or Acquiring, respectively. This determination is made without regard to whether such person has or would have any actual Federal income tax liability for the taxable year of the transaction.

(2) *Look-through rule in the case of certain pass-through entities*. Notwithstanding the general rule in paragraph (d)(1) of this section, the determination of whether any gain or loss on a hypothetical sale would be treated as subject to Federal income tax is made by reference to the person that would be required to include such gain or loss in its taxable income if the hypothetical seller is—

(i) A trust treated as owned by its grantors or others (see section 671);

(ii) A partnership (see section 701); or

(iii) An S corporation (see sections 1363 and 1366).

(3) *Controlled foreign corporations (CFC), passive foreign investment companies (PFIC)*. For purposes of this section, gain or loss that would be recognized by a CFC (as defined in section 957(a)) or a PFIC (as defined in section 1297(a)) is not deemed taken into account in determining a Federal income tax liability solely because it could affect an inclusion under section 951(a) or section 1293(a).

(4) *Look-through treatment in the case of certain avoidance transactions*. (i) *Application of section*. This paragraph (d)(4) applies if—

(A) The transferor is a domestic entity that is a trust, estate, regulated investment company (RIC) (as defined in section 851(a)), a real estate investment trust (REIT) (as defined in section 856(a)), or a cooperative (see section 1381); and

(B) The transferor transfers, directly or indirectly, property that was transferred to or acquired by it as part of a plan (whether of transferor, Acquiring, or any other person) to avoid the application of section 362(e)(1) and this section to a section 362 transaction.

(ii) *Effect of application of section*. Notwithstanding paragraph (d)(1) of this section, if a transferor is described in both paragraphs (d)(4)(ii)(A) and (d)(4)(ii)(B) of this section—

(A) The transferor is treated as though it distributes the proceeds of the hypothetical sale (which, for this purpose, are presumed to be an amount greater than zero);

(B) To the fullest extent possible under the transferor's organizing instrument, taking into account the beneficiaries or owners of interests (as applicable) in the transferor, the deemed distribution is treated as made to a distributee or distributees that would not take distributions from the transferor into account in determining a Federal income tax liability; and

(C) The determination of whether the gain or loss on the hypothetical sale is treated as subject to Federal income tax is made by reference to the deemed distributee or distributees.

(iii) *Tiered entities*. If a deemed distributee is an entity described in paragraph (d)(4)(i)(A) of this section, the determination of whether gain or loss on the hypothetical sale is taken into account in determining a Federal income tax liability is made by treating the deemed distributee, and any successive such deemed distributees, as a transferor and applying the rules in paragraphs (d)(4)(i) and (d)(4)(ii) of this section to its deemed distribution (and to all successive deemed distributions), until no deemed distributee or successive deemed distributee is an entity described in paragraph (d)(4)(i)(A) of this section.

(e) *Special rules for gain or loss that would be taken into account by multiple persons*—(1) *In general*. If gain or loss from a disposition of property would be includible in income by more than one person, the property is treated as tentatively divided into separate portions in proportion to the amount of gain or loss recognized with respect to the property that would be allocated to each such person. If an entity's organizing instrument specially allocates gain and loss, the tentative division of property under this paragraph (e) must reflect the manner in which gain or loss on the disposition of such property would be allocated under the terms of the organizing instrument, taking into account the net gain or loss actually recognized by the entity in that tax year.

(2) *Application of section*. The rules of this section apply independently to each tentatively divided portion to determine if the portion is importation property. Each tentatively divided portion that is deter-

mined to be importation property is included with all other importation property in the determination of whether the transaction is a loss importation transaction.

(3) *Acquiring's basis in property tentatively divided into separate portions*. Immediately after the application of section 362(e)(1) and this section and before the application of section 362(e)(2), each property treated as tentatively divided into separate portions for purposes of applying section 362(e)(1) and this section ceases to be treated as tentatively divided and Acquiring has a single, undivided basis in such property that is equal to the sum of—

(i) The value of each tentatively divided portion that is importation property, if the transaction is a loss importation transaction; and

(ii) Acquiring's basis in each tentatively divided portion that is not importation property received in a loss importation transaction, as determined under section 362(a) or section 362(b), as applicable, and without regard to any potential application of section 362(e)(2).

(f) *Examples*. The examples in this paragraph (f) illustrate the application of section 362(e)(1) and the provisions of this section. Unless otherwise indicated, the examples use the following nomenclature and assumptions: A and B are U.S. citizens. DC, DC1, and P are domestic corporations that have not elected to be S corporations within the meaning of section 1361(a)(1) and that are not members of a consolidated group. F is a foreign individual. FP is a foreign partnership. FC, FC1, and FC2 are foreign corporations. Unless the facts indicate otherwise, the foreign individuals, corporations, and partnerships are not engaged in a U.S. trade or business, have no U.S. real property interests, and have no other relationships, activities, or interests that would cause them, their shareholders, their partners, or their property to be subject to Federal income taxation. There is no applicable income tax treaty, and all persons and transactions are unrelated unless the facts indicate otherwise.

Example 1. Basic application of section. (i) *Section 351 transfer of importation property in a loss importation transaction*. (A) *Facts*. FC owns three assets, A1 (basis $40, value $150), A2 (basis $120, value $30), and A3 (basis $140, value $20). On Date 1, FC transfers A1, A2, and A3 to DC in a transaction to which section 351 applies.

(B) *Importation property*. If FC had sold A1, A2, or A3 immediately before the transaction, no gain or loss recognized on the sale would have been taken into account in determining a Federal income tax liability. Further, if DC had sold A1, A2, or A3 immediately after the transaction, DC would take into account any gain or loss recognized on the sale in determining its Federal income tax liability. Therefore, A1, A2, and A3 are all importation properties. See paragraph (c)(2) of this section.

(C) *Loss importation transaction*. FC's transfer of A1, A2, and A3 is a section 362 transaction. Furthermore, but for section 362(e)(1) and this section and section 362(e)(2), DC's aggregate basis in the importation properties, A1, A2, and A3, would be $300 ($40 + $120 + $140) under section 362(a) and the properties' aggregate value would be $200 ($150 + $30 + $20). Therefore, the importation properties' aggregate basis would exceed their aggregate value and the transaction is a loss importation transaction. See paragraph (c)(3) of this section.

(D) *Application of section 362(e)(1) and this section to importation property received in loss importation transaction*. Because the importation properties, A1, A2, and A3, were transferred in a loss importation transaction, paragraph (b)(1) of this section applies and DC's basis in A1, A2, and A3 will each be equal to the property's value ($150, $30, and $20, respectively) immediately after the transfer.

(E) *Basis of property received in transaction*. Following the application of section 362(e)(1) and this section, the provisions of section 362(e)(2) must be taken into account because the transfer is a section 362(a) transaction. Taking into account the application of section 362(e)(1) and this section, DC's aggregate basis in the transferred properties would not exceed their aggregate value immediately after the transfer. Therefore, FC does not have a net built-in loss, FC's transfer is not a loss duplication transaction, and section 362(e)(2) does not apply to this transaction. DC's bases in A1, A2, and A3, as determined under paragraph (i)(D) of this *Example 1*, are $150, $30, and $20, respectively. Under section 358(a), FC receives the DC stock with a basis of $300 (the sum of FC's bases in A1, A2, and A3 immediately before the exchange).

(ii) *Reorganization*. The facts are the same as in paragraph (i)(A) of this *Example 1* except that, instead of transferring property to DC in a section 351 exchange, FC merges with and into DC in a transaction described in section 368(a)(1)(A). The analysis and results are the same as set forth in paragraphs (i)(B), (i)(C), (i)(D), and (i)(E) of this *Example 1*, except that, under section 358(a), FC's shareholders will take the DC stock with a basis determined by reference to their FC stock basis.

(iii) *FC's property used in U.S. trade or business*. (A) *Facts*. The facts are the same as in paragraph (i)(A) of this *Example 1*, except that FC is engaged in a U.S. trade or business and uses all the properties in that U.S. trade or business. In this case, none of the properties would be importation property because FC would take any gain or loss on the disposition of the properties into account in determining its Federal income tax liability. Accordingly, this section does not apply to the transaction.

(B) *Basis of property received in transaction*. Following the application of section 362(e)(1) and this section, the provisions of section 362(e)(2) must be taken into account because the transfer is a section 362(a) transaction. Taking into account the application of section 362(e)(1) and this section but without taking into account the provisions of section 362(e)(2), DC's aggregate basis in the transferred properties would be $300 ($40 + $120 + $140) under section 362(a) and the properties' aggregate value immediately after the transfer would be $200 ($150 + $30 + $20). Therefore, FC has a net built-in loss and FC's transfer of A1, A2, and A3 is a loss duplication transaction. Accordingly, under the general rule of section 362(e)(2), FC's $100 net built-in loss ($300 aggregate basis over $200 aggregate value) would be allocated proportionately (by the amount of built-in loss in each property) to reduce DC's basis in the loss properties, A2 and A3. See §1.362–4. As a result, DC's basis in A2 would be $77.14 ($120 basis under section 362(a) reduced by $42.86, A2's proportionate share of FC's net built-in loss, computed as $90/$210 x $100) and DC's basis in A3 would be $82.86 ($140 basis under section 362(a) reduced by $57.14, A3's proportionate share of FC's net built-in loss, computed as $120/$210 x $100). However, if FC and DC were to elect under section 362(e)(2)(C) to apply the $100 basis reduction to FC's basis in the DC stock received in the transaction, DC's bases in A2 and A3 would remain their section 362(a) bases of $120 and $140, respectively. Under section 362(a), DC's basis in A1 is $40 (irrespective of whether the section 362(e)(2)(C) election is made). If FC and DC do not make a section 362(e)(2)(C) election, FC's basis in the DC stock received in the exchange will be $300; if FC and DC do make the election, FC's basis in the DC stock will be $200 ($300 –$100 net built-in loss). See §1.362–4(b).

Example 2. Multiple transferors. (i) *Facts*. The facts are the same as in paragraph (i)(A) of *Example 1*, except that FC only owns A1 (basis $40, value $150) and A2 (basis $120, value $30) and F owns A3 (basis $140, value $20). On Date 1, FC transfers A1 and A2, and F transfers A3, to DC in a single transaction described in section 351.

(ii) *Importation property*. A1 and A2 are importation properties for the reasons set forth in paragraph (i)(B) of *Example 1*. A3 is also an importation property because, if F had sold A3 immediately before the transaction, no gain or loss recognized on the sale would have been taken into account in determining a Federal income tax liability, and, further, if DC had sold A3 immediately after the transaction, DC would take into account any gain or loss recognized on the sale in determining its Federal income tax liability.

(iii) *Loss importation transaction*. The transfers by FC and F are a section 362 transaction. The transaction is a loss importation transaction for the reasons set forth in paragraph (i)(C) of *Example 1* (notwithstanding that one of the transferors, FC, did not transfer a net built-in loss). See paragraph (c)(3) of this section.

(iv) *Application of section 362(e)(1) and this section to importation property received in loss importation transaction*. Because the importation properties, A1, A2, and A3, were transferred in a loss importation transaction, paragraph (b)(1) of this section applies and DC's basis in A1, A2, and A3 will each be equal to the property's value ($150, $30, and $20, respectively) immediately after the transfer.

(v) *Basis of property received in transaction*. Following the application of section 362(e)(1) and this section, the provisions of section 362(e)(2) must be taken into account because the transfer is a section 362(a) transaction. The application of section 362(e)(2) is determined separately for each transferor. See §1.362–4(b). Taking into account the application of section 362(e)(1) and this section, neither DC's aggregate basis in FC's properties nor DC's basis in F's property would exceed the properties' respective values immediately after the transaction. Therefore neither FC nor F has a net built-in loss, neither transfer is a loss duplication transaction, and section 362(e)(2) does not apply to either transfer. DC's bases in A1, A2, and A3, as determined under paragraph (iv) of this *Example 2*, are $150, $30, and $20, respectively. Under section 358(a), FC's basis in the DC stock received is $160 ($40 + $120) and F's basis in the DC stock received in the exchange is $140.

Example 3. Transfer of importation and non-importation property. (i) *Facts*. As in paragraph (i) of *Example 2*, FC owns A1 (basis $40, value $150) and A2 (basis $120, value $30), and F owns A3 (basis $140, value $20). In addition, A2 is a U.S. real property interest as defined in section 897(c)(1). On Date 1, FC transfers A1 and A2, and F transfers A3, to DC in a single transaction described in section 351.

(ii) *Importation property*. A1 and A3 are importation properties for the reasons set forth in paragraph (i)(B) of *Example 1* and paragraph (i) of *Example 2*, respectively. However, A2 is not importation property because, if FC had sold A2 immediately before the transaction, FC would take into account any gain or loss recognized on the sale in determining its Federal income tax liability.

(iii) *Loss importation transaction*. FC's transfer is a section 362 transaction. Furthermore, but for section 362(e)(1) and this section and section 362(e)(2), DC's aggregate basis in the importation properties, A1 and A3, would be $180 ($40 + $140) and the properties' aggregate value would be $170 ($150 + $20) immediately after the transaction. Therefore, the importation properties' aggregate basis would exceed their aggregate value immediately after the transaction, and the transfer is a loss importation transaction.

(iv) *Application of section 362(e)(1) and this section to importation property received in loss importation transaction*. Because the importation properties, A1 and A3, were transferred in a loss importation transaction, paragraph (b)(1) of this section applies and DC's basis in A1 and in A3 will each be equal to the property's value ($150 and $20, respectively) immediately after the transfer.

(v) *Basis of property received in transaction*. Following the application of section 362(e)(1) and this section, the provisions of section 362(e)(2) must be taken into account because the transfer is a section 362(a) transaction. The application of section 362(e)(2) is determined separately for each transferor. See §1.362–4(b).

(A) *FC's transfer*. Taking into account the application of section 362(e)(1) and this section but without taking into account the provisions of section 362(e)(2), DC would have an aggregate basis of $270 in the transferred properties ($150 in A1, as determined under paragraph (iv) of this *Example 3*, plus $120 in A2, determined under section 362(a)), and the properties would have an aggregate value of $180 ($150 + $30) immediately after the transfer. Therefore, FC has a net built-in loss and FC's transfer of A1 and A2 is a loss duplication transaction. Accordingly, under the general rule of section 362(e)(2), FC's $90 net built-in loss ($270 aggregate basis to DC over $180 aggregate value) would be allocated proportionately to reduce DC's basis in the loss property transferred by FC. As a result, FC's entire net built-in loss would be allocated to A2, the only loss property transferred by FC, and DC's basis in A2 would be $30 ($120 basis under section 362(a) reduced by $90 net built-in loss). However, if FC and DC were to elect under section 362(e)(2)(C) to apply the $90 basis reduction to FC's basis in the DC stock received in the transaction, DC's basis in A2 would remain its section 362(a) basis of $120. DC's basis in A1 is $150 as determined under paragraph (iv) of this *Example 3* (irrespective of whether the section 362(e)(2)(C) election is made). If FC and DC do not make a section 362(e)(2)(C) election, FC's basis in the DC stock received in the exchange will be $270; if FC and DC do make the election, FC's basis in the DC stock will be $180 ($270–$90 net built-in loss). See §1.362–4.

(B) *F's transfer of A3*. Taking into account the application of section 362(e)(1) and this section, DC's basis in A3, the property transferred by F, would not exceed its value immediately after the transfer. Therefore, F does not have a built-in loss, F's transfer is not a loss duplication transaction, and section 362(e)(2) does not apply to F's transfer. DC's basis in A3, as determined under paragraph (iv) of this *Example 3*, is $20. Under section 358(a), F receives the DC stock with a basis of $140.

Example 4. Multiple transferors of non-importation properties. (i) *Facts*. DC1 owns A1 (basis $40, value $150). In addition, as in *Example 3*, FC owns A2 (basis $120, value $30), a U.S. real property interest as defined in section 897(c)(1), and F owns A3 (basis $140, value $20). On Date 1, DC1 transfers A1, FC transfers A2, and F transfers A3, to DC in a single transaction described in section 351.

(ii) *Importation property*. A2 is not importation property and A3 is importation property for the reasons set forth in paragraph (ii) of *Example 3* and paragraph (i)(B) of *Example 1*, respectively. A1 is not importation property because, if DC1 had sold A2 immediately before the transaction, DC1 would take into account any gain or loss recognized on the sale in determining its Federal income tax liability.

(iii) *Loss importation transaction*. The transfer of A1, A2, and A3 is a section 362 transaction. Furthermore, but for section 362(e)(1) and this section and section 362(e)(2), DC's basis in importation property, A3, would be $140 and the value of the property would be $20 immediately after the transaction. Therefore, the importation property's basis would exceed value and the transfer is a loss importation transaction.

(iv) *Application of section 362(e)(1) and this section to importation property received in loss importation transaction*. Because the importation property, A3, was transferred in a loss importation transaction, section 362(e)(1) and paragraph (b)(1) of this section applies and DC's basis in A3 will be equal to A3's $20 value immediately after the transfer.

(v) *Basis of property received in transaction*. Following the application of section 362(e)(1) and this section, the provisions of section 362(e)(2) must be taken into account because the transfer is a section 362(a) transaction. The application of section 362(e)(2) is determined separately for each transferor. See §1.362–4.

(A) *DC1's transfer*. Taking into account the application of section 362(e)(1) and this section, DC's basis in A1 ($40 under section 362(a)) would not exceed its value immediately after the transfer. Therefore, DC1 does not have a net built-in loss, DC1's transfer is not a loss duplication transaction, and section 362(e)(2) does not apply to DC1's transfer. DC's basis in A1, determined under section 362(a), is $40. Under section 358(a), DC1 receives the DC stock with a basis of $40.

(B) *FC's transfer*. Taking into account the application of section 362(e)(1) and this section, but without taking into account the provisions of section 362(e)(2), DC would have a section 362(a) basis of $120 in A2, which would exceed A2's $30 value immediately after the transfer. Therefore, FC has a net built-in loss and FC's transfer of A2 is a loss duplication transaction. Accordingly, under the general rule of section 362(e)(2), FC's $90 net built-in loss (DC's $120 basis in A2 over A2's $30 value) would be applied to reduce DC's basis in A2, the only loss property transferred by FC. As a result, DC's basis in A2 would be $30 ($120 basis under section 362(a), reduced by the $90 net built-in loss). However, if FC and DC were to elect under section 362(e)(2)(C) to apply the $90 basis reduction to FC's basis in the DC stock received in the transaction, DC's basis in A2 would be its $120 basis determined under section 362(a). If FC and DC do not make a section 362(e)(2)(C) election, FC's basis in the DC stock received in the exchange will be $120; if FC and DC do make the election, FC's basis in the DC stock will be $30 ($120–$90). See §1.362–4.

(C) *F's transfer*. F's transfer of A3 is a transaction described in section 362(a). However, taking into account the application of section 362(e)(1) and this section, DC's basis in A3 ($20) would not exceed its value immediately after the transfer. Therefore, F does not have a built-in loss, F's transfer is not a loss duplication transaction, and section 362(e)(2) does not apply to F's transfer. DC's basis in A3, as determined under paragraph (iv) of this *Example 4*, is $20. Under section 358(a), FC receives the DC stock with a basis of $140.

Example 5. Partnership transactions. (i) *Transfer by foreign partnership, foreign and domestic partners*. (A) *Facts*. A and F are equal partners in FP. FP owns A1 (basis $100, value $70). Under the terms of the FP partnership agreement, FP's items of income, gain, deduction, and loss are allocated equally between A and F. FP transfers A1 to DC in a transfer to which section 351 applies. No election is made under section 362(e)(2)(C).

(B) *Importation property*. If FP had sold A1 immediately before the transaction, any gain or loss recognized on the sale would be allocated to and includible by A and F equally under the partnership agreement. Thus, A1 is treated as tentatively divided into two equal portions, one treated as owned by A and one treated as owned by F. If FP had sold A1 immediately before the transaction, any gain or loss recognized on the portion treated as owned by A would have been taken into account in determining a Federal income tax liability (A's); thus A's tentatively divided portion of A1 is not importation property. However, no gain or loss recognized on the tentatively divided portion treated as owned by F would have been taken into account in determining a Federal income tax liability. Further, if DC had sold A1 immediately after the transaction, any gain or loss recognized on the sale would have been taken into account in determining a Federal income tax liability (DC's); thus, F's tentatively divided portion of A1 is importation property.

(C) *Loss importation transaction*. FP's transfer of A1 is a section 362 transaction. Furthermore, but for section 362(e)(1) and this section and section 362(e)(2), DC's basis in the importation property, F's portion of A1, would be $50 under section 362(a) and the property's value would be $35 immediately after the transaction. Therefore, the importation property's basis would exceed its value and the transfer is a loss importation transaction.

(D) *Application of section 362(e)(1) and this section to importation property received in loss importation transaction*. Because the importation property, F's tentatively divided portion of A1, was transferred in a loss importation transaction, section 362(e)(1) and paragraph (b)(1) of this section applies and DC's basis in F's portion of A1 will be equal to its $35 value.

(E) *Basis of property received in transaction*. Following the application of section 362(e)(1) and this section, the provisions of section 362(e)(2) must be taken into account because the transfer is a section 362(a) transaction. Taking into account the application of section 362(e)(1) and this section but without taking into account the provisions of section 362(e)(2), DC's aggregate basis in A1 would be $85 (the sum of the $35 basis in F's tentatively divided portion of A1, as determined under paragraph (i)(D) of this *Example 5*, and the $50 basis in A's tentatively divided portion of A1, determined under section 362(a), see paragraph (d)(2) of this section) and A1's value immediately after the transfer would be $70. Therefore, FP has a net built-in loss and FP's transfer of A1 is a loss duplication transaction. Accordingly, under the general rule of section 362(e)(2), FP's $15 net built-in loss ($85 basis over $70 value) would be allocated to reduce DC's basis in the loss asset, A1, the only loss property transferred by FP. As a result, DC's basis in A1 would be $70 ($85 basis under section 362(a) and this section, reduced by the $15 net built-in loss). Under section 358, FP's basis in the DC stock received in the exchange will be $100. See §1.362–4.

(ii) *Transfer with election to apply section 362(e)(2)(C)*. The facts are the same as in paragraph (i)(A) of this *Example 5*, except that FP and DC elect to apply section 362(e)(2)(C) to reduce FP's basis in the DC stock received in the exchange. The analysis and results are the same as in paragraphs (i)(B), (i)(C), (i)(D), and (i)(E) of this *Example 5*, except that the $15 reduction to DC's basis in A1 is not made and, as a result, DC's basis in A1 remains $85, and FP's basis in the DC stock received in the exchange is reduced from $100 to $85. The $15 reduction to FP's basis in DC stock reduces A's basis in its FP interest under section 705(a)(2)(B). See §1.362–4(f)(1).

(iii) *Transfer by domestic partnership*. The facts are the same as in paragraph (i)(A) of this *Example 5* except that FP is a domestic partnership. The analysis and results are the same as in paragraphs (i)(B), (i)(C), (i)(D), and (i)(E) of this *Example 5*.

(iv) *Transfer of interest in partnership with liability*. (A) *Facts*. F and two other individuals are equal partners in FP. F's basis in its partnership interest is $247. F's share of FP's §1.752–1 liabilities (as defined in §1.752–1(a)(4)) is $150. F transfers his partnership interest to DC in a transaction to which section 351 applies. FP has no section 754 election in effect. If DC were to sell the FP interest immediately after the transfer, DC would receive $100 in cash or other property. In addition, taking into account the rules under §1.752–4, DC's share of FP's §1.152–1 liabilities (as defined in §1.752–1(a)(4)) is $145 immediately after the transfer.

(B) *Importation property*. If F had sold his partnership interest immediately before the transaction, no gain or loss recognized on the sale would have been taken into account in determining a Federal income tax liability. Further, if DC had sold the partnership interest immediately after the transaction, any gain or loss recognized on the sale would have been taken into account in determining a Federal income tax liability. Therefore, F's partnership interest is importation property.

(C) *Loss importation transaction*. F's transfer is a section 362 transaction. However, but for section 362(e)(1) and this section and section 362(e)(2), DC's basis in the importation property, the partnership interest, determined under section 362(a) and taking into account the rules under section 752, would be $242 (F's $247 basis reduced by F's $150 share of FP liabilities and increased by DC's $145 share of FP liabilities) and, under § 1.362–4(c)(12)(ii), the value of the FP interest would be $245 (the sum of $100, the cash DC would receive if DC immediately sold the partnership interest, and $145, DC's share of the §1.752–1 liabilities (as defined in §1.752–1(a)(4)) under section 752 immediately after the transfer to DC). Therefore, the importation property's basis ($242) would not exceed its value ($245), and the transfer is not a loss importation transaction.

(D) *Basis in property received in transaction*. Following the application of section 362(e)(1) and this section, the provisions of section 362(e)(2) must be taken into account because the transfer is a section 362(a) transaction. As described in paragraph (iv)(C) of this *Example 5*, taking into account the application of section 362(e)(1) and this section, DC's basis in the partnership interest would not exceed its value. Therefore, under §1.362–4, F does not have a net built-in loss, the transfer is not a loss duplication transaction, and section 362(e)(2) does not apply to the transfer. DC's basis in F's partnership interest is $242, determined under sections 362(a) and 752. Under section 358, taking into account the rules under section 752, F's basis in the DC stock received in the exchange is $97 ($247 reduced by F's $150 share of FP liabilities).

Example 6. *Transactions involving tax-exempt entities*. (i) *Exempt transferor*. (A) *Facts*. InsCo is a benevolent life insurance association of a purely local character exempt from Federal income tax under section 501(a) because it is described in section 501(c)(12). InsCo owns shares of stock of DC1 (basis $100, value $70) for investment purposes, which are not debt-financed property (as defined in section 514). On December 31, Year 1, InsCo transfers the DC1 stock to DC in a transaction to which section 351 applies. No election is made under section 362(e)(2)(C).

(B) *Importation property*. If InsCo had sold the DC1 stock immediately before the transaction, any gain or loss realized would be excluded from unrelated business taxable income (UBTI) under section 512(b)(5), and thus no gain or loss recognized on the sale would have been taken into account in determining Federal income tax liability. Further, if DC had sold the DC1 stock immediately after the transaction, any gain or loss recognized on the sale would have been taken into account in determining Federal income tax liability. Therefore, the DC1 stock is importation property.

(C) *Loss importation transaction*. InsCo's transfer is a section 362 transaction. Furthermore, but for section 362(e)(1) and this section and section 362(e)(2), DC's basis in importation property, the DC1 stock, would be $100, and the stock's value would be $70 immediately after the transaction. Therefore, the importation property's basis would exceed its value and the transfer is a loss importation transaction.

(D) *Application of section 362(e)(1) and this section to importation property received in loss importation transaction*. Because the importation property, the DC1 stock, was transferred in a loss importation transaction, paragraph (b)(1) of this section applies and DC's basis in the stock will be equal to its $70 value.

(E) *Basis of property received in transaction*. Following the application of section 362(e)(1) and this section, the provisions of section 362(e)(2) must be taken into account because the transfer is a section 362(a) transaction. Taking into account the application of section 362(e)(1) and this section, DC's basis in the DC1 stock would not exceed its value immediately after the transaction. Therefore, InsCo does not have a net built-in loss, InsCo's transfer is not a loss duplication transaction, and section 362(e)(2) has no application to the transaction. DC's basis in the DC1 stock, as determined under paragraph (i)(D) of this *Example 6*, is $70. Under section 358, InsCo's basis in the DC stock received in the exchange will be $100.

(ii) *Transferor loses tax-exempt status*. (A) *Facts*. The facts are the same as in paragraph (i)(A) of this *Example 6* except that InsCo fails to be described in section 501(c)(12) in Year 1.

(B) *Importation property*. If InsCo had sold the DC1 stock immediately before the transaction, any gain or loss recognized on the sale would have been taken into account in determining a Federal income tax liability. Therefore, the DC1 stock is not importation property and this section does not apply to the transaction.

(C) *Basis of property received in transaction*. Following the application of section 362(e)(1) and this section, the provisions of section 362(e)(2) must be taken into account because the transfer is a section 362(a) transaction. Taking into account the application of section 362(e)(1) and this section but without taking into account the provisions of section 362(e)(2), DC would have a section 362(a) basis of $100 in the stock, which would exceed its value of $70 immediately after the transfer. Therefore, InsCo has a net built-in loss and InsCo's transfer of the DC1 stock is a loss duplication transaction. Accordingly, under the general rule of section 362(e)(2), InsCo's $30 net built-in loss ($100 basis over $70 value) would be allocated to reduce DC's basis in the loss asset, the DC1 stock, the only loss property transferred by InsCo. As a result, DC's basis in the DC1 stock would be $70 ($100 basis under section 362(a), reduced by the $30 net built-in loss). Under section 358, InsCo's basis in the DC stock received in the exchange will be $100.

(iii) *Transfer of property that is subject to unrelated business tax*. (A) *Facts*. The facts are the same as in paragraph (i)(A) of this *Example 6* except that, on December 31, Year 1, instead of the DC1 stock, InsCo transfers A1 (basis $200, value $150) to DC. A1 is an office building that InsCo owned from January 1 to December 31 of Year 1. During the entirety of this period, A1 constitutes debt-financed property (as defined in section 514). Pursuant to sections 512 and 514, InsCo would be required to include in UBTI a portion of the gains or losses from a sale of A1 at the end of Year 1. DC does not take the property subject to the debt.

(B) *Importation property*. If InsCo had sold A1 immediately before the transaction, the gain or loss recognized on the sale would have been taken into account in determining a Federal income tax liability, even though at a lesser rate of inclusion. Therefore, A1 is not importation property and this section does not apply to the transaction.

(C) *Basis of property received in transaction*. The analysis and results are the same as in paragraph (ii)(C) of this *Example 6*.

Example 7. *Transactions involving CFCs.* (i) *Transfer by CFC*. (A) *Facts*. FC is a CFC with 100 shares of stock outstanding. A owns 60 of the shares and F owns the remaining 40 shares. FC owns two assets, A1 (basis $70, value $100), which is used in the conduct of a U.S. trade or business, and A2 (basis $100, value $75), which is not used in the conduct of a U.S. trade or business. FC transfers both assets to DC in a transaction to which section 351 applies.

(B) *Importation property*. If FC had sold A1 immediately before the transaction, any gain or loss recognized on the sale would have been taken into account in determining a Federal income tax liability (FC's). See section 882(a). Therefore, A1 is not importation property. If FC had sold A2 immediately before the transaction, FC would not take the gain or loss recognized into account in determining its Federal income tax liability, but the gain or loss could be taken into account in determining a section 951 inclusion to FC's U.S. shareholders. However, under paragraph (d)(3) of this section, gain or loss is not deemed taken into account in determining a Federal income tax liability solely because it could affect an inclusion under section 951(a). Further, if DC had sold A2 immediately after the transaction, any gain or loss recognized on the sale would have been taken into account in determining a Federal income tax liability. Therefore, A2 is importation property.

(C) *Loss importation transaction*. FC's transfer is a section 362 transaction. Furthermore, but for section 362(e)(1) and this section and section 362(e)(2), DC's basis in the importation property, A2, would be $100 and the property's value would be $75 immediately after the transaction. Therefore, the importation property's basis would exceed its value and the transfer is a loss importation transaction.

(D) *Application of section 362(e)(1) and this section to importation property received in loss importation transaction*. Because the importation property, A2, was transferred in a loss importation transaction, paragraph (b)(1) of this section applies and DC's basis in A2 will be equal to A2's $75 value immediately after the transfer.

(E) *Basis of property received in transaction*. Following the application of section 362(e)(1) and this section, the provisions of section 362(e)(2) must be taken into account because the transfer is a section 362(a) transaction. Taking into account the application of section 362(e)(1) and this section but without taking into account the provisions of section 362(e)(2), DC would have an aggregate basis of $145 in the transferred properties ($70 in A1, determined under section 362(a), plus $75 in A2, determined under this section) and the properties would have an aggregate value of $175 ($100 + $75) immediately after the transfer. Therefore, FC does not have a net built-in loss, FC's transfer is not a loss duplication transaction, and section 362(e)(2) does not apply to the transaction. DC's basis in A1 will be $70, determined under section 362(a), and DC's basis in A2 will be $75, as determined under paragraph (i)(D) of this *Example 7*. Under the general rule in section 358(a), FC receives the DC stock with a basis of $170 ($70 attributable to A1 plus $100 attributable to A2).

(ii) *Transfer of CFC stock*. (A) *Facts*. The facts are the same as in paragraph (i)(A) of this *Example 7*, except that A transfers its 60 shares of FC stock (basis $80, value $105) and F transfers its 40 shares of FC stock (basis $100, value $70) to DC in an exchange that qualifies under section 351.

(B) *Importation property*. If A had sold its FC shares immediately before the transaction, any gain or loss recognized on the sale would have been taken into account in determining a Federal income tax liability (A's). Therefore, A's FC shares are not importation property. However, if F had sold its FC shares immediately before the transaction, no gain or loss recognized on the sale would have been taken into account in determining a Federal income tax liability. Further, if DC had sold F's FC shares immediately after the transaction, any gain or loss recognized on the sale would have been taken into account in determining a Federal income tax liability. Therefore, F's FC shares are importation property.

(C) *Loss importation transaction*. The transfer of the FC shares is a section 362 transaction. Furthermore, but for section 362(e)(1) and this section and section 362(e)(2), DC's aggregate basis in the importation property, F's shares of FC stock, would be $100 under section 362(a) and the shares' aggregate value would be $70. Therefore, the importation property's aggregate basis would exceed its aggregate value, and the transfer is a loss importation transaction.

(D) *Application of section 362(e)(1) and this section to importation property received in loss importation transaction*. Because the importation property, F's shares of FC stock, was transferred in a loss importation transaction, paragraph (b)(1) of this section applies and DC's aggregate basis in the shares will be equal to their $70 aggregate value immediately after the transfer.

(E) *Basis of property received in transaction*. Following the application of section 362(e)(1) and this section, the provisions of section 362(e)(2) must be taken into account because the transfer is a section 362(a) transaction. The application of section 362(e)(2) is determined separately for each transferor. See §1.362–4(b).

(*1*) *A's transfer*. Taking into account the application of section 362(e)(1) and this section, DC's aggregate basis in the shares ($80 under section 362(a)) would not exceed the shares' value ($105) immediately after the transaction. Therefore A does not have a built-in loss, A's transfer is not a loss duplication transaction, and section 362(e)(2) does not apply to A's transfer. DC's aggregate basis in A's shares, determined under section 362(a), is $80. Under section 358(a), A receives the DC stock with a basis of $80.

(*2*) *F's transfer*. Taking into account the application of section 362(e)(1) and this section, DC's aggregate basis in the shares would not exceed their value immediately after the transaction. Therefore, F does not have a built-in loss, F's transfer is not a loss duplication transaction, and section 362(e)(2) does not apply to F's transfer. DC's aggregate basis in F's shares, as determined under paragraph (ii)(D) of this *Example 7*, is $70. Under section 358(a), F receives the DC stock with a basis of $100.

Example 8. *Property subject to withholding tax*. (i) *Facts*. FC owns a share of DC1 stock (basis $100, value $70) as an investment. FC receives dividends on the share that are subject to Federal withholding tax of 30 percent of the amount received under section 881(a); under section 1442(a), DC1 must withhold tax on the dividends paid. FC transfers the DC1 share to DC in a transaction to which section 351 applies.

(ii) *Importation property*. Although any dividends received with respect to the DC1 stock were subject to withholding tax, if FC had sold the share of stock of DC1, no gain or loss recognized on the sale would have been taken into account in determining a Federal income tax liability. See section 865(a)(2). Further, if DC had sold the share of DC1 stock immediately after the transaction, any gain or loss recognized on the sale would be taken into account in determining Federal income tax liability. Therefore, the share of DC1 stock is importation property.

(iii) *Loss importation transaction*. FC's transfer is a section 362 transaction. Furthermore, but for section 362(e)(1) and this section and section 362(e)(2), DC's basis in the importation property, the share of DC1 stock, would be $100 and the share's value would be $70 immediately after the transaction. Therefore, the share's basis would exceed its value and the transfer is a loss importation transaction.

(iv) *Application of section 362(e)(1) and this section to importation property received in loss importation transaction*. Because the importation property, the DC1 share, was transferred in a loss importation transaction, paragraph (b)(1) of this section applies and DC's basis in the share will be equal to the share's $70 value.

(v) *Basis of property received in transaction*. Following the application of section 362(e)(1) and this section, the provisions of section 362(e)(2) must be taken into account because the transfer is a section 362(a) transaction. Taking into account the application of section 362(e)(1) and this section, DC's basis in the DC1 share would not exceed the share's value immediately after the transaction. Therefore, FC does not have a net built-in loss, FC's transfer is not a loss duplication transaction, and section 362(e)(2) does not apply to the transaction. DC's basis in the DC1 share, as determined under paragraph (iv) of this *Example 8*, is $70. Under section 358, FC's basis in the DC stock received in the exchange will be $100.

Example 9. *Property transferred in triangular reorganization*. (i) *Foreign subsidiary*. (A) *Facts*. P owns the sole outstanding share of stock of FC (basis $1), FC1 owns the sole outstanding share of FC2 (basis $100), and FC2 owns one asset, A1 (basis $100, value $20). In a forward triangular merger described in §1.358–6(b)(2)(i), FC2 merges with and into FC, and FC1 receives shares of P stock in exchange for its FC2 stock. The forward triangular merger is a transaction described in section 368(a)(2)(D) and, therefore, in section 362(b).

(B) *Determining P's basis in its FC share*. Pursuant to §1.358–6, for purposes of determining the adjustment to P's basis in its FC shares, P is treated as though it first received A1 in a transaction in which its basis in A1 would be determined under section 362(b) and then it transferred A1 to FC in a transaction in which P's basis in its FC stock would be determined under section 358.

(*1*) *P's deemed acquisition and transfer of A1*. If FC2 had sold A1 for its value immediately before the deemed transaction, no gain or loss recognized on the sale would have been taken into account in determining a Federal income tax liability. If P had sold A1 immediately after the deemed transaction, any gain or loss recognized on the sale would have been taken into account in determining a Federal income tax liability (P's). Therefore, with respect to P's deemed acquisition, A1 is importation property. Furthermore, immediately after the deemed transaction, P's basis in A1, but for section 362(e)(1) and this section and section 362(e)(2), would be $100 and A1's value is $20. Therefore, the importation property's basis would exceed its value and the transfer is a loss importation transaction. Accordingly, P's deemed basis in A1 will be equal to A1's $20 value.

(*2*) *P's FC stock basis*. As a result of P's deemed transfer of A1 to FC (and applying the principles of §1.367(b)–13), P's basis in its FC stock is increased by its $20 deemed basis in A1. Accordingly, following the transaction, P's basis in its share of FC stock will be $21 (the sum of its original $1 basis and the $20 adjustment for the deemed transfer of A1).

(C) *FC's basis in A1*. FC's basis in A1 is determined under the rules of this section without regard to the determination of P's adjustment to its basis in FC stock. If FC2 had sold A1 for its value immediately before the transaction, no gain or loss recognized on the sale would have been taken into account in determining a Federal income tax liability. However, if FC had sold A1 immediately after the transaction, no gain or loss recognized on the sale would have been taken into account in determining a Federal income tax liability, so A1 is not importation property. Accordingly, this section will not apply to the transaction. Although there is a net built-in loss in A1, the transaction is not described in section 362(a), and so section 362(e)(2) and §1.362–4 will not apply to the transaction. Thus, under section 362(b), FC's basis in A1 will be $100.

(D) *FC1's basis in P stock*. Under section 358, FC1's basis in the P stock it receives in the exchange will be $100.

(ii) *Property transferred to U.S. subsidiary in triangular reorganization*. (A) *Facts*. The facts are the same as in paragraph (i)(A) of this *Example 9*, except that P also owns the sole outstanding share of DC (basis $1) and, instead of merging into FC, FC2 merged into DC.

(B) *Determining P's basis in its DC share*. As determined under paragraph (i)(B)(*2*) of this *Example 9*, P's basis in its DC share is $21, the sum of its original $1 basis plus the $20 adjustment for the deemed transfer of A1.

(C) *DC's basis in A1*. If FC2 had sold A1 for its value immediately before the transaction, no gain or loss recognized on the sale would have been taken into account in determining a Federal income tax liability. However, if DC had sold A1 immediately after the transaction, any gain or loss recognized on the sale would have been taken into account in determining a Federal income tax liability, so A1 is importation property with respect to DC. Furthermore, immediately after the transaction, DC's basis in A1, but for section 362(e)(1) and this section and section 362(e)(2), would be $100 and A1's value is $20. Therefore, the importation property's basis would exceed its value and the transfer is a loss importation transaction. Accordingly, DC's basis in A1 will be $20, A1's value immediately after the transaction.

(D) *FC1's basis in P stock*. Under section 358, FC1's basis in the P stock it receives in the exchange is $100.

(g) *Effective/applicability date*. This section applies to any transaction occurring on or after the date these regulations are published as final regulations in the **Federal Register**, unless effected pursuant to a binding agreement that was in effect prior to that date and at all times thereafter. However, taxpayers may apply this section to transactions occurring after October 22, 2004.

Par. 9. Section 1.362–4 is amended by:

1. Revising the introductory text in paragraph (h).

2. Revising paragraph (h) *Example 11*.

3. Adding a new sentence to the end of paragraph (j).

The revisions and addition read as follows:

§1.362–4 Basis of loss duplication property.

* * * * *

(h) * * * The examples in this paragraph (h) illustrate the application of section 362(e)(2) and the provisions of this section. Unless the facts otherwise indicate, the examples use the following nomenclature and assumptions: X, Y, P, S, S1, and S2 are domestic corporations; A and B are U.S. individuals; FC1 and FC2 are foreign corporations and are not engaged in a U.S. trade or business, have no U.S. real property interests, and have no other relationships, activities, or interests that would cause them, their shareholders, or their property to be subject to Federal income taxation; there is no applicable income tax treaty; PRS is a domestic partnership; no election is made under section 362(e)(2)(C); and the transferred property is not importation property (as defined in §1.362–3(c)(2)) and the transfers are not loss importation transactions (as defined in §1.362–3(c)(3)), so that the basis of no property is determined under section 362(e)(1). All persons and transactions are unrelated unless the facts indicate otherwise, and all other relevant facts are set forth in the examples. See §1.362–3(f) for additional examples illustrating the application of section 362(e)(2) and this section, including to transactions that are subject to section 362(e)(2), and section 362(e)(1).

* * * * *

Example 11. *Transfers of importation property with non-importation property*. (i) *Single transferor, loss importation transaction*. (A) *Facts*. FC1 transfers Asset 1 (basis $80, value $50) and Asset 2 (basis $120, value $110) to DC in a transaction to which section 351 applies. Asset 1 is not importation property within the meaning of §1.362–3(c)(2). Asset 2 is importation property within the meaning of §1.362–3(c)(2).

(B) *Application of section 362(e)(1)*. Immediately after the transfer, and without regard to section 362(e)(1) or section 362(e)(2) and this section, DC's aggregate basis in importation property (Asset 2) would be $120. The aggregate value of the importation property immediately after the transfer is $110. Accordingly, the transaction is a loss importation transaction within the meaning of §1.362–3(c)(3) and, under section 362(e)(1), DC's basis in Asset 2 would equal its value, $110.

(C) *Application of section 362(e)(2) and this section*. (*1*) *Analysis*. (*i*) *Loss duplication transaction*. FC1's transfer of Asset 1 and Asset 2 is a transaction described in section 362(a). But for section 362(e)(2) and this section, DC's aggregate basis in those assets would be $190 ($80 under section 362(a) + $110 under section 362(e)(1)), which would exceed the aggregate value of the assets $160 ($50 + $110) immediately after the transaction. Accordingly, the transfer is a loss duplication transaction and FC1 has a net built-in loss of $30 ($190–$160).

(*ii*) *Identifying loss duplication property*. But for section 362(e)(2) and this section, DC's basis in Asset 1 would be $80, which would exceed Asset 1's $50 value immediately after the transaction. Accordingly, Asset 1 is loss duplication property. But for section 362(e)(2) and this section, DC's basis in Asset 2 would be $110, which would not exceed Asset 2's $110 value immediately after the transaction. Accordingly, Asset 2 is not loss duplication property.

(C) *Basis in loss duplication property*. DC's basis in Asset 1 is $50, computed as its $80 basis under section 362(a) reduced by FC1's $30 net built-in loss.

(D) *Basis in other property*. Under section 362(e)(1), DC's basis in Asset 2 is $110. Under section 358(a), FC1 has an exchanged basis of $200 in the DC stock it receives in the transaction.

(ii) *Multiple transferors, no importation of loss*. (A) *Facts*. The facts are the same as paragraph (i)(A) of this *Example 11*, except that, in addition, FC2 transfers Asset 3 (basis $100, value $150) to DC as part of the same transaction. Asset 3 is importation property within the meaning of §1.362–3(c)(2).

(B) *Application of section 362(e)(1)*. Immediately after the transfer, and without regard to section 362(e)(1) or section 362(e)(2) and this section, DC's aggregate basis in importation property (Asset 2 and Asset 3) would be $220 ($120 + $100). The aggregate value of the importation property immediately after the transfer is $260 ($110 + $150). Accordingly, the transaction is not a loss importation transaction within the meaning of §1.362–3(c)(3) and DC's bases in the importation property is not determined under section 362(e)(1).

(C) *Application of section 362(e)(2) and this section: FC1*. Notwithstanding that the transfers by FC1 and FC2 are pursuant to a single plan forming one transaction, section 362(e)(2) and this section apply to each transferor separately.

(*1*) *Analysis*. (*i*) *Loss duplication transaction*. FC1's transfer of Asset 1 and Asset 2 is a transaction described in section 362(a). But for section 362(e)(2) and this section, DC's aggregate basis in those assets would be $200 ($80 + $120), which would exceed the aggregate value of the assets $160 ($50 + $110) immediately after the transaction. Accordingly, the transfer is a loss duplication transaction and FC1 has a net built-in loss of $40 ($200–$160).

(*ii*) *Identifying loss duplication property*. But for section 362(e)(2) and this section, DC's basis in Asset 1 would be $80, which would exceed Asset 1's $50 value immediately after the transaction. Accordingly, Asset 1 is loss duplication property. But for section 362(e)(2) and this section, DC's basis in Asset 2 would be $120, which would exceed Asset 2's $110 value immediately after the transaction. Accordingly, Asset 2 is also loss duplication property.

(*2*) *Basis in loss duplication property*. DC's basis in Asset 1 is $50, computed as its $80 basis under section 362(a) reduced by $30, its allocable portion of FC1's $40 net built-in loss ($80/$200 x $40). DC's basis in Asset 2 is $110, computed as its $120 basis under section 362(a) reduced by $10, its allocable portion of FC1's $40 net built-in loss ($120/$200 x $40).

(*3*) *Basis in other property*. Under section 358(a), FC1 has an exchanged basis of $200 in the DC stock it receives in the transaction.

(D) *Application of section: FC2*. FC2's transfer of Asset 3 is not a loss duplication transaction because Asset 3's value exceeds its basis immediately after the transaction. Accordingly, under section 362(a), DC's basis in Asset 3 is $100.

* * * * *

(j) * * * The introductory text and Example 11 of paragraph (h) of this section apply to transactions on or after the date these regulations are published as final regulations in the **Federal Register** unless effected pursuant to a binding agreement that was in effect prior to that date and at all times thereafter; however, taxpayers may apply such provisions to transactions occurring after October 22, 2004.

Par. 10. Section 1.368–3 is amended by revising paragraphs (a)(3), (b)(3) and adding a sentence to the end of paragraph (e) to read as follows:

§1.368–3 Records to be kept and information to be filed with returns.

(a) * * *

(3) The value and basis of the assets, stock or securities of the target corporation transferred in the transaction, determined immediately before the transfer and aggregated as follows—

(i) Importation property transferred in a loss importation transaction, as defined in §§1.362–3(c)(2) and 1.362–3(c)(3), respectively;

(ii) Loss duplication property as defined in §1.362–4(c)(1);

(iii) Property with respect to which any gain or loss was recognized on the transfer (without regard to whether such property is also identified in paragraph (a)(3)(i) or (a)(3)(ii) of this section);

(iv) Property not described in paragraphs (a)(3)(i), (a)(3)(ii) or (a)(3)(iii) of this section; and

* * * * *

(b) * * *

(3) The value and basis of all the stock or securities of the target corporation held by the significant holder that is transferred in the transaction and such holder's basis in that stock or securities, determined immediately before the transfer and aggregated as follows—

(i) Stock and securities with respect to which an election is made under section 362(e)(2)(C); and

(ii) Stock and securities not described in paragraph (b)(3)(i) of this section.

* * * * *

(e) *Effective/applicability date*. * * * Paragraphs (a)(3) and (b)(3) of this section apply to any taxable year beginning on or after these regulations are published as final regulations in the **Federal Register**, unless effected pursuant to a binding agreement that was in effect prior to that date and at all times thereafter.

Beth Tucker,
Deputy Commissioner for Operations Support.

(Filed by the Office of the Federal Register on September 6, 2013, 8:45 a.m., and published in the issue of the Federal Register for September 9, 2013, 78 F.R. 54971)

Deletions from Cumulative List of Organizations Contributions to Which are Deductible Under Section 170 of the Code

Announcement 2013–42

The Internal Revenue Service has revoked its determination that the organizations listed below qualify as organizations described in sections 501(c)(3) and 170(c)(2) of the Internal Revenue Code of 1986.

Generally, the Service will not disallow deductions for contributions made to a listed organization on or before the date of announcement in the Internal Revenue Bulletin that an organization no longer qualifies. However, the Service is not precluded from disallowing a deduction for any contributions made after an organization ceases to qualify under section 170(c)(2) if the organization has not timely filed a suit for declaratory judgment under section 7428 and if the contributor (1) had knowledge of the revocation of the ruling or determination letter, (2) was aware that such revocation was imminent, or (3) was in part responsible for or was aware of the activities or omissions of the organization that brought about this revocation.

If on the other hand a suit for declaratory judgment has been timely filed, contributions from individuals and organizations described in section 170(c)(2) that are otherwise allowable will continue to be deductible. Protection under section 7428(c) would begin on October 28, 2013, and would end on the date the court first determines that the organization is not described in section 170(c)(2) as more particularly set forth in section 7428(c)(1). For individual contributors, the maximum deduction protected is $1,000, with a husband and wife treated as one contributor. This benefit is not extended to any individual, in whole or in part, for the acts or omissions of the organization that were the basis for revocation.

American College of Forensic Examiners
International, Inc.
Springfield, MO

B & L Grace Foundation
Fresno, CA

Big Apple Day School
Brooklyn, NY

BuildClean
Houston, TX

Foster Care Network, Inc.
Goodyear, AZ

Generational Arts Limited
New York, NY

Help End Hunger Now Foundation
Troy, MI

IDA Foundation for Autism and
Alzheimer's Research and Solution, Inc.
Homestead, Fl

J. D. Davis Community Service, Inc.
Inglewood, CA

Joy Center, Inc.
Stuart, FL

Lifeskills 411
Richmond, CA

Music Box Lurrine Burgess, The
Los Angeles, CA

One World Hunger
Union City, CA

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 laws 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 a 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.—Statement 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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Key to Abbreviations:

Ann	Announcement
CD	Court Decision
DO	Delegation Order
EO	Executive Order
PL	Public Law
PTE	Prohibited Transaction Exemption
RP	Revenue Procedure
RR	Revenue Ruling
SPR	Statement of Procedural Rules
TC	Tax Convention
TD	Treasury Decision
TDO	Treasury Department Order

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INCOME TAX—Cont.

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TAX CONVENTION

Internal Revenue Service
Washington, DC 20224

Official Business
Penalty for Private Use, $300

INTERNAL REVENUE BULLETIN

The Introduction at the beginning of this issue describes the purpose and content of this publication. The weekly Internal Revenue Bulletins are available at *www.irs.gov/irb/*.

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